



530 Woodlake Circle, Suite 100
Chesapeake, VA 23320
(757) 523-1900

Robert L.



“Robb” Riddle, CCIM



The Riddle Report

Prospective Tenants For Commercial Centers

Owners must think about vacancies when checking a prospective tenant. Will the tenant’s business survive? When you have a prospective tenant for a commercial center, you must consider whether that prospect would be a good tenant. There are two key standards to apply; (1) the prospective tenant’s financial stability; and (2) the prospective tenant’s potential for success.

Financial Stability

The prospective tenant must be able to afford the rental that you set. Its overall financial condition should be sound. Among the first things you’ll do is to see if the prospective tenant pays its bills on time. Having a reputable credit agency do a credit check on the tenant can easily check this. It is also wise to talk to the tenant’s main suppliers and its current landlord.

An examination of the tenant’s assets is also essential. Ask to see the tenant’s financial records, study them carefully, and discuss with the prospective tenant’s accountant any questions you may wish to have clarified.

Once you are satisfied that the prospective tenant is financially stable, you must ask the question: Will the tenant be successful in your center? To answer this question you must determine the following;

- The tenant’s reputation at its present location.
- The tenant’s sales volume. In the retail business, a turnover of stock at the rate of four to five times a year is considered good.

- The trend of the tenant’s sales. Has the tenant’s sales been increasing from year to year?
- The type of merchandise the tenant will be selling in your center. You’ll look to avoid duplications with other tenants in the center.
- The profile of the tenant’s average customer at its present location.
- How efficiently is the tenant’s business now being run? Is the efficiency or inefficiency likely to continue?
- The nature and extent of the tenant’s advertising.

No Track Record

The preceding is for the prospective tenant who has an established record, who has been in business and offers tangible evidence of performance. But what about a newly owned business that wants to rent space in your shopping center as its first-ever place of business?

You should appraise this kind of prospective tenant by using the same two key standards: financial stability and potential for success. But instead of looking at past records, you will be predicting and forecasting and making judgments about the prospective tenant’s ability, ideas, and business expertise. It is a riskier situation for the center’s owner-manager but a totally new business might generate totally new interest in the center—it’s not the same old merchants merely doing business from a new location. □

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This publication is not a solicitation but is an information service from this office.

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When ideas in tax and other legal areas in this publication seem to fit your situation, it is recommended that you discuss them with your professional advisor before taking action.

Lenders, Property Managers – A Service Joint Venture

Whether times are good or bad, lenders always have foreclosed properties in inventory. During a recession the inventory may be high. One of the problems that banks and insurance companies have is disposing of this real estate owned (REO). They are faced with the decision of whether they wish to dispose of the property immediately or hold it for a period of time to hope for an increase in value. They would like to see the value of the REO increase to equal the loan amount.

These lenders are not professional real estate investors but money managers. Therefore, they are reluctant to invest any additional money in the properties. This problem is compounded because a troubled property needs more attention than does a healthy one. It would not have been in foreclosure if it didn't need help.

The solution might be a service joint venture. This type of contract with a real estate firm allows the lender to minimize management fees until the property is generating cash flow again.

Asset Manager As An Agent

The service joint venture is a form of incentive compensation by which the lender retains an asset management firm as its agent, with the firm agreeing to defer a portion of its fees until payment can be made out of future cash flow. The relationship may be a straight principal-agent one, or a new joint venture can be created in which both the lender and the management firm are partners. Some lenders who want to avoid a formal ownership position in distressed property desire this approach.

The differences between the fee structure of a service joint venture and more traditional

arrangements are as follows:

- **Management fee.** In a service joint venture, the agent receives anything from a below-market fee to no fee at all until the project achieves a specified level of net operating income (NOI). After that, the asset manager receives a designated portion (for example, 50%) of the NOI over the threshold amount. By comparison, the traditional management firm receives either a fixed fee or a fee based on a percent of the gross income.
- **Lease-up fee.** In a service joint venture, the agent may receive anywhere from a full leasing fee to none at all. The variable relates to the type of property involved. In the case of an office building, retail property, or industrial project, the agent normally receives the full market fee because payment is usually a commission rather than a straight salary. On the other hand, for residential properties, the fee often is deferred until a future date.
- **Commissions upon sale.** In a service joint venture, the manager receives a substantial portion of the sales price over a threshold price, together with a negotiated commission that is slightly below the traditional percentage. By comparison, a traditional arrangement gives the agent a higher percentage of the total sales price but no share of the amount over a designated threshold.
- **On-site marketing and management.** Here, both the service joint venture and the conventional agent receive a fee as provided for in the property budget.

The value of the service joint venture is that the management company is co-opted because it receives incentives in exchange for fees. In this way, the management company shares the objectives of the lender to maximize NOI and value as fast as possible. □

Kinds of Commercial Leases

A lease is an integral part of many real estate investments. It should outline all the obligations of the tenant and of the landlord. This sounds simple, but many questions arise. If, for example, property taxes increase, does the tenant pay all of the increase or only part of it? If the property must be modernized, who pays for the improvement? Can the tenant be moved out during the renovation? If the costs of servicing the property

rise, should the tenant pay none, all, or part of the increased costs? How should inflation be handled—with automatic rental increases? With increases tied to some index, perhaps the Consumer Price Index?

Kinds Of Leases

Here are some of the variations of leases used on commercial and industrial properties:

Flat Rate Lease. This is the traditional lease in

(continued)

which the tenant agrees to pay a flat periodic rate for the term of the lease. This might work with a very short lease, say one year.

Net Lease. Some investors try to protect their net income flows by requiring the tenant part (double net) or all (triple net) of the expenses. For example, the tenant may pay the property taxes; or property taxes and insurance; or property taxes, insurance, and all maintenance and operation expenses. When a net lease is mentioned, always ask what the landlord pays and what the tenant pays.

Sandwich Lease Or Subordinated Lease. The tenant leases all or a portion of the property to a third party who pays to the original tenant. The sandwich lease may be at a rate slightly higher than the original lease payments, thus allowing the tenant to make money from such an arrangement. For this reason, some leases do not allow subleasing.

Percentage Lease. The amount of rent is related to a fixed amount, plus a share expressed as a percentage of the gross or net sales or profits of the business to be paid as additional rent.

Ground Lease. Only the land is rented. The tenant owns the improvements. When the lease

ends, provisions are made for allowing the tenant to buy the land or the landlord to buy the improvements.

Leasehold Estate. The value of the lease to the tenant. If the tenant has negotiated a rent below market the tenant has a valuable right (perhaps by subletting at market rents). If the rent is above market the landlord has an advantage, but if the tenant is a strong, credit-worthy tenant the lease may be subject to renegotiation.

Index Lease. The lease amount is related to an index and changes as the index changes. For example, banks located in shopping centers cannot be charged on the basis of percentage of sales because there are none. In such cases an index such as the Consumer Price Index might be used.

Renegotiable Leases. The rents are subject to review and renegotiation at a particular event or after a given number of years. These are usually related to inflation measures and indices.

Improperly drawn leases may not produce enough income to cover the costs of owning and operating the property. And long-term leases in particular present problems when prices, costs, and money rates are fluctuating. There is no substitute for a lease prepared by a skilled professional. □

A Comfort Zone in Loans and Investments

Each investor has a “comfort zone” about loans. The leverage seeker wants the largest loan that is practical. Others may have experience or training that calls for no loans at all. They must have the property free and clear.

Most of us have a loan comfort zone somewhere between these extremes. Nearly everyone accepts the idea of some sort of mortgage. The use of OPM (other people’s money) makes sense.

The comfort in loans may affect the type of investment. Many of these “free and clear” owners prefer land as the investment. They want no improvements on it, just the bare land.

Here’s some of the benefits of investing in unimproved land. These can make a lot of sense:

1. There are no tenant problems. There may be a

simple lease for farming or grazing, but only limited contacts between lessor and lessee. Often, the investment land lies unused.

2. A well-chosen land investment can result in huge profits. We have all heard stories of owners who have purchased land for just a few dollars an acre, then later sold for millions! (The key is “well-chosen.”)

3. Land is a secure investment. Even in the worst economic situations, the land is still there. Value can fluctuate, but the investment will not disappear.

4. Land represents wealth. It can be a quick source of cash for an owner to use for another investment. Land looks good on a financial statement. It adds permanence and stability to an applicant for loans or for a line of credit. □

Investment Planning For Everyone

A prospective investor may have a problem getting started with a real estate investment because of the great variety of properties that are out there. They may be fearful that someone will "sell" them something - something that is wrong for them.

An answer to these problems can be an interview with an interested professional real estate broker who can act as a real estate investment counselor. Each prospective investor can be interviewed in depth to find out specific needs in an income property. At the same time their needs are being evaluated, the broker will also communicate what benefits are available in various properties and how to identify them.

Some considerations should be given to the risk of loss for each age bracket of investor. Should an older investor purchase a property with the smallest down payment and highest leverage position? This will limit cash flow and may cause the property to have a "negative" cash flow. Is this what they want - or do they want cash flow from the property?

How about the younger couple? Are their objectives for long-range estate building or for current cash flow? Would they be more willing to take chances with a marginal investment that might bring big returns later?

These answers must be decided by each investor for himself or herself. But, only after enough information has been furnished so that an intelligent decision can be made.

When a new investor has a better idea of the type of property that will do the right job for him/her, or them, then and only then should they be exposed to the market place and shown specific properties. Now the investor or investors can evaluate the various benefits and risks for the information shown on each property and apply the information to their own situation.

What is right for you? A new rental unit? A strip center? A one-hundred unit apartment property? An Outlet Center? Perhaps you should have five or six apartments or commercial properties in scattered locations. Real estate counseling can show you that you can choose which is right for you and know the reasons why it is right! □

Real Estate Investment Consultants

When you need professional advice and help in commercial real estate you must come to our office. We are experts in values and knowledge of the entire market in this area. If you have been looking for a certain type of property we probably have the full information on several like it already.

Today's investor in real estate must have a grasp of market conditions and potential that is usually beyond their own available time to attain. Investors need assurance about the true condition of the market. With increased competition, the market place is becoming more complicated. As your professional commercial real estate advisors, we are in the position to represent you in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of

real estate

More investors are turning to real estate consultants as a means of providing a sounding board for their ideas as well as expertise in the planning and construction stages for their projects.

Feasibility studies are essential for commercial office, industrial, resort and hotel investors. With this kind of information, planning is better and there is less chance for error.

Real estate investing is not just the structure and the land. It is investing in the type of property that you want at the price and terms that suit you at the time you want to make the purchase.

We can be your consultants. □



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Robert L.



"Robb" Riddle, CCIM



A CCIM is a professional real estate practitioner with proven technical expertise in commercial property. A CCIM is a person truly committed to the fundamentals of effective commercial-investment brokerage. The CCIM has completed a full schedule of Post Graduate Level Courses in investments, taxation, development and marketing all types of commercial-investment properties. The designation of Certified Commercial-Investment Member is unquestionably the highest degree awarded in the commercial-investment real estate practice.