National Association of REALTORS®
2014 NAR Commercial Innovation Grant
Executive Summary

Innovation Name: Commercial Seminar
Association Name: West San Gabriel Valley Association of REALTORS®
Contact Person: Albert Tran

1. **Project Summary:**

   a. **Statement of purpose**

   The purpose of this innovative project is that the West San Gabriel Valley Association of REALTORS® (WSGVAR) held a one-day Commercial Seminar on Saturday, November 1, 2014. We invited our members as well as members from neighboring associations to participate in this commercial real estate educational event.

   b. **Original Goals**

   Originally, our goals were to train REALTOR® members with a variety of commercial topics to include, but not limited to Business Opportunities, Retail Stores, Industrial, Property Management, Contracts, Cap Rates, Foundations of Commercial and the ABC's of Commercial. These topics will be presented by subject matter experts/Commercial speakers/Brokers/practitioners throughout the day. However, due to a shortage of time in searching for subject matter experts, we had to deviate from the original goals with the aforementioned topics, but rather keep the foundations of Commercial and the ABC's of Commercial.

   c. **Objectives**

   The main objectives of this Commercial Summit are to help members learn a basic of commercial real estate with a variety of topics including (1) Introduction to Commercial Real Estate, (2) Fundamentals of Investment Analysis, and (3)

Annual Property Operating Data (APOD). These topics were presented by Steven McMurtrie, Executive Director of the California Commercial Alliance (CCA), Association Executive of the Northern California Commercial Association of REALTORS® (N.C.C.A.R.), and Executive Director of the California Commercial Property Information Exchange (CaCPIX).

d. Success Criteria

We would like to reach as many residential and commercial practitioners as possible throughout San Gabriel Valley and Greater Los Angeles County basin.

2. Project Financials:

a. Project Budget Overview

The "Understanding the Basics of Commercial Real Estate" Seminar was held on Saturday, November 1, 2014. Due to a Saturday event, the Association office operations must be extended an additional day. The association had to pay staff overtime to run this seminar. The instructor fee was $40.00 per person and the registration fee is $49.00 per person. The financials are listed as follows:

b. Incomes

Class Admission ($49/student x 79 students):	$3,871
NAR Innovation Grant:	$1,000
Two Affiliates sponsored lunch: ($100 each)	$ 200
Total Incomes	**$5,071**

c. Expenses:

Instructor Fee: ($40/student x 79 students):	$3,160
Meals: (Breakfast & Lunch)	$1,500
Staff Fees:	$400
Facility Fee:	$800
Copy & Print:	$640
Total Expenses	**$6,500**
Net Loss:	**($1,430)**

In summary, the Association also dipped in $1,430 from its general fund to fund for this Commercial Seminar.

3. **Performance Measurements:**

The Commercial Seminar, hosted by West San Gabriel Valley Association of REALTORS® on Saturday, November 1st at the Association office created a lot of interests to residential REALTORS®. Our first success was to secure a good and knowledgeable instructor: Steven McMurtrie. Steven plays many roles for the commercial associations: the Executive Director of the California Commercial Alliance (CCA), the Association Executive of the Northern California Commercial Association of REALTORS® (N.C.C.A.R.), and the Executive Director of the California Commercial Property Information Exchange (CaCPIX). Securing an expert in commercial real estate is essential to having our members become informed in the field. The association continued its success by training 79 members. The participants were REALTORS® who specialize in various residential and commercial real estates. This Commercial Seminar also allowed REALTORS® a great networking and educational opportunity. The participants left with positive reviews of the class and instructor and hope to participate in future commercial real estate classes.

4. **Project Timeline:**

After NAR awarded WSGVAR the Commercial Innovation Grant in mid-August, the members of the Commercial Investment Committee and the Education Committee worked closely with the Association staff to secure instructors. However, due to time constraint, we narrowed down to one instructor for this Commercial Seminar in September 2014. We designed the seminar flyer and began to promote the event. We also solicited affiliates to sponsor food. E-blasts and weekly newsletters were scheduled to send to members.

5. **Project Management:**

   a. **Marketing Strategy**

The Association communicates with its 2,400 members through e-Blasts, bulletins (weekly newsletters) and ad on the Association website. Numerous invitations, flyers, registration opportunities and links were provided to our members throughout this period of time. The "Understanding the Basics of Commercial Real Estate" Commercial Seminar flyers and printouts were available in the WSGVAR office; a link was available to REALTORS® through the Association website and was also published in our weekly newsletters throughout the months

of September and October. In addition, our instructor also promoted the Commercial Seminar on his Commercial Association's website.

b. Planning Meetings

The members of the Commercial Investment Committee and the Education Committee and the Association staff met almost every week to plan for this event. Meetings are taken place in-person, by emails and by conference calls.

c. Day-to-Day Project Management

The focus of the day-to-day project management began on organizing the event from timing, topics, and technology needed then shifted to marketing, monitoring registration and keeping everyone informed.

6. Lesson Learned/Outcomes:

a. Who Benefitted From Your Project?

The Commercial Seminar was available to every REALTOR® member from WSGVAR as well as from its adjacent associations of REALTORS®.

b. **Project Highlights**

The attendees, ranging from no commercial experience to those are very well versed in the commercial field, had learned the basics of commercial real estate, the fundamentals of investment analysis, and how to calculate the Annual Property Operating Data (APOD).

During the lunch break, attendees had a chance to learn commercial loans from two affiliates. In addition, attendees, affiliates and the instructor had the opportunity to network, share experiences and unwind.

With the great turnouts on Saturday, November 1, 2014 and as a follow-up to this seminar, WSGVAR will plan to offer more intermediate and advanced commercial seminars in the future.

7. Support Documents: (Please see attached for support documents)

a. November 1, 2014 Commercial Seminar Flyer
b. Introduction to Commercial Real Estate PowerPoint (Student Copy)

c. Fundamentals of Investment Analysis PowerPoint (Student Copy)
d. Annual Property Operating Data (APOD) PowerPoint (Student Copy)

UNDERSTANDING THE BASICS OF COMMERCIAL REAL ESTATE

Saturday, November 1, 2014 | 9:30AM to 4:15PM

Seminar Schedule

9:30AM to 11:30AM Introduction to Commercial Real Estate

- California Commercial Alliance
- Expand Your Real Estate Business
- Commercial Basics You Need to Know
- Property Types
- Identify Commercial Real Estate Opportunities
- Cash Flow Model Basics
- Income Analysis Basics
- Risk Management and Article 11
- Commercial Referral Guidelines

11:30AM to 12PM Lunch

12PM to 2PM CRE 102: Fundamentals of Investment Analysis

- Types of Commissions
- Fundamentals of Investment Real Estate
- Types of Leases and Lease Structures
- Adding Value
- Impact of Debt on Commercial Real Estate
- Case Study
- Sales Strategy

2PM to 2:15PM Break

2:15PM to 4:15PM CRE 103: Annual Property Operating Data (APOD)

- What is an APOD?
- Why Do We Use an APOD?
- Completing an APOD-Case Study
- Calculating Cost Recovery and Why?

Don't miss out on this Seminar! It is not just for the commercial minded real estate practitioner. Residential agents will acquire very useful information to help them increase their level of expertise to list and sell single family investment properties.

Date: Saturday, November 1, 2014
Time: 9:30AM to 4:15PM
Location: West San Gabriel Valley Association of REALTORS® (WSGVAR)
1039 E. Valley Blvd. #205B
San Gabriel, CA 91776
Cost: $49 includes admission and lunch

Instructor: Steven McMurtrie
-Executive Director of the California Commercial Alliance (CCA)
-Association Executive of the Northern California Commercial Association of REALTORS® (N.C.C.A.R.)
-Executive Director of the California Commercial Property Information Exchange (CaCPIX)

WAYS TO REGISTER: Register online at www.WSGVAR.com and click on the "Education Calendar" under the "Education" menu or fill out the below information and mail to WSGVAR, 1039 E. Valley Blvd. #205B, San Gabriel, CA 91776 or fax to 626-288-7658

Name_____ Company_____ NRDS#_____

Address_____ City, State, Zip _____

Phone_____ E-mail _____

Credit Card Type: ☐Visa ☐ MasterCard ☐ AMEX ☐ Discover or ☐Check Enclosed *payable to:* ***WSGVAR***

*Cardholder Name*_____ *Credit Card Number*_____

*Exp. Date*_____ *Signature*_____

Please note all cancellations will result in a $25 cancellation fee. No refunds will be given for cancellations within 7 days of the course. For a hotel directory please contact WSGVAR staff.

West San Gabriel Valley Association of REALTORS®
WE PUT OUR MEMBERS FIRST


CCA
California Commercial Alliance

Overview of Commercial Real Estate
CRE

Steven McMurtrie
Executive Director
California Commercial Alliance

CALIFORNIA COMMERCIAL ALLIANCE

California Commercial Alliance Presentations

- This is the first commercial class of a series of 35+ commercial classes.
- Options
  - Each month a two hour presentation for each class
  - Each month four (4) hours presentation each month combining multiple classes together.
  - One day classes included the first 3-4 classes
  - Webinars online for 4Q2014

CRE Presentations

- Introduction to Commercial Real Estate
- CRE Guidelines for the Commercial practitioner
- CRE Property Types
- Income Analysis
- What is the CRE Market?
- CRE Tenant Representation
- CRE Leasing Do and Don’s
- Land Sales
- Investment, Hospitality
- Investments, Single Tenant NNN
- Sales-Lease Back
- CRE Indicators
- CRE Investor Analysis
- Basics of TIC
- CRE Listings and Marketing
- CRE REO Auctions
- CRE Brokerage and Leasing
- CRE REO Overview

CRE Basics
CRE Referrals
What is an APOD
CRE Fundamentals
Commercial Leasing
CRE Lease Analysis
Zoning and Building Codes
Investments, Multi-Family
Investments, Retail
CRE Listings and Marketing
CRE 1031 Exchange
CRE Property Management
CRE Investment Analysis
CRE Business Development
CRE Brokerage in a Bad Market
CRE Lease vs. Purchase
CRE Business Opps Brokerage
Cost Segregation

Introduction to Commercial Real Estate

- California Commercial Alliance
- Expand your RE Business by including CRE
- Property Types
- Types of Clients
- Identify Commercial RE Opportunities
- Cash Flow Model Basics
- Income Analysis Basics
- Risk Management and Article 11
- Commercial Referral

What is CCA?

Mission Statement

The goal of the California Commercial Alliance is to unify, network and collaborate with all commercial real estate practitioners, facilitate Communications, Education, and Professionalism, to promote and support the business interests of all commercial practitioners throughout California.

How Does CCA Help Me?

Value Proposition

- Commercial Standards
- Commercial Support
- Commercial Marketing
- Commercial Training

Standards

- Organize Local Commercial Deal Exchanges
- Commercial Pro-Standards
  - Professional Standards Committee
  - Commercial Grievance Committee
  - Commercial Arbitration and Mediation
- Commercial Referral Program

Support

- Provide CRE Tools and Services
  - Leverage the membership to lower cost
- Commercial Transaction Document

Marketing

- Commercial Information Exchange (CIE)
Local, State and National Platform

California Commercial Property
Information Exchange
(CACPIX)
www.cacpix.com

- C.C.A. Website
CRE members listed by county, city, market,
Generalist or Specialist
Business Profile
www.caca.us and www.nccar.org

Training

- Monthly Training (Local)
- Quarterly Masterminds (Regional)
- Annual State and Regional CRE Events
- Commercial Referral Program
- Commercial RE Academy

Today's Goals:

How?

- Expand your business plan to include commercial real estate income
  - Direct Sales/Leases
  - Passive Sales/Leases - Referrals

Commercial RE Referral Course

- Know commercial real estate basics
- Identify Commercial Opportunities
- How to acquire CRE Opportunities
- CRE relationships within your AOR
- Referral Guidelines
- Referral Paperwork
- Get Paid!

Commercial Real Estate

Property Types

Retail Sales and Leasing

Office Sales and Leasing

Industrial Sales and Leasing

Multi-family Sales

Land Brokerage

Business Brokerage

Generalist or Specialist

- Hospitality
- Senior Facilities
- Gas Stations
- Leasing (Tenant Representation)
- Single Tenant NNN Investments
- Heavy Industrial Manufacturing
- Shopping Malls
- Medical Facilities

Real Estate Clients you may represent

- Sellers
- Buyers (Investors or End Users)
- Landlords
- Tenants

Commercial Clients

- There are two types of Commercial Clients:
  1. Investor
     Buyers, Sellers, and Landlords
  2. User (End User)
     Buyers, Sellers and Tenants

“Investor”

Investors buy and sell property that generate income.
Investors are buying the properties Cash Flow
What if there is not any income?

The motivation for investors to buy/sell property is:

PROFIT

Cash Flow/Equity/Tax Shelter

How much do I make on my investment?

Real Estate Tax Shelter

- An Investment that generates cash that is sheltered from tax.
- An investment that generates tax losses
  - This loss can reduce other income and therefore reduce income tax liability

"User"

- Business owners who need to purchase or lease property to occupy and operate their business
  - Corporations, LLC, Sole Proprietorship etc.

- CCIM "Build vs. Buy Decision Analysis"
- CCIM "Buy vs. Lease Analysis"
- CCIM "Sales-Leaseback Analysis"

“User”

- Purchase an exiting business to operate (with or without property)

  - Business Brokerage

- E&O will require an endorsement or separate policy depending on your carrier.

Identifying Commercial Opportunities

Referrals

Business Development

Buzz Words and Hints

- Expanding, downsizing, or re-locating?
- Starting a business?
- Interested in buying a business?
- Do they own investment property?

Identifying CRE Opportunities

- Looking for commercial space
  1. To buy or Lease

- Retiring or 1031 and needs to sell their income properties

- Going out of business

Commercial Real Estate

- How is the Market?

Before the Shift

Lenders provided easy access to money

- LTV- Higher
- DCR- relaxed
- Underwriting- Low Requirement

Property Income was not the highest priority

- Negative Cash Flow

"Double Digit Appreciation"
(Equity)

CRE Today

- The market has changed!
  - Commercial Loans?
  - Lower NOI – Lower Property Value
  - Price Gap
  - REO
  - Appreciation

List Price is subject to interpretation

Commercial Real Estate

- Why is the owner selling?
- What is the owners motivation to sell?
- When does the owner's loan mature?

CRE Reality

- Recommendations to owners looking to sell:
  - Manage the Asset to increase the Net Operating Income (NOI)
  - Correct management and physical deficiencies
  - Test the market
  - Accept and meet the market

Cash Flow Model

Potential Rental Income
- Vacancy and Credit Loss
= Effective Income
+ Other Income
= Gross Operating Income
- Operating Expenses
= NOI

CCIM provides us with the APOD

Net Operating Income (NOI)

- Using the example of a property with a gross operating income of $52,000 and operating expenses of $37,000, our net operating income would be:

- $52,000 - $37,000 = $15,000 NOI

The List Price Must Meet the Market

- Simplistic methods to determine the listing price of income properties:
  - Gross Rent Multiplier (GRM) *residential*
    - Limited reliability. GRM does not consider vacancy, credit losses, operating expense, financing and tax impact
  - Direct Capitalization (CAP rate) *commercial*
    - Limited reliability. CAP rate does not consider financing or tax impact

Gross Rent Multiplier

- "GRM" is the ratio of the price of a real estate investment to its *annual* rental income before expenses:

  GRM = Sale Price / Potential Gross Income

  Sale Price = GRM x Potential Gross Income

- Historically, the GRM was used primarily for 2-4 unit properties.

Getting the GRM for recent sold properties:

- Market Value / Annual Gross Income = GRM

- Property sold for $750,000
- It's Annual Income $110,000
- What is the GRM?

6.82

Estimating value of property based on GRM

- Recent comparable sold properties GRM's averaged around 6.75. Now you want to approximate the value of the property being considered for purchase. You know that its gross rental income is $68,000 annually.
- What is the Market Value?

- GRM x Annual Income = Market Value

- 6.75 X $68,000 = $459,000

- If it's listed for sale at $695,000, you might not want to waste more time in looking at it for purchase.

Capitalization (CAP) Rate

A rate of return on a real estate investment property based on the expected income that the property will generate.

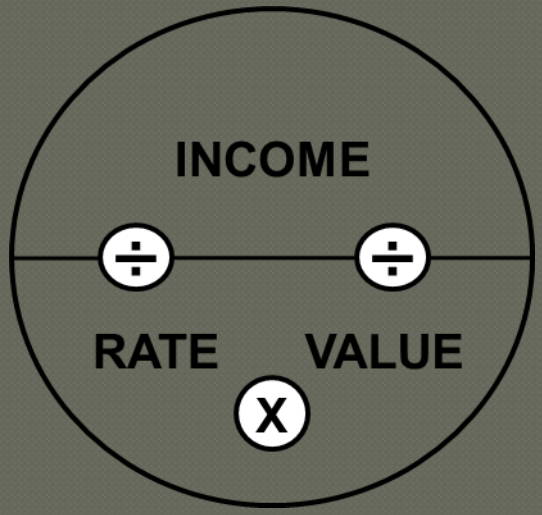
Capitalization rate is used to estimate the investor's potential return on his or her investment.

CAP Rate is the ratio between the NOI produced by an asset and its capital cost (the original price paid to buy the asset) or alternatively its current market value. The rate is calculated as follows:

$$\text{Capitalization Rate} = \frac{\text{Annual Net Operating Income}}{\text{Cost (or Value)}}$$

Calculating the Cap Rate

IRV Formula



A Cap Rate does not account for debt service and income tax for the investment.

Problem?

- An investor is considering a property with a forecasted NOI of $50,000. The investor has established a market Cap rate of 9.75% based on similar properties.
- What would this investor consider paying for the property?

Answer

V = I / R

$50,000
Divided by
9.75% or 0.0975 =
$512,821

The investor would consider paying $512,821 for this property

Before You List a Commercial Property

- Property Analysis
  - Sale or lease
  - Sale - Lease Back
  - Land Lease
  - TIC Conversion
- Market Analysis (Demand Study)
- Financial Analysis (APOD)
  - Acquisition – Operation – Disposition
- Tax Liability
  - Capital gains tax – Recaptured Depreciation

CRE Today

Investors want to know
how much ***profit*** is produced by the property

What is the Cash on Cash (Yield)?

$$\text{Cash on Cash} = \frac{\text{annual cash flow (Before Tax)}}{\text{total cash invested}}$$

Net Cash Flow to Owner

Cash Flows	Comments
Rental Income	Derived From Leases
- owner-paid Operating Expenses	Varies based on type of property and lease
= **Net Operating Income (NOI)**	Key figure used to determine value, loan amount
- Debt Service (Mortgage)	Sometimes referred to as ADS (Annual Debt Service)
= **Cash Flow Before Taxes**	Net to the Owner before paying income taxes; used for cash-on-cash calculation

CASH ON CASH RETURN

- Suppose an investor purchases a $1,200,000 apartment complex with a $300,000 down payment. Each month, the cash flow from all leases, less expenses and mortgage, is $5,000. Over the course of a year, the before-tax income would be $5,000 × 12 = $60,000.

- What is the cash-on-cash return?

CASH ON CASH RETURN

$$\text{cash-on-cash return} = \frac{\text{annual before-tax cash flow}}{\text{total cash invested}}$$

$$\frac{\$\ 60{,}000}{\$\ 300{,}000} = 0.20 = 20\%$$

Annual Cash Flow(CFBT)

- Income (PRI)
- + Other Income
- = Total Gross Income
- - Vacancy/Credit Losses
- = Gross Operating Income (GOI)
- - Operating Expenses
- = Net Operating Income (NOI)
- - Debt Service
- = Cash Flow Before Tax

Annual Cash Flow (CFAT)

Taxable Income

- NOI
- - Interest on Mortgage (1st, 2nd etc.)
- - Cost Recovery (Improvements)
- - Other (will cover later)
- = Real Estate Taxable Income or (loss)
- x Your Income Tax Rate (10% to 39.6%)
- = Tax Liability (Savings)

- Cash Flow Before Tax
- - Tax Liability (Savings)
- = Cash Flow After Tax

The cash-on-cash return (or equity dividend rate) is a percentage that measures the return on actual cash invested in an income-producing property. It is one of the most widely used rates of return to measure an income property's financial performance for the first year of ownership.

The cash-on-cash return is only one of several very important return ratios that measure the profitability of an income-producing property. In addition to looking at the cash-on-cash return, investors should also calculate other key performance ratios such as the

Internal Rate of Return (IRR)
Modified Internal Rate of Return (MIRR).

Internal Rate of Return (IRR)

- The Internal Rate of Return (IRR) is added to the income Analysis.
- The technical definition of IRR is the discount rate at which the Net Present Value (NPV) of future cash flows equal to your initial cash investment.
- The IRR also accounts for the time value of money. In other words, the value of a dollar today is greater than the value of a dollar 10 years from now, due to inflation.

Acquisition + Operation (years) + Disposition

Purchase + Holding Period + Sale of Property

Cash Flow Model
T-Bar

The Cash Flow Model is a template for the T-Bar that illustrates the timing and cash flows of a property from the owner's perspective.

N	$
0	(85,000)
1	15,000
2	14,000
3	13,000
4	12,000
5	11,000 + 50,000

n = 5 x 1

i = ?

We will use this cash flow model for Time Value of Money
Compounding
Discounting
Internal Rate of Return (IRR)

CRE Reality

Investors require a more comprehensive evaluation of the property to measure and forecast performance.

- Yield Capitalization
  - Discounted Cash Flows
  - Internal Rate of Return
  - Modified Internal Rate of Return
  - Net Present Value
  - Capital Accumulation Comparison

Covered in future presentation

CRE Reality

- Today's investors expect that the rate of return on investments meet or exceed their goals.
- What happens when the yield is low?

Residential vs. Commercial

- Similar basic steps?
  - List the property?
  - Sell the property?
  - Close the transaction?

Residential vs. Commercial

- Commercial is very different
  - Income Analysis
  - Demand Studies
  - Demographics and Traffic Counts
  - Commercial Contracts, LOI's, RFP's
  - Due Diligence (Environmental, Use, Zoning)
  - Attorneys (Legal Review)
  - Commissions paid by the buyer/investor/tenant/landlord
  - Tax Liability

    Capital Gains Tax and Recaptured Depreciation

Do You Want More Money!

You don't need to be a Commercial Agent to make money in Commercial Real Estate

How?

Expand your business into commercial real estate
Two Paths to consider!

1. Direct Sales/Leasing
   Training and Mentorship

2. Passive Sales/Leasing
   Referrals

CRE Business Development

When you are talking with clients about residential real estate,

don't forget

Ask if they need any assistance with their Commercial Real Estate

If You Do Not Have the Expertise?

- Then refer your CRE Clients to

- YOUR
Commercial REALTOR®

Why?
Ask the Question!
REALTOR® vs. Non-Realtor

Commercial REALTORS®
Can Do It For You

Provide the analysis necessary to help sellers, investors and end users make informed decisions to sell, purchase, or lease commercial real estate.

Reason to Refer your Commercial Opportunities

- Do you want additional passive income?

- Do you want to avoid issues with Article 11 of the REALTOR® Code of Ethics.

The Code of Ethics
Duties to the Public

- **Article 11**
  The services which REALTORS® provide to their clients and customers shall conform to the standards of practice and competence which are reasonably expected in the specific real estate disciplines in which they engage; specifically, residential real estate brokerage, real property management, commercial and industrial real estate brokerage, land brokerage, real estate appraisal, real estate counseling, real estate syndication, real estate auction, and international real estate.

- REALTORS® shall not undertake to provide specialized professional services concerning a type of property or service that is outside their field of competence unless they engage the assistance of one who is competent on such types of property or service, or unless the facts are fully disclosed to the client. Any persons engaged to provide such assistance shall be so identified to the client and their contribution to the assignment should be set forth. (Amended 1/10)

Article 11

- REALTORS® should not provide specialized professional services concerning a type of property or service outside their field of competence, ***unless***
- They engage the assistance of one who is competent on such types of property or service ***or***
- Their lack of competence or expertise is fully disclosed to the client.
- If someone else assist the REALTOR®, that person must be identified to the client and their contribution made clear.

Security and Protection For You

Refer and reduce your Risk!

Complete a Written Referral Agreement

Referrals avoid issues with C.A.R. Article 11 of the REALTOR® Code of Ethics.

Referral Fees!

- Typical fees to referring agents are 25%

- If your are licensed, you can receive a referral fee.

Commercial Referral Guidelines

- The following should be considered merely as a guideline depending on the client relationship and level of assistance the referring agent may be providing to the commercial transaction.

Level 1 – “Cold Lead”

- Approximately 10% to referring REALTOR®
  - Refers the name of the referral with contact information
  - Business brokerage

Level 2 – “Warm Lead”

- Approximately 20% to referring REALTOR®
  - Knows the referred client
  - Provides an introduction
  - Describes the opportunity
  - May set up the meeting between the referral and the Commercial REALTOR®

Level 3 – “Hot Lead”

- Approximately 25+% to referring REALTOR®
  - There is a trust factor between the referring REALTOR® and the prospective commercial client.
  - The referring REALTOR® helps deliver business through the relationship.

Action Items

- Get to know the Commercial REALTORS® in your Company, Local Association and Region. Who are the CRE Generalist and CRE Specialist?
- Talk to your clients and ask the questions
- Refer your commercial opportunities and let the Commercial REALTOR® qualify your client and close the transaction

You Decide

Decide what CRE path is best for you

Passive
Refer and collect a check!

Direct
Training and Mentorship
Generalist or Specialist
Sales and/or Leasing

List of Commercial Reference Material

- A field Guide To Commercial Real Estate Evaluation, by Richard M. Fenker, PhD
- Income Property Brokerage, by John M. Peckham III
- Negotiation Commercial Property Leases, Eric L. Nesbitt, Esq.
- Negotiating Commercial Real Estate leases, by Martin Zankel
- Commercial Real Estate Investing for Dummies, Peter Conti and Peter Harris

Q & A

Any Questions?
www.caca.us

California Commercial Alliance

Steven McMurtrie

Executive Director

CCA 102

Fundamentals of Investment Analysis

Commercial 102

- Types of Commissions
- Fundamentals of Investment Real Estate
- Types of Leases and Lease Structures
- Adding Value to the Properties NOI
- Impact of Debt on Commercial Real Estate
- Case Study

Summary and Discussion

- There are many types of commercial real estate transactions.

GENERALIST or **SPECIALIST**

- Specialization is often the key to success in commercial real estate.
- What special knowledge or prior experience do you bring to the commercial arena?

COMMERCIAL MARKET

The commercial market includes properties that are zoned and intended for commercial and business purposes. These properties are income-producing businesses and **their stream of income is the key to their value.** In its broadest definition, this includes office buildings, retail property, industrial property, and other commercial property, such as mini-storage facilities and hospitality property

Income Producing Properties

Office Space

- Free-Standing Buildings
- Business Parks
- Office Buildings

Retail Space

- Free-Standing Buildings
- Strip Centers
- Neighborhood Centers
- Regional Malls
- Factory Outlets

Industrial Properties

- Factories
- Manufacturing
- Industrial Parks
- Research and Development Parks

Hospitality Properties

- Motels and Hotels
- Resorts
- Bed and Breakfasts
- Inns and Lodges

Section I:

Types of Commissions

- Sales
- Leases

Commission/Fees:
Common Scenarios

Sales

- Commission varies often times, depending upon size ($) of the sale.
- Typically, the larger the sale amount ,the smaller the commission percentage.
- It is usually Cooperation between the Listing agent and Buyer's agent, ***but this can vary .***

Do NOT Assume automatic Cooperation between Brokers

Commission/Fees: Common Scenarios (cont.)

Leases

- Commissions are typically based on the total contract rent over the term or Gross Lease Consideration (GLC)*
- Often, the tenant rep receives a disproportionate share of the commission.
- The landlord is represented sometimes by the listing agent and sometimes by him/herself or an employee

- * Rent of $3,000/month x 60 months
  = $180,000 GLA

Who Leases and Why

"Users" lease space and become tenants

- ✓Lease space to operate their primary business
- ✓Want to maintain flexibility
- ✓Want to retain capital for primary business rather than purchase of real estate
- ✓Seek lower cost of occupancy than purchase

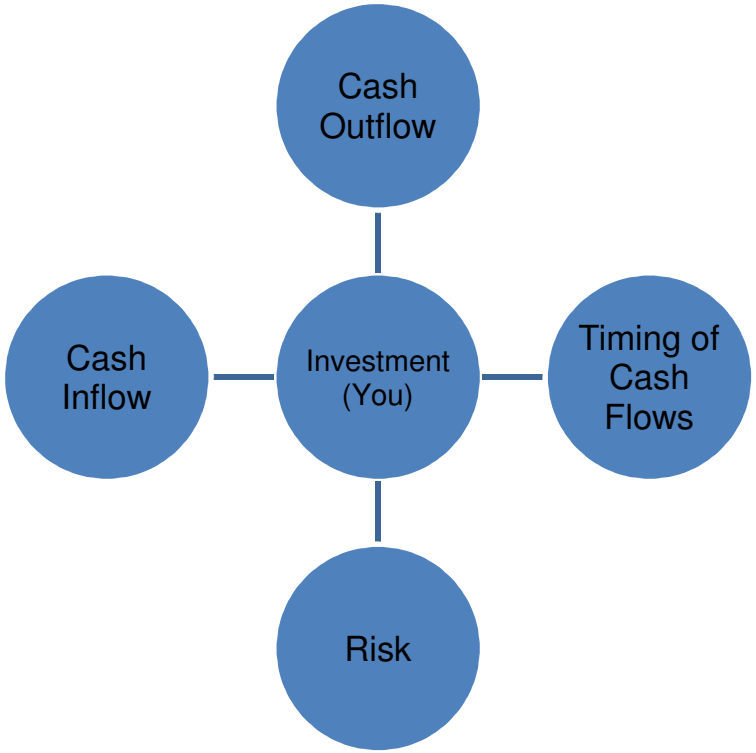
Landlord/Owner Objectives

- Maximize Net Operating Income.
  - Maintain high occupancy
  - Achieve highest rents market allows at lowest front-end costs
- Have quality tenants.
- Have quality leases.
- Control costs.

Section II:

Fundamentals of Investment Real Estate

Elements of an Investment



- Cash Outflow: Money expended for the investment
- Cash Inflow: Money you receive from the investment
- Timing: When do cash flows (positive or negative) occur?
- Risk: What is the probability that predicted cash flows will occur? What is the variance?

Net Operating Income

- The Most Important Number
  In Commercial Real Estate

NOI

Income-Producing Properties

- Investors Buy Properties based on their Income/Cash Flow (existing or pro forma)
  - Office, Industrial, Retail, Multifamily, etc.
- Income is derived from Leases
- Key Lease Issues:
  - Revenue (Rents)
  - Expenses (Owner-paid Operating Expenses)

Net Operating Income

- Net Operating Income is a key figure for income-producing properties
- Investors use it to determine Value
- Lenders use it to determine Loan Amount

Rent

- Operating Expenses paid by owner

= **N**et **O**perating **I**ncome (NOI)

APOD

Annual

Property

Operating

Data

Net Operating Income

	Potential Rental Income
-	Vacancy and Credit Loss
=	Effective Income
	+ Other Income
=	Gross Operating Income
	- Operating Expenses
	= NOI

Net Operating Income

- Operating expenses consist of:
  - Real estate taxes
  - Property insurance
  - Property management and maintenance
  - Utilities
  - Legal fees
  - Advertising
  - And accounting, to name a few

Net Operating Income

- Using Net Operating Income to Establish a Purchase Price
- The value of a property is determined by dividing the NOI by the Cap Rate, which results in the value of the property.

V = Value I = NOI R = Cap Rate

$$V = I / R$$

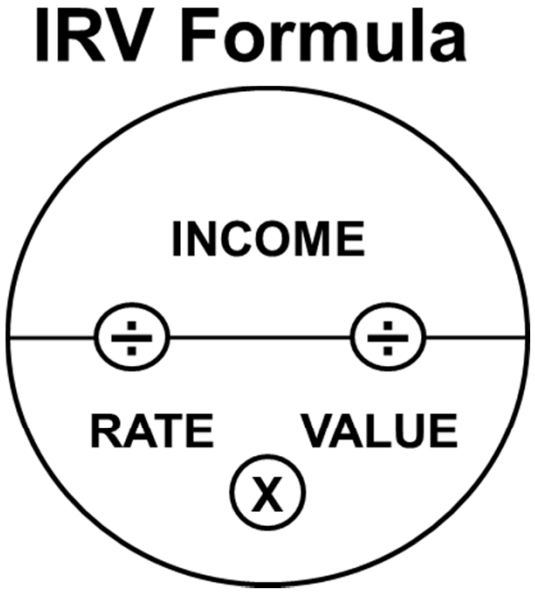
Cap Rate as a Way of Measuring an Investment

- A rate of return on a real estate investment property based on the expected income that the property will generate. Capitalization rate is used to estimate the investor's potential return on his or her investment.
- Cap Rate is a measurement rate of the first year NOI as it relates to the current value of the investment.

- Is a Cap Rate complete?

  NO

Calculating the Cap Rate



A Cap Rate does not account for debt service and income tax for the investment.

NOI Problem #1

- An investor is considering a property with a forecasted NOI of $50,000. The investor has established a market Cap rate of 9.75% based on similar properties.

- What would this investor consider paying for the property?

NOI Problem #1

V = I / R

$50,000

Divided by

9.75% or 0.0975 =

$512,821

The investor would consider paying $512,821 for this property

NOI Problem #2

- Using problem #1, assume that an investor is considering purchasing a property that is priced at $521,821 with a forecasted NOI of $50,000. What is the Cap rate?
- What is the formula?

  R = I/V

  I = $50,000

  V = $512,821

  R = 9.75% or 0.0975

Capitalization

Capitalization:

- Uses the Income (NOI) of a property to determine Value
- The relationship (ratio) of Income to Value is expressed by a factor known as a Cap Rate

Cap Rate:

- Cap Rate = NOI / Value (Price)
- Expressed as a % (i.e., 8%) but calculated as a decimal (8% = .08)
- Cap Rate calculation is a one-year "snapshot" analysis

Capitalization

Cap Rates have an Inverse relationship with Value (Price)

- Lower Value = Higher Cap Rate
- Higher Value = Lower Cap Rate

Example: A property has a NOI of $10,000 based on that year's leases and expenses:

- NO**I** / **V**alue = Cap **R**ate
- List Price is $110,000 = Cap Rate ?
- 9.09% Cap Rate
- List Price is $130,000 = Cap Rate ?
- 7.69% Cap Rate

Calculating Value Using Cap Rate

Value = NOI / Cap Rate

Cap Rate used can be Market Based or Investor Preference

- Appraisers use Market Based Cap Rate as well as many Investors
- Market Cap Rate is average of what similar properties are selling for in that market
- An Investor's preferences may be reflected by the Cap Rate he is willing to pay for a particular property

Capitalized Value Example

Rent	$1,000,000
Op. Expenses	- $600,000
NOI	$400,000

V = I/R R = 8%* What is I ? _____

$400,000

What is V? _____

$5,000,000

* Market Cap Rates reflect market conditions for type, location, age, etc., of property.

* Investor Cap Rate expresses how much an investor is willing to pay for a given NOI based on investor's preferences, risk tolerance, etc.

Pros and Cons of Using Cap Rate

- Pros
  - Simplicity of Calculation
  - Accounts for:
    - Any Vacancy and credit losses
    - Any Operating Expenses
- Cons
  - Simplicity limits its reliability because it does not take into consideration:
    - Financing
    - Any Tax Impact
    - It only looks at one year forecast when determining value or measuring performance.

Section III

Types of Leases and Lease Structures

Commercial Leases

BASE RENT

- Monthly Rent
- Price per Cubic Foot ($/CF)
- Price per Square Foot ($/SF)
  - Price per Square Foot/year ($/SF/Year)
  - Price per Square Foot/month ($/SF/Month)

Types of Lease Structures

- Lease structures are defined by how Operating Expenses are Paid.

  Who pays the Operating Expenses?

  Landlord or Tenant?

- Which Operating Expenses, if any, are included in Base Rent?

Operating Expenses

- The costs of “operating” the property may include any or all of the following:

  - Property Taxes
  - Property Insurance
  - Janitorial and Waste Removal
  - Maintenance – Various Types (Building, Landscape, Elevator, etc.)
  - Property Management
  - Utilities

Lease Analysis
to determine NOI

- NOI derived differently for property types based on lease structure
- Different lease structures often common to different property types
- Lease structures vary depending on what Operating Expenses (if any) are included in base rent

Common Lease Structures

Full-service/Gross Lease						
Property Taxes	Property Insurance	Maintenance	Management	Water	Janitorial	Electric

Included in Base Rent:* Paid/Reimbursed by Tenant:

*Subject to Expense Stop

Types of Properties Most Likely to Use This Lease Structure

- Multi-tenant Office

Office Properties - NOI
Common Lease Structure

- Typical office leases are “full service”
- Base rent includes all Operating Expenses
- NOI determined by netting owner-paid Operating Expenses from rent

Monthly Rent*
- Maintenance**
- Management**
- Taxes**
- Insurance**
- Utilities**
- Janitorial**
- Other Expenses**

= Net Operating Income

*Lease **Landlord

Common Lease Structures (cont.)

Modified Gross (aka Industrial Gross)						
Property Taxes	Property Insurance	Maintenance	Management	Water	Janitorial	Electric

Included in Base Rent:*

*Subject to Expense Stop

Paid/Reimbursed by Tenant:

Types of Properties Most Likely to Use This Lease Structure

- Flex
- Office/Showroom
- Single Tenant Office

Flex Properties - NOI
Common Lease Structure

- Flex buildings are light Industrial / R&D
- Typical Flex Leases are often called "Modified Gross"
- Base rent includes taxes, insurance, and common area maintenance (CAM)

Monthly Rent*
- Maintenance*
- Management*
- Taxes*
- Insurance*

= Net Operating Income

*Lease **Landlord

Common Lease Structures (cont.)

Triple Net (NNN)						
Property Taxes	Property Insurance	Maintenance	Management	Water	Janitorial	Electric

Included in Base Rent:* Paid/Reimbursed by Tenant:

*Subject to Expense Stop

Types of Properties Most Likely to Use This Lease Structure

- Industrial/Warehouse
- Retail

Retail and Industrial - NOI
Common Lease Structure

- Typical retail and industrial leases are "Triple Net" (NNN)
- Base rent does not include Operating Expenses
- Tenants pay their proportionate share of all Operating Expenses

Monthly Rent* is the Net Operating Income

*Lease **Landlord

Lease Structure

- A unique feature that Retail leases sometimes include is Percentage Rent.
  - Shopping Malls
  - Strip Centers

Percentage Rent

- In some retail leases the tenant is required to pay an additional rental amount above Base Rent: Percentage Rent .
- This is calculated at a percentage of retail sales above a certain level - the Breakpoint.
- The Breakpoint can be negotiated or the “Natural Breakpoint.”
- The Natural Breakpoint is calculated by dividing the annual Base Rent by the percentage (%) that the landlord is seeking as Percentage Rent.

Section IV:

Adding Value

Adding Value

- Since Value is largely determined by NOI, increasing NOI can increase a property's value

- NOI for a property can be increased by
  - Increasing rental rates
  - Increasing occupancy
  - Reducing expenses

Adding Value: Example

Value Increase through increase in Rental Rate

Rental Rate	$18/sf	$20/sf
- Operating Expenses	$8/sf	$8/sf
= NOI	$10/sf	$12/sf
Value Based on 8% (.08) Cap Rate*	$125/sf	$150/sf

*Value = NOI/CAP Rate

Lease Analysis:
Escalation, Options, Lease Expires - New Lease

Adding Value: Example

Value Increase through Reducing Operating Expenses

Rental Rate	**$18/sf**	**$18/sf**
- Operating Expenses	**$8/sf**	**$6/sf**
= NOI	**$10/sf**	**$12/sf**
Value Based on 8% (.08) Cap Rate*	**$125/sf**	**$150/sf**

*Value = NOI/CAP Rate

Adding Value: Example

Value increase through increasing occupancy

30,000 sq ft office building at $18/sf rental rate	70% Occupancy	90% Occupancy
Income	$378,000	$486,000
- Operating Expenses @ $8/sf occupied; $4/sf vacant	$204,000	$228,000
= NOI	$174,000	$258,000
Value Based on 8% Cap Rate*	$2,175,000	$3,225,000

*Value = NOI/Cap Rate

Corrected Deferred Maintenance
Replaced Property Management

Factors that Affect Rental Rates and Occupancy

Market Forces (Supply and Demand) Play a Significant Role

- Demand for that type of space
- Job growth in the sector the property serves
  - White-collar jobs = office space
  - Blue-collar jobs = industrial space
  - Both types of jobs drive demand for retail and multifamily properties

Other Factors that Affect Rental Rates and Occupancy

Improving a Property through Maintenance or Capital Improvements

May increase the desirability of the Property and thereby demand.

May allow increase in Rental Rates consistent with other improved properties in the market.

Section V

Impact of Debt on Commercial Real Estate

Debt

- Debt—Mortgage(s)—plays a vital role in commercial real estate investment
- Enables investor to buy a larger property with less cash for a down payment (vs all cash)
- Investor spreads the risk with the lender
- Tax benefits with interest write-off

Loan Selection

- What you need to know:
  - Types of Commercial loans available
  - Types of loan structures (Hard Money, Swap, Equity, etc.)
  - Which lenders offer the loans you need/want
    - Underwriting Requirements

Always have your own trusted lender for custom packages.

Loan Selection

It’s important to do the following:

– Build relationships with lenders.

– Find a mentor.

– Ask questions.

Lender Requirements

- Lenders determine maximum amount of loan with two methods
  - LTV (Loan to Value)
  - DSCR (Debt Service Coverage Ratio)

- Lenders often calculate both and **lend the lesser loan amount with a higher down payment**

LTV – Loan to Value

- LTV represents the proportion of purchase price being financed
  - Example:
    - $1,000,000 Price
    - $800,000 Loan
    - $200,000 Equity (Down Payment)
    - $800,000/$1,000,000 = .80 or 80% LTV

- If lender's requirement is 75% LTV, maximum loan will be the purchase price times 75% (.75)

Example: $500,000 price at a 75% LTV

What is the maximum loan amount?

$375,000 loan

Net Operating Income and Debt

- NOI is a key figure in determining the loan amount (debt)
- NOI reflects property's ability to pay debt service (mortgage payment), expenses, and provide profit
- Lenders use NOI to determine the amount of debt or loan for a property by the Debt Service Coverage Ratio

>D.S.C.R.<

- A DSCR of 1.2 means the NOI must be 120% of the annual loan payments
  - for every $1 of debt you need $1.20 of NOI

DSCR – Debt Service Coverage Ratio

- The second method lenders use is DSCR
- DSCR represents the proportion that NOI exceeds the ADS (Annual Debt Service)
- ADS is the total annual loan payments
- DSCR represents a margin of safety for lender
- A DSCR of 1.15 means NOI must be 115% of ADS
  - after using NOI to pay the loan, there is 15% extra to cover all other expenses and profit.
  - Example: $144,000 NOI with 1.20 DSCR means total ADS cannot exceed $120,000

$$\$144,000 / 1.2 = \$120,000$$

Example

- My property generates $185,000 Net Operating Income (NOI)

- My Bank's underwriting requires a DSCR of 1.25
- What is the maximum Annual Debt Service?

NOI/DSCR = The Banks maximum ADS

$185,000 / 1.25 = $148,000

Total ADS cannot exceed $148,000

$148,000/12 = Monthly Mortgage Payments of $14,800

Case Study
List or Offer Price is $500,000

- NOI is $45,000.00
- Bank DSCR is 1.2 and a LTV of 75%
- What is the allowable ADS?

NOI/DCR = ADS

$45,000/1.2 = $37,500.00

- What is the PMT (Monthly Payment)

ADS $37,500.00/ 12 =$3,125.00

- What is the PV (Loan Amount)?

We need more information!

List or Offer Price is $500,000

- ✓ *Interest Rate (I/YR) is 8%*
- ✓ *5 year term (Note) but amortization 25 years (N)*
- ✓ Monthly payment of $3,125
- What is the allowable Loan Amount?

  $404,889
- What is the LTV?

  81%
- What is my down payment?

  Bank LTV 75% = $125,000

- What is the Bank Loan?

  $375,000

NOI is $45,000.00 - Interest 8%
Amortization 25 years

- What if the Bank DSCR is 1.3, what is the loan amount?

$373,743 Loan Amount

- What if the bank DSCR is 1.0, what is the loan amount?

$485,866 Loan Amount

Net Cash Flow to Owner

Cash Flows	Comments
Rental Income	Derived From Leases
- owner-paid Operating Expenses	Varies based on type of property and lease
= **Net Operating Income (NOI)**	Key figure used to determine value, loan amount
- Debt Service (Mortgage)	Sometimes referred to as ADS (Annual Debt Service)
= **Cash Flow Before Taxes**	Net to the Owner before paying income taxes; used for cash-on-cash calculation

The Cash Flow Model
Debt Service and Taxes

Rent

- Operating Expenses (paid by owner)

Net **O**perating **I**ncome (NOI)

- Debt Service (Annual Mortgage Payment)

Cash **F**low **B**efore **T**axes

- Taxes

Cash **F**low **A**fter **T**axes

Cash Flow Before Tax

- CFBT is the heart of the analysis. Your goal is to determine the CFBT
- This will give you the amount of income your property is providing before tax .
- This is the benchmark to calculate your return

Cash Flow Before Tax
Based on a DSCR

NOI of $50,000 / DSCR of 1.25 = ADS $40,000

The above analysis will have a result of:

NOI – ADS = CFBT

($50,000 – $40,000 = $10,000)

$10,000 a year CFBT

ADS/12 ($40,000/12) = Monthly Payment of $3,333

Now I can calculate the mortgage that $3,333 will service.

8% Interest
25 year Amortization
Monthly Payment $3,333

Pmt	Principal	Interest	Cum Prin	Cum Int	Prin Bal
1	454.08	2878.92	454.08	2878.92	431383.9
2	457.11	2875.89	911.19	5754.81	430926.8
3	460.15	2872.85	1371.34	8627.66	430466.7
4	463.22	2869.78	1834.56	11497.44	430003.4
5	466.31	2866.69	2300.87	14364.13	429537.1
6	469.42	2863.58	2770.29	17227.71	429067.7
7	472.55	2860.45	3242.84	20088.16	428595.2
8	475.7	2857.3	3718.54	22945.46	428119.5
9	478.87	2854.13	4197.41	25799.59	427640.6
10	482.06	2850.94	4679.47	28650.53	427158.5
11	485.28	2847.72	5164.75	31498.25	426673.3
12	488.51	2844.49	5653.26	34342.74	426184.7
13	491.77	2841.23	6145.03	37183.97	425693
14	495.05	2837.95	6640.08	40021.92	425197.9
15	498.35	2834.65	7138.43	42856.57	424699.6
16	501.67	2831.33	7640.1	45687.9	424197.9
17	505.01	2827.99	8145.11	48515.89	423692.9
18	508.38	2824.62	8653.49	51340.51	423184.5
19	511.77	2821.23	9165.26	54161.74	422672.7
20	515.18	2817.82	9680.44	56979.56	422157.6
21	518.62	2814.38	10199.06	59793.94	421638.9
22	522.07	2810.93	10721.13	62604.87	421116.9
23	525.55	2807.45	11246.68	65412.32	420591.3
24	529.06	2803.94	11775.74	68216.26	420062.3

- Based on an NOI of $50,000, with a DSCR of 1.25, the max loan amount would be *$431,838*.

- With an asking price of $500,000 - $431,838 you would have to put down $68,161.45

- What is the CAP Rate?
  NOI/Price = CAP Rate
  10%

Cash on Cash

- Many investors use Cash on Cash to measure performance of the initial investment
- Uses the first year's Cash Flow Before Taxes and Initial Investment (Down Payment plus other up front costs)
- Represents investor's first year pretax return on "out of pocket" dollars

$$\textbf{Cash-on-Cash Return} = \frac{\text{First year CFBT}}{\text{Initial Investment}}$$

CASH ON CASH RETURN
Example

- Suppose an investor purchases a $1,200,000 apartment complex with a $300,000 down payment. Each month, the cash flow from rentals, less expenses and mortgage, is $5,000. Over the course of a year, the before-tax income would be $5,000 × 12 = $60,000.

- What is the cash-on-cash return?

CASH ON CASH RETURN

$$\text{cash-on-cash return} = \frac{\text{annual before-tax cash flow}}{\text{total cash invested}}$$

$$\frac{\$\ 60{,}000}{\$\ 300{,}000} = 0.20 = 20\%$$

Calculating “Cash on Cash” Returns

First determine the maximum loan amount to determine the down payment based on the following assumptions:

- Net Operating Income (NOI) of $50,000
- Debt Service Coverage Ratio (DSCR) of 1.25
- Annual Debt Service (ADS) of $40,000 (NOI/DSCR = ADS)
- Loan – 8% interest, fully amortized over 25 years
- Current asking price of $500,000
- What is the Cash Flow Before Taxes (CFBT) ? _____

  NOI – ADS = CFBT

  $10,000.00

ADS $40,000/12 = $3,333 /monthly payments

What is the maximum loan that $3,333 will service? _____

$431,838

What is the LTV? _____

86%

What is the down payment? _____

$68,162

What if the bank's LTV max is 80%?

What is the down payment? _____

$100,000.00

Purchase or Offer Price $500,000

Calculating “Cash on Cash” Returns

- Compare the $10,000 CFBT you receive against the down payment amount of $68,161.45

Which is called…

CASH on CASH Return

Calculating “Cash on Cash” Returns

- Cash-on-Cash Return (COC) is:
  - The first year’s Cash Flow Before Tax (CFBT) / Initial Capital Invested
- $10,000/$68,161.45 = 15% Return on Equity
- $10,000/$100,000 = 10% Return on Equity

Investors usually think of this percentage as
“THE” Return!

Return on Equity
on any Income producing Property

- Determine the NOI
- Determine the ADS
- Determine the CFBT

NOI – ADS = CFBT

- Take the CFBT and divide it by the Equity = Return on Equity

$50,000 CFBT / $1,000,000 Equity = 5% COC

Or Return on Equity

50,000 NOI

8% Interest - Amortization 25 yrs.

- What if the Bank's DSCR is 1.30?

  ADS = _____

  NOI/DSCR =ADS $50,000/1.30 = $38,461.54

  $38,461.54/12 = $3205.13/mo.

  - What is the Max. Loan ? _____

    $415,270.91

  - What is the LTV ? _____

    $415,270/$500,000 = **83%**

  - What is the Down Payment ? _____

    $500,000 - $415,270 = $84,730

What is the Cash on Cash COC

- NOI – ADS = CFBT

$50,000 - $38,461.54 = $11,538.46

- CFBT/Equity = COC

$11,538.46/$84,730 = 13.62%

What if the Bank's DSCR is 1.15?

- NOI/ DSCR = ADS _____

  $50,000/1.15 = **$43,478.26/12 = $3623.19/mo.**

- Max. Loan ? _____

  $469,436.68

- LTV ? _____

  $469,436/$500,000 = **94%**

- Down Payment ? _____

  $500,000 - $469,436 = **$30,564**

Note: 8% interest - 25 yrs. Amortization, $50K NOI

What is the Cash on Cash COC

- NOI – ADS = CFBT

$50,000 - $43,478.26 = $6,521.74

- CFBT/Equity = COC

$6,521.74/$30,564= 21.34%

NOI of $50,000
$500,000 Purchase Price

- DSCR of 1.3
  - The loan amount is $415,270 w DnP of $84,730
  - The COC is 13.62%
- DSCR of 1.25
  - The loan amount is $431,838 w DnP of $68,162
  - The COC is 15%
- DSCR of 1.15
  - The loan amount is $469,436 w DnP of $30,564
  - The COC is 21.34%

A higher DSCR requires a higher down payment and lowers the COC Return

Section VI

CASE STUDY

Case Study

- A property is currently on the market for a List price of $750,000 with a Cap Rate of 9%.

- What purchase price would you need to offer to receive a 9% COC return?

Case Study

- Step 1: The NOI (if real) should be _____based on a 9% Cap Rate and market price of $750,000.
- What is the NOI? _____

(I = R x V)

$67,500

- Step 2: If the NOI is $67,500 and you know that your lender has a loan program of 8% interest, fully amortized over 25 years, no points, and a DSCR of 1.25, your max Annual Debt Service (ADS) will be:

NOI/DSCR or $67,500 / 1.25 = _____ ADS

$54,000

Case Study

- Step 3: $67,500 NOI

  - $54,000 ADS = $4,500 a month

  = $13,500 CFBT

- Step 4: A monthly payment of $4,500 consisting of 8% interest over a 25-year term will bring the max loan amount to_____

  $583,040

- Compare that to your purchase price of _____.

  $750,000

Case Study

- What is your down payment? _____

  $750,000 - $583,040 = $166,960

- What is your CFBT ? _____

  $13,500 a year.

- What is the COC ? _____

  CFBT/Initial Investment = COC

  $13,500/ $166,960 = 8%.

Case Study

Items that you should review to help achieve a higher COC:
Your Client wants a 9% COC Return

1. Lower your asking price.

2. Achieve a higher NOI.

3. Get a lower interest rate.

4. Any combination of the above.

All of these will get you there! Let's look!

Case Study

- By *reducing the offer price* to $735,000 or by 2%, a COC of 9% can be achieved.

- If you *increase the NOI* by 2% a year ($1,350), your NOI would be $14,850, giving you a COC of 9%.

- *Lower interest rate* of 7.75%, but keeping monthly payments at $4,500, would produce a COC of 9%.

Reduced the Down Payment

List of Commercial Reference Material

- A field Guide To Commercial Real Estate Evaluation, by Richard M. Fenker, PhD
- Income Property Brokerage, by John M. Peckham III
- Negotiation Commercial Property Leases, Eric L. Nesbitt, Esq.
- Negotiating Commercial Real Estate leases, by Martin Zankel
- Commercial Real Estate Investing for Dummies, Peter Conti and Peter Harris

Questions ?

Next Class

CRE 103

- Annual Property Operating Data (APOD)
- What is an APOD?
- Why Do We Use an APOD?
- Completing an APOD-Case Study
- Calculating Cost Recovery and Why?
- Calculating Capital Gains Tax and Why?

Commercial 103

APOD

Annual Property Operating Data

Steven McMurtrie

California Commercial Alliance

Introduction

- The goal of investing in real estate is to generate income or a profit.
- Financial analysis tools help identify an investment's profit potential.
- For RE investments, a key tool is the;

"Cash Flow Model"

– Which helps to analyzes an investment's;

Income – Expenses - Yield

Cash Flow Model

- The cash flow model combines calculations that use financial analysis techniques and estimations from forecasted conditions in the real estate market and their impact on a given property
- This process involves;
  - Judgment
  - Knowledge of the RE market
  - Research using various CRE resources

Cash Flow Model Continued

- Key value of the cash flow model is the NOI

- NOI affect many decisions
  - Lenders use NOI to determine loan amount
  - Investors use NOI to determine what they will pay
  - Appraisers use NOI to determine value

Components of the Cash Flow Model

- Initial Investment
- Investment holding period (yrs. or months)
- Cash flow from operations
  - any periodic cash flows, negative or positive
- Sales proceeds from sale
  - any cash flow generated from the sale of the investment

Cash Flow Model
T-Bar

The Cash Flow Model is a template for the T-Bar that illustrates the timing and cash flows of a property from the owner's perspective.

N	$
0	(85,000)
1	15,000
2	14,000
3	13,000
4	12,000
5	11,000 + 50,000

n = 5 x 1

i = ?

We will use this cash flow model for Time Value of Money
Compounding
Discounting
Internal Rate of Return (IRR)

Cash Flow Model
T Bar

N	$
0	(85,000)
1	15,000
2	14,000
3	13,000
4	12,000
5	11,000 + 50,000

n = 5 x 1

i = ?

Refer to APOD

Net Operating Income
NOI

- NOI is the annual income generated by an income-producing property after collecting all income from operations and deducting all expenses required to operate the property.
- NOI is unaffected by financing or tax status of the owner/investor

NOI

- NOI can be Negative or Positive
  - Negative or Positive cash flow
- NOI can be historic value using records of income and expenses from prior years
  - P&L Statements , Owner's income Tax records, Property Management Records
- NOI can be forecasted for future years
  - Pro forma

NOI

- NOI is calculated for a period of 1 year.
- NOI is for any given 12 month period as a calendar year or any other 12 month period being analyzed.

NOI DATA

- Obtain NOI Data
  - Leases
  - Financial Records
  - Market Studies
  - Other Available sources to forecast trends in the market, local economy and overall economy as they impact the property's NOI

NOI and Lease Analysis

- Lease analysis is used to determine a property's potential rental income, a critical first step in using this Cash Flow Model.

- The lease identifies the main sources of income and who pays for which expenses.

Gross, Modified Gross, NNN

or Percentage Rents etc.

Calculating NOI Using CCIM Business Forms

- Because NOI involves using data from multiple sources, it is helpful to organize all income and expense data and calculations in a standard format using standard terminology.

  The APOD serves this purpose!

- The APOD worksheet lists potential components of the NOI model and provides instructions for adding or subtracting values to calculate NOI.

- Not every property will include all 30 line items in its NOI.

APOD

- What is an APOD?
- Where does it come from?
- Who prepares it?
- When is it used?
- Where do I get that information?

What is the APOD?

- The APOD is a form used to do a basic analysis on an income producing property so that it is summarized in a simple, organized and consistent format.

Where does it come from?

The CCIM Institute

Certified

Commercial

Investment

Manager

Who prepares it?

- The listing agent is most likely the person to prepare such a form as a tool in their analysis of the property. **List Price?**
- A buyer's agent or the buyer may also prepare such a form so that they can compare one property to another in an organized and consistent format. **Offer Price?**

When is it used?

- By the listing agent in their initial analysis of the property.
- By the buyer's agent to study the *proposed offering* and to compare to other properties under consideration.
- By owners or prospective investors to help analyze an income producing property

Where do I get that information to complete the APOD?

- The Seller
- The Buyer
- The Bank
- The Insurance Company
- The City/County
- Etc.

Filling in the APOD Form
See APOD Handout

Upper Left Corner

- Property Name: Name of Property (if any), major tenant name, or street names at intersection for reference.
- Location: Street address of property, city
- Type of Property: Property Type, Office, Retail, Multi-Family, Industrial etc., you may also add class of property A,B,C,D
- Size of Property: Building size in sq. ft. and number of rental units.
- Purposes of Analysis: Put in why you are doing this analysis and what will be the use of this analysis. Also, indicated if this is an actual (last 12 months) or pro forma (next 12 months) analysis.

Assessed and or the Appraised Values

- Estimated Land Value
- Estimated Improvement Value
- Estimated Personal Property Value (if any)
- Total(s)
- Adjusted Basis as of indicated dates

Calculating Basis

- Basis is used for tax purposes to determine;
  - Cost-recovery deductions
  - Gain or Loss upon disposition (sale)
  - Amortization deductions

The basis for a property is determined by the method in which the property is acquired.

Purchase, Inheritance, Gift, Tax-deferred Exchange

Basis through Purchase

Equity, Down Payment

+

Total Debt Incurred to Finance the Purchase

= Basis of Property

Cash down payment $40,000

Mortgage Financing $200,000

Basis of Property is $240,000

Allocation of Basis

- Land
- *Improvements
  - Buildings, fences, new roof, and similar constructions
- *Personal Property
  - Furniture, appliances and computers

	Assessors Records	Percent of Total
Land	$50,000	25%
Improvements	$150,000	75%
Total Assessments	$200,000	100%

*Use an Appraiser or tax assessment ratios

Calculate Basis Allocation

- Purchase Price $240,000

	Allocation %	x	Purchase $	=	Basis
Land	25%				
Improvements	+75%				
Total	100%				

Calculate Basis Allocation

	Allocation %	x	Purchase $	=	Basis
Land	25%		$240,000		$60,000
+ Improvements	75%		$240,000		$180,000
Total	100%				$240,000

Upper Right Corner

- Purchase Price
- Plus Acquisition Costs
- Plus Loan Fees/Costs
- Less Mortgage
- Equals Initial Investment

- Balance
- Periodic Payment
- Pmts/Yr.
- Interest
- Amort. Period
- Loan Term
    - 1st
    - 2nd

Main Analysis Section

- ALL FIGURES ARE ANNUAL
- May be $/SF OR $/Unit
- Line 5; Gross Operating Income (% of GOI)
- Lines 7-28 – for expenses in $ or % of GOI
- Comments/Footnotes

Line 1 – POTENTIAL RENTAL INCOME (PRI)

- Existing Leases on the Property
  - Total of all rents under the terms of each lease, assuming the property is 100% occupied.
  - For any vacant space, the PRI is based on market rents

- Competitive market rents in the area
  - Market Assessment Data
  - RE Brokers
  - Local Financial Institutions
  - Appraisers

Source Data

- Determine rent under the terms of each lease
  - **READ THE LEASES** to understand the rent increases, terms, and any expense sharing or reimbursement arrangements.

- Total all rents due under all leases
  - Other factors to consider are the quantity ($), quality (risk) and durability (tenant financial strength) of the income stream.
- If a property only has one long term absolute net leasing Tenant, What is the NOI?

The PRI

Line 2 – Less: Vacancy & Credit Losses

- Income lost due to vacancies and/or tenants defaulting on lease payments.
- Source of data
  - Existing leases, which specify when each lease expires
  - Lease Options to renew under different terms
  - Vacancy/credit loss of comparable properties when rented at market rents.

Line 2 – Less: Vacancy & Credit Losses
Analysis and Calculation

- Determine competitive market rents in area
- Review rent history of property
- Assess availability of competing space
- Establish vacancy rates for this market
- Review length of existing leases and lease guarantees
- Assess tenant quality, economic strength and current lease satisfaction

Line 2 – Less: Vacancy & Credit Losses

- The range may be
  - Actual
  - Required by the lender underwriting
  - Pro forma
  - Depending on the property
    - Type
    - location
    - the real estate market cycle.

Line 3 - EFFECTIVE RENTAL INCOME (ERI/EGI)

- This is the Potential Rental Income less the Vacancy and Credit Loss Allowance.
- This is the rental income that the owner anticipates collecting

Calculating Effective Rental Income

- Rental income for an Eight Unit building

Number of Units	Market Rents	Occupied/Vacant
4	$600/month	Occupied
3	$750/Month	Occupied
1	$800/Month	Vacant

What is the potential rental income for this property? _____

4 X 600 x 12 = $28,800

3 x 750 x 12 = $27,000

1 x 800 x 12 = $9,600

$65,400

Calculating Effective Rental Income continued

What is the effective rental income for this property for the year (if the single unit remains vacant)? _____

PRI	$65,400
- Vacancy	- $9,600
ERI	$55,800

Calculating Effective Rental Income continued

- Annual data for a three-unit property

Unit	Total Area	Market Rents
A	1,000 SF	$10/psf
B	1,250 SF	$10/psf
C	1,500 SF	$12/psf

Vacancy/credit is 7%

Unit C is vacant but is expected to be rented at the above price.

What is the PRI for this property for the year? _____

1,000 X 10 x 1 = $10,000

1,250 x 10 x 1 = $12,500

1,500 x 12 x 1 = $18,000

$40,500

Calculating Effective Rental Income

What is the estimated Vacancy/credit loss for the year?

PRI x Vacancy/Credit Loss

$40,500 x 7% = $2,835

What is the ERI for this property for the year?

PRI – Vacancy/Credit Loss

$40,500 - $2,838 = $37,665

Line 4 - Plus: Other Income (Collectable)

A property may produce income other than rental income

- Examples are:
  - Parking,
  - Laundry,
  - Storage,
  - Vending Machines
  - Billboard Space

Line 5 - GROSS OPERATING INCOME

This line is the EFFECTIVE RENTAL INCOME

- plus Other Income from all sources
- This represents the total income from the operation of the property before operating expenses are deducted

Line 6 - OPERATING EXPENSES

- Are cash outlays made each year to maintain and operate the property so it continues to produce market rents.
  - **Real Estate Taxes (line 7)**
    - **What happens when the property is sold?**
  - **Personal Property Taxes, if any (line 8)**
  - **Property Insurance (line 9)**
    - **Fire**
    - **Flood**
    - **Liability, vandalism**
    - **Earthquake**

Operating Expenses

Lines 10-28 to list Operating Expenses

Line 29 TOTAL OPERATING EXPENSES

Line 5 – Line 29 = Line 30

Line 30 Net Operating Income NOI

- Line 30 separates those expenses as **"above the line" or "below the line".**

Line 10 - Property Management

- On or Off Site
- Normally is based on a percentage of the gross operating income (GOI)

Line 14 - Repairs and Maintenance

- Painting Interior and Exterior public areas
- Periodic repairs of building systems
- Elevator maintenance
- Supplies, light bulbs, paper, cleaning supplies etc.
- Solid Waste removal
- Landscaping

Utilities

- Water
- Sewer
- Gas (metered separately)
- Electric (metered separately)

Line 19 Through 28

- Other expenses must be estimated on a case by case basis.
- You may use your expense ratios that you have developed by knowing your market.
  - What are the typical expense ratio percentages for down town San Jose?

Line 29 - Total Operating Expenses

Source Data:

- Local, city, state, federal taxing authorities
- Insurance agencies
- Maintenance records
- Utility companies or commissions
- Property managers or building managers

When forecasting you will estimate operating expenses

Items Excluded from Operating Expenses

- Interest and principal on debt encumbering the property
- Depreciation
- Capital expenditures
- Income taxes
- Reserves for replacement
- Tenant Improvements
- Real Estate Commissions

Capital Expenditure
or
Operating Expense

- The distinction usually made is whether the expenditure occurs annually, which would categorize it is an operating expense, or less frequently, categorizing it as a capital expenditure
- How an expense is classified is a tax and investment issue that should be determined by the investor and a qualified tax advisor!

Reserves Above or Below the Line?

- Similar judgment is called for in deciding whether to include reserves for replacement as an operating expense.
- If it is an operating expense it is “Above the Line” of NOI
- If it is a Fund Reserve it is “Below the Line” of NOI.
- Expenses placed “Above or Below the line” affect what?

The Properties NOI

Line 30 - Net Operating Income

- Net operating income is gross operating income minus operating expenses. This is the end result of the NOI calculation

Potential Rental Income (PRI)

\- Vacancy and credit losses

Effective Rental Income (ERI)

\+ Other Income (collectible)

Gross Operating Income (GOI)

\- Operating Expenses

Net Operating Income

Non Operating Expenses are listed on lines 31-34

- Less annual debt service,
- Less participation payments to the lender, if any,
- Less leasing commissions,
- Less funded capital improvement reserves, actual capital improvements,

These are expenditures not essential or pertinent to the operation of the property.

Calculating Operating Expenses

- March Expenses for an Office Property

Expense	Amount
Utility Bill	$275
Monthly Mortgage Payment	$2,000
Building Repairs	$175
Money Set Aside for a new Roof	$350

What are the operating expenses for March? _____

$450

Are any expenses listed above not considered an operating expense? _____

YES, Mortgage Payment and New Roof Reserves

Line 35 – Cash Flow Before Taxes

Cash flow before deducting the Tax Liability on the owner's ordinary income from the property

Owner's Tax Bracket

2014 Tax Rate

10% to 39.6%

Calculating CFAT

- Tax Liability (Savings)

NOI

\- Interest on Mortgage

\- Cost Recovery

= Taxable Income

X Tax Rate %

= Tax Liability (savings)

Calculating CFAT

NOI

- Annual Debt Service

= Cash Flow Before Taxes

- Tax Liability (Savings)

= Cash Flow After Tax

Multiple Years Analysis

- If NOI is forecast for several years.
- Each year is forecasted on a separate APOD worksheet or on the;

"Cash Flow Analysis Worksheet"

Page 2

Calculating the Interest on a Mortgage

- The interest paid on a mortgage loan is deductible for tax purposes. The amount of interest includes interest from all the mortgages on the property.

- Refer to your operation manual of the HP calculator

Calculating Cost Recovery

- Once the basis has been allocated between the land and the improvements of the property, multiply the basis by the cost-recovery percentage.

  Basis of improvements x Cost-recovery percentage = Cost-recovery deduction

Cost-Recovery

1. Determine Property Type
2. Determine the class of life of improvements for the property
3. Apply the Straight-line cost-recovery method using the appropriate percentage

Property Type

- Residential
- Commercial

Class Life of Improvements

Property Type	Class Life
Residential	27.5 years
Commercial	39 years

See handout

Calculating Cost-Recovery Deductions (CRD)

A commercial property is acquired on Jan. 1st , held for 5 years and sold on Dec 31st.

The Basis Allocation of improvements =$200,000

What is the CRD for the year of Acquisition?

2.457% x $200,000 = $4,914

What is the CRD for the full year of ownership?

2.564% x $200,000 = $5,128

What is the CRD for the year of Disposition?

2.457% x $200,000 = $4,914

Cost Recovery Deduction (CRD)

- What is the total CRD?
- 2.457% x $200,000 = $4,914
- 2.564% x $200,000 = $5,128 x 3 = $15,384
- 2.457% x $200,000 = $4,914

Recaptured Depreciation $25,212

Tax on Recaptured Depreciation is 25%

$25,212 x 25% = $6,303

Recaptured Depreciation

- You are going to list a multi-family property that the owners have held for 15 years.
- The Basis Allocation (80%) for improvements is $1,000,000. (Purchase 1,250,000)
- What is the Recaptured Depreciation tax liability?

The Basis Allocation for Improvements is $1,000,000

- Acquisition year 3.485% x 1,000,000 = $34,850
- Held for 13 years of operation 3.636% x 1,000,000 = $36,360
- Disposition year 3.485% x 1,000,000 = $34,850

15 Years total Recaptured Cost Recovery is $542,380

Tax Liability on Sale of Property

*Tax rate is 25% = $135,595

*Cost recovery is taxed at ordinary income rates up to a maximum of 25%

Net Sales Proceeds to Owner

Cash Flows	Comments
Sales Price	
- Selling Expenses	Commissions and other closing costs
- Balance of Mortgage(s)	Remaining principal and penalties, if applicable
- Taxes	Combination of capital gains, cost recovery (depreciation) recapture, and personal
= **Net Sales Proceeds**	

Calculating Sales Proceeds after Tax

See

“Alternative Cash Sales Worksheet”

Handout

Capital Gain Tax

- Current Federal top marginal tax rate on long-term capital gains is 23.8%

  (20% plus 3.8% to fund Affordable Care Act)

California taxes long and short term capital gains as regular income.

California does not have a preferential tax rate for capital gains. All income that is taxable in California is taxable at the state's marginal rate based upon the tax brackets.

Currently, California's marginal rate is 1% to 12.3 percent.

Capital Gains Tax could be as high as 37.1%

Calculation of Sale Proceeds
Purchased for $1,250,000 Sold for $2,500,000

Calculation of Adjusted Basis

Basis at Acquisition is	$1,250,000
-Cost Recovery	$542,380
= Adjusted Basis	$707,620

Calculation of Capital Gain on Sale

Sales Price	$2,500,000
- cost of sale	$125,000
- Adjusted Basis	$707,620
= Gain or (loss)	$1,667,380
- Cost Recovery	$542,380
= Capital Gain From Appreciation	$1,125,000

Calculation of Sales Proceeds After Tax

- Sale Price $2,500,000
  - Cost of Sale (5%) $125,000
  - Mortgage Balance $650,000
  - = Sales Proceeds before Tax 1,725,000
  - -Tax on Recaptured Depreciation
    - $542,380 x 25% = $125,559
  - -Tax on Capital Gains
    - $1,125,000 x 34.1% = $383,625
  - = Sales Proceeds After Tax $1,215,816

Tax Liability on the Sale of this Property

$509,184

Questions?