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The Riddle Report

Adding Value Means Increased Cash Flow

Since the value of a rental property is based directly on the cash return, adding value means increasing cash flow.

When small investors set out to increase real estate values, the steps are in upgrading houses, duplexes, triplexes, etc., enhancing the cash flow and therefore increasing equity when the property is sold.

When working with larger commercial and apartment properties, there are two major actions:

- Be aware of the things that have the potential of adding value, taking advantage of this knowledge and moving quickly before another buyer can purchase or option the property.
- Do the required homework on the property. A feasibility analysis can measure the ability to add value. There may be many other measures that must be taken, such as market analyses, applications for new zoning, design and construction planning and a plan for marketing.

Making Money

Investors purchase commercial income producing real estate to make money. There are two obvious ways of making money from a property.

First, the owner takes a share of the annual operating profit generated by the investment, and

Second, profits from increasing the market value of the investment beyond what it would be because of inflation alone.

Apartment properties lend themselves to the second way of making profits better than many other types of investments. Increasing the market value of rental units does require know-how, absolute understanding of the market values of this type of property and excellent management.

The Operating Income

Good management has always been the most important point in increasing or maintaining annual operating profits. Being a skillful manager requires intelligent handling of the functions of buying and selling properties, rent collections, maintenance, leasing, controlling expenses, refurbishing, management accounting and more. All of this requires long "hands-on" experience in the field with plenty of assistance from the latest in operational and administrative hardware and software. Professional property managers will do a much better job than most owners and will more than cover their fees. ❑

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Factors To Consider For An Apartment Investment

When any particular apartment building is under consideration for purchase, there are a number of factors that should be considered. Here are some of the more important points:

- **Location** is always at the top of every list of considerations in real estate. Always check not only the building itself but also the entire neighborhood. How does this building compare with others in the area? How do rents compare? How close is a business area and is there adequate transportation? How close are schools, recreation areas, shopping and churches?
- **Rentals and floor plans.** What is the layout of the apartments and the average rent per room? How competitive is the rent level and is there any chance for increases? The rent level may not always be equal to the rental value. An apartment that is rented at a bargain price in a good community may have more rental value than high-rent premises in a declining area.
- **Condition of the property** can be the difference between profit and loss after purchase. Check the building and the grounds. What is the age and type of any equipment used? Is there any deferred maintenance? If you have checked the other nearby buildings, your building and grounds must compare favorably with the others to get the same rents.
- **Vacancies.** How many currently vacant units? Based on comparisons with neighboring buildings and past history of this building, when do you feel that the vacancies will be filled?
- **Amenities offered** to your tenants must be in line with the type of tenant. Singles might be interested in recreational equipment and a pool. Tenants with children might want play areas. Perhaps the amenities you offer will be compared more to other apartments by potential tenants than the apartment itself. Does your unit have air conditioning, fireplaces, built-in kitchen appliances and modern bathrooms?
- **The Income**. As stated, the value of the property is based on the income. While everything should be checked thoroughly, anything to do with the cash flow and expenses should be double-checked. Income can come from many sources, apartments, garages, utilities, parking spaces, coin-operated washers & dryers, or other vendors. You must see if there are any pre-paid rentals, rents in arrears, and contractual rent increases. Find out if there are any free rent concessions and be aware that these concessions may not appear in the rental agreements or leases, but in some side agreement.

The following may be a way to protect you from any problems with the income and possible concessions or side agreements:

A. Have the seller state in writing the rent for each unit, the terms and amounts, any concessions or pre-paid rents, any written or unwritten arrangements between the tenants and the owner or his agent. A provision can be included that these representations will survive the transfer of title and any misrepresentation found before that time will be grounds for rescinding the contract, with the buyer to be entitled to costs and disbursement incurred.

B. Verify the information on the seller's statement against the leases and against seller's receipt books. Interview several tenants to check terms of their leases against seller's statement.

C. Have the seller sign an affidavit that the statement reflects the correct rental amounts and terms, that there are no other lease agreements in existence, and that he is making the statements to induce the buyer to purchase, knowing that the buyer is relying on the affidavit.

D. Also look into the possibility of options to cancel leases and commitments for future improvements to apartments.

E. Finally, check whether the amounts that the seller has reported as tenant's security deposits are correct. Check contracts with any outside company, such as coin-operated washers and dryers to check for the terms and income.

- **The Expenses.** Examine the expense statements for past years, not just for a few months or one year. See if there could be any under maintenance, which might not be apparent in an inspection. Maintenance could have been deferred recently to improve the current net income to facilitate the sale of the property. Check the number of employees, their jobs and the total payroll, and any requirements of union contracts. Are there any rent concession agreements with employees? Can you reduce costs by better staff management?

The following items of expense should be carefully examined:

1. **The loans on the property.** Check all of the terms of any existing mortgage that will be assumed. Determine if refinancing is desirable and feasible.
2. **Real estate taxes.** Are assessments and tax rates correct? What will the recording of the sale do to change the assessment? Will the property tax change after the purchase? Determine the percentage of assessed valuation between land and improvements to see if a satisfactory corresponding allocation of the purchase price can be made to establish a depreciation base.
3. **Insurance.** Is property properly covered? Can

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premiums be reduced in any way? Will more insurance be required if you increase the mortgage?

4. **Utilities.** Check the bills for the costs of heating, gas, water, and electricity. Check bills on an annual basis, rather than a few months. Are there separate sewer charges? If so, how are they computed?

5. **Check all outside contracts.** There may be contracts for maintenance, separate contracts for elevator maintenance, cable TV, and exterminating.

All of these checks and investigations are part of the routine of the real estate professional. Some of the duties of the broker or brokers representing the buyer and seller in a real estate transaction are to satisfy the buyer that all of the information about the property is correct and complete. Normally, when employing the most professional real estate firms, this research will be completed by the brokers before the information is presented to the purchaser.

After the purchase, continue with the most professional actions by employing a professional real estate management company. ❑

The Cancellation Clause In A Commercial Lease

Whether a rental market is weak or strong, lease negotiations can be difficult when the landlord wants concessions that are different from the norm.

One situation that happens is when the owner of an office building or other commercial property intends to sell when market conditions improve, whether that occurs next year or five years from now. Another is the holder of vacant or underimproved property who plans to develop it whenever market conditions justify. In the meantime, these properties must be leased to generate sufficient cash flow to pay operating costs and debt service. Such an owner will be amenable to giving significant concessions, including a low rental, provided the landlord can cancel the lease during the term.

An alternative to a long-term lease subject to cancellation is a series of short-term leases. However, a long term lease subject to cancellation under specific conditions may be much more preferable to a tenant than a short-term lease that the landlord can refuse to renew for any reason. Here are some guidelines for drafting a fair cancellation clause:

The Guidelines

The option to cancel the lease by the landlord could easily lead to misunderstandings and lawsuits unless it is carefully drafted. Here are some important things to consider:

- **Definite Reason.** A landlord asking for the option to cancel in order to sell the property or demolish the improvements nevertheless may want the option clause in the lease to be unconditional. The need to specify a reason in the notice exercising the option could raise questions of good faith or improper exercise if, for example, a subsequent sale or demolition is delayed or postponed for a period. On the other hand, the tenant may insist that a reason be given; oral representation during negotiations will not themselves limit a cancellation option that is unconditional in the lease.

- **How the option is exercised.** One solution to the problem of an unconditional option is to make it exercisable only on actual sale of the premises. This would mean that possession could not be given at the closing of title and so be unacceptable to the buyer. The landlord will want the option exercisable at the time the contract is signed (perhaps with the tenant to be entitled to remain until title is closed).

- **Notice to tenant.** The tenant will need a reasonable time to terminate its business and remove its property. The landlord will not want the notice period to be so long as to discourage a prospective buyer.

- **Reimbursement to tenant.** If the tenant will incur substantial costs to prepare or improve the premises for use, it may insist on reimbursement if the lease is canceled. A common formula is to amortize the up-front costs over the lease term, with reimbursement to equal the unamortized cost at the time of cancellation. (An alternative method is for the rent to be set initially at a low level, stepping up after periodic intervals.)

The lease should make clear when any such payment is to be made–at the time the notice of cancellation is given, at the time the tenant vacates, or at a subsequent time. Use of an escrow may be a solution to this issue.

- **The new landlord.** Suppose the original landlord sells the property to a buyer willing to take the property subject to the existing lease so no cancellation occurs. Does the new owner have the right of cancellation, or does it terminate on the sale? This should be made clear; if the option extends to the new landlord, it should also be clear as to whether the original or successor landlord is responsible for any payment due the tenant.

- **Right of first refusal.** The tenant may seek a right of first refusal in the event of a proposed sale accompanied by a cancellation of the lease. This would give the tenant the right to match the offer of a third party to buy the property. Landlords do not like rights of first refusal because they complicate efforts to sell; in this situation, it is unlikely that the tenant will insist on the right since the value of the property to a third party intending to develop it is likely to be substantially above the market value of the property under its current use.

- **Tenant's right to cancel.** The tenant may ask for a similar right to cancel the lease under certain conditions. While the landlord's cancellation option is fully valid without a corresponding right for the tenant, the landlord may be willing to make this concession in order to gain agreement. ❑

Property Management Increases Value

Management of a building is not just handling problems as they arise and renting units, it is making the asset more valuable to the owner by concentrating on every aspect of the property. Some owners of very large income properties still do not take professional property management seriously and fall behind in values.

The professional property manager is keenly aware of all of the recurring costs of a property and how they can effect the bottom line. The owner may applaud and give attention to a one-time saving on a "high-cost" item such as insurance on the property while overlooking the multipliers in the number of units.

For example, a $6,000 reduction on that annual insurance premium is a big item. However, it is only a $6,000 item once a year. A change of $10 per month per unit in a 400-unit apartment, either in rent increase or expense savings, can add $4,000 a month to income, or $48,000 a year. This small $10 per month could add $600,000 in value to the property in a sale ($48,000 increase in rents divided by 8% capitalization rate). Using the same capitalization rate, the $6,000 savings in cost of insurance would only increase the value by $75,000.

The Down Side

The manager must also be aware of the multiplier effect in downward changes in income and the possibility of changing a marginally profitable property into an investment loss. For instance, a seeming insignificant increase in the price of janitorial service in a 250,000 square foot office park could significantly decrease the cash flow and adversely effect the resale value by hundreds of thousands of dollars.

The larger the property, whether in square footage or number of rental units, the greater the significance of the multiplier effect.

Strategies should be defined and stated in a management plan developed by the owner and the management company.

Another important goal of property management is to ensure that tenants live, work, shop, and play in a safe and clean environment and have their real estate-related problems attended to promptly. ❑

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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