

VENTURES

10 Ways to Stumble In Commercial Real Estate

By VIVIAN MARINO

AS the residential market softens, many hands-on real estate investors are turning their attention to the commercial side, believing that they can find more opportunities in office buildings and retail space than in flipping houses and converting buildings to condominiums.

"It's been a trend now," said Chad Brue, the managing director of the private-client group at CB Richard Ellis, the big commercial brokerage firm. "We've seen a significant amount of money coming out of residential as well as the stock market and other equities and into commercial real estate, and it's continuing to strengthen."

Making the jump, however, is not always easy. "A lot of the beginners, when they get into nonresidential, find it is very different from residential," said John T. Reed, the publisher of Real Estate Investor's Monthly, a newsletter. "It is a very, very complicated business."

(That may help explain the popularity of passive investments like dividend-paying real estate investment trusts, or REITs, which own large portfolios of commercial property.)

Commercial real estate is also a business in which even one misstep can quash a deal or have a negative impact on your earnings for years. That makes it important to identify pitfalls in advance. Here are 10 common mistakes that experts say are often made by neophyte investors and, occasionally, by those more seasoned:

NO FINANCIAL PLAN "The first step for investing in anything — whether it's real estate or diamonds — is to have a plan, and your plan is based on your goals," said Jack Cummings, who runs a commercial brokerage firm in Fort Lauderdale, Fla., and is the author of "Commercial Real Estate Investing: 12 Easy Steps to Getting Started" (John Wiley & Sons, 2004).

For example, are you looking for a property that can be leased out, generating a monthly cash flow? Or, do you want to make a quick profit with a property that can appreciate in value after improvements?

You will also need to focus on a specific property type, based on personal interest and expertise. Mr. Cummings suggests taking on partners with "personal knowledge or specific talent dealing with this category of

property." He also recommends having an exit strategy, just in case.

Those who are most likely to fail, the experts say, take the investment plunge without first immersing themselves in commercial real estate basics.

THINKING LOCATION ONLY The axiom about location isn't infallible when it comes to commercial sites.

"It's not location, location, location — it's location, use and approval," Mr. Cummings said. While finding a good location in a well-traveled corridor is important, he explained, you must also ensure that the proposed use for a property fits within zoning and deed restrictions as well as other local laws. That's a crucial part of due diligence.

"The investor who wants to build something, or even buy what they see, may discover that if it burns down, they cannot replace it due to a change in zoning," Mr. Cummings said.

NOT RESEARCHING A CITY Even with zoning laws on your side, you may still be unable to move ahead with plans. "Some communities are getting impossible to develop," Mr. Cummings said.

He recalled a situation a few years ago when he was working as a consultant for a developer planning a 60-unit midrise apartment building in Fort Lauderdale. Although the site was zoned for such buildings, the local planning board said the design and scope of the project were incompatible with the area, he said. The developer

eventually abandoned its plans, though only after spending \$400,000 in legal fees.

"Many savvy investors with years of experience often have to walk away from a project," Mr. Cummings said, "because local political attitudes have successfully blocked their ability to obtain a permit to do what the investor is allowed to do by zoning, but not without commission or other authority's approval."

SEEING ALL AREAS AS SIMILAR "Real estate is a local singular market," Mr. Cummings said. "What goes on in San Francisco may appear to be the same as what is going on in Chicago or Miami, but in reality it is not."

You will need to explore an area's demographics — learning, for instance, the average age of the residents and potential customers, as well as household income. And while you're at it, check on the prevailing

**Sure, location
is important.
But so is the
discipline of
doing your
homework.**

rents, along with vacancy rates and property taxes. Some of this information can be found by contacting the local government or Chamber of Commerce, and by talking with neighboring business owners.

"The key here is to be alert to future events," Mr. Cummings said. "Never buy anything without double-checking the community, county and state plans for the area."

NO THOUGHT TO TENANT MIX While many factors — from location to demographics to aesthetic appeal — contribute to a commercial property's success, you can't expect to draw much business unless you have the right mix of tenants, both within your property and in the neighborhood. An "anchor," or a business with a history of successful performance, can help.

(Take the time, too, to check the financial history and the references of future tenants — for instance, landlords and employers.)

Mr. Reed of Real Estate Investor's Monthly said he encountered complaints several years ago after renting office space to a busy state government agency in a building occupied by professionals. "The mix was not compatible," he said, noting, for example, that the agency took up myriad parking spaces. He said he ended up buying out the state's lease.

MISCALCULATING COSTS A thorough inspection by a qualified engineer or contractor can help uncover hidden problems in a building — structural, mechanical or environmental. The seller can then decide to fix the problems or renegotiate the sales price.

But you still need to set aside a cushion for future repairs or improvements. (Even tenants with so-called triple-net leases, in which they agree to pay all the continuing operating expenses like property taxes, may need to have a property reconfigured to meet their needs.)

"Many people do not take the time necessary to quantify deferred maintenance — from an antiquated heating system to a leaking roof to holes in the parking lot," said Ray Alcorn, the chief executive of Park Real Estate in Blacksburg, Va.

Mr. Alcorn said that some investors also forget that they inherit the lease obligations for existing tenants — obligations that sometimes last 25 or more years. "One of the popular things in leases here in Virginia is to replace the carpet every three years," he said. "If you don't read the lease closely or have an attorney read it, you don't know."

MISCALCULATING RETURNS "You can make a lot of money — and you can lose a lot of money," noted Mr. Alcorn, who says he has done both as an investor and a developer.

To get an idea of your initial rate of return, or capitalization rate, review expenses and income for the most recent year.

Some brokers and investors base their calculations on occupancy rates at or close to 100 percent. But take into account the likelihood of vacancies, Mr. Reed cautioned. Some tenants may leave because their business stumbles, while others may outgrow your facilities. "Residential vacancies can always be filled by lowering the rent," he said. "In the nonresidential business, that doesn't work that way. You can go vacant and stay vacant for a long time."

Mr. Brue at CB Richard Ellis said he preferred to focus on the longer term, using what's known as the internal rate of return, or I.R.R., which is the compounded annual rate of return on investments held for a year or more. Though complicated to calculate, it is often used when there are differing amounts of annual cash flow. "It can take into consideration tenants on a five-year lease," he said.

TAKING ON ONEROUS DEBT "There are eight million ways to get a mortgage on a house and eight million different payment patterns," Mr. Reed said. "You leave single-family land and go into commercial-property land, and you have to put up with very onerous terms."

Mr. Brue says investors should be especially careful with adjustable-rate loans. "If your floating rate goes up, you may not be able to cover your debt service," he said.

To decrease debt load and increase equity, some investors use their cash flow to pay off principal on their mortgages, thereby speeding up the amortization schedule.

DOING IT ALL YOURSELF Sure, you can research zoning maps and property tax rates on your own. But experienced investors typically have a group of experts in place, including brokers, engineers, lawyers, accountants and property managers, to help with conducting due diligence.

If you are unsure about whom to hire, talk to other investors or brokers.

"I read everything myself," Mr. Alcorn said, "but then I turn it over to my partners and my lawyers."

PROCRASTINATION What good is doing the research if you never put it to use?

Some people take the time to attend seminars, read books and listen to CDs about commercial real estate but still never buy anything, out of fear of making a financial mistake. □