7 DEADLY SINS OF COMMERCIAL REAL ESTATE INVESTING

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Over the years, we at Bittner Commercial Advisors have seen the many mistakes that new investors can make when starting their commercial real estate portfolio. Knowledge is your best defense when it comes to protecting yourself against making bad investments, so in an effort to help you understand and minimize the risks associated with commercial real estate investments, we've put together this list of the 7 Deadly Sins of Commercial Real Estate Investing.

1ST SIN: BEING OVER-LEVERAGED

For an investor in commercial real estate, it is common to underestimate the ramifications of over-leveraging your investments. If you're borrowing an excessive amount of money to finance your purchase, you'll need to factor in the amount of interest paid on the loan until you've reached the point where you can either generate a profit or sell the property. Borrowing excessive amounts of money can produce unfavorable results which will eventually catch up to you and make it difficult, if not impossible for you to maintain your payment schedule on the loan.

While there may be situations where highly leveraged deals happen, in order for them to be successful, they must be backed by a precise plan and adequate funding. A blend of investment planning coupled with appropriate deal structuring is required. You should assess your investment property in terms of the "break-even ratio", meaning operating expenses plus debt service (which is the amount of cash required over a given period in order to repay the interest and principal on the debt) divided by your net potential income. If your break-even ratio is higher than 80%, then your deal structure needs to be iron clad in order to succeed, and this is a dangerous approach.

It wasn't that many years ago that a property would easily appraise for the purchase price and some banks would allow you to borrow 85% to 90% of that figure based on the appraisal. The lender wouldn't usually have factored in a down-turn in the market, but instead would have reasonably expected the property to appreciate during the term of the loan so that the property could be easily refinanced when the loan matured.

Unfortunately, many loan documents contain a codicil which requires a certain loan-to-value ratio and provides the lender with the right to obtain a new appraisal every year. The downside of course is, the new appraisal may show that the value of the property has decreased, meaning a large principal payment is

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required in order to maintain this loan-to-value ratio. This is going to come straight from you, the investor.

With this in mind, it is still possible to use real estate leverage advantageously. The objective is to avoid making decisions without properly considering the areas of risk in the leverage and doing what you can to minimize risk.

2ND SIN: NOT UNDERSTANDING THE LOCAL MARKET, LACK OF MARKET KNOWLEDGE

Ignorance of local market conditions is one area where investors in commercial real estate investing can make serious mistakes.

There are two important areas to consider when evaluating a real estate investment; the market and the property. Of these, local market conditions outweigh all else. A great property in a bad market can end up being a big loser. Conversely, a poor property in a great market can end up being a real winner. So how will you know the difference?

Every market is different and a deal proposal or property type that's profitable in one market doesn't necessarily make it so elsewhere. Evaluating the demographic trends of population growth, income and employment in the local market will tell you where the greatest opportunity lies. It will reveal which property types are in demand and those which are surplus. These conditions can make or break you in your investment. Take the time to collect just a few local demographic statistics and property performance basics, so you can come out on top. Many cities and counties have an economic development authority or similar agency that collects this information and makes it readily available to the public. You can also find much of this data through the U.S Census Bureau at http://www.census.gov/.

A good measure of whether or not to invest in a property is simply this; if the property you're considering is an office building, then ask yourself if you would want your own company to have an office in this building. If the answer is no, then this could be an indicator that you should avoid this particular investment. If the answer is yes, then identify the particular reasons for this. What is it about the building that makes you want to have an office there? Is it the location? Is there easy access? Is the general appearance positive? Is there plenty of parking? Are there any tenants in the building that use more than their proportionate share of parking spaces? These are some of the questions that any prospective tenants will be asking when considering whether or not to lease from you, so it's important that you view the property as if you're the one who will be leasing it.

Since it's not always possible or practical to personally visit each potential property, many realtors or property consultants throughout the country are in a position to provide you with additional information regarding the demographics of the area and connect you with sources or industries that can provide further information on projected job growth, major employers in the area and average household income information. Once you learn your market, it will guide you on how, when and where to invest your money.

3RD SIN: FAILING TO UNDERSTAND AND LIMIT THE RISKS OF INVESTMENT

It's extremely important that you review and understand the risk factors as they relate to this type of investment. As an example, the risks associated with investing in property designed to meet the needs of a few tenants is completely different than those associated with property designed for 10 to 15 tenants. Evaluation and management of risk are major factors of consideration in any successful real estate investment plan. It's important to be aware that different risks may develop in many different avenues throughout the various stages of the investment process.

Over the past decade, it's become evident that risk management is not as big of an issue during periods of high returns. As interest rates and property cap rates fell and escalating numbers of real estate transactions appeared to indicate an end to worries about liquidity, institutional real estate investment underwent a noteworthy shift in focus, moving away from traditional, balanced investments with no or low leverage properties to higher leverage and riskier value-added opportunistic markets. The fundamentals of real estate were something that only the most cautious investors considered, and considering the current economic climate, you'd be well advised to follow suit.

The importance of understanding where negative issues arise cannot be understated. The more you understand the nature and source of risk within commercial real estate, the more you can anticipate and take appropriate measures to control them.

There are a number of areas of concern for the investor of commercial real estate, particularly with recent economic uncertainty and the subsequent impact of the credit crunch. There are many ways that you can reduce your risk if you take the time to anticipate, monitor and manage the risk within your real estate portfolio. Some of these risk reduction strategies include:

- Take time in review, seeking properties that are currently renting below market value. With the opportunity to increase rents, the risk is automatically reduced due to increased cash flow.

- Negotiate favorable financing. Lower interest rates will provide greater cash flow reducing leverage risk.

- Reducing leverage through the use of large equity interests can pay greater dividends.

- Selection of properties that you can rehabilitate to some degree to incur the benefit of immediate appreciation and increased rental potential. You can use this increase in appreciation, increased equity, to finance other investments or to reduce debt service.

- Take time to shop for value. It may take more time to find a property that is currently below market, but the result will be immediate equity. You'll also have reduced the risk that may present itself should the market rent value drop, or if you encounter some other unforeseen financial problem.

- Study foreclosure laws and sales, as foreclosures can be a potential source of inexpensive property. When choosing this route, it's important that you understand the ramifications of foreclosure techniques to avoid getting caught with an unexpected condition to a sale.

- Monitor the current interest rates and market rates frequently since they're one of the best indicators of real estate prices. Learn to recognize the signs of a market upturn that make it a good time to sell or a downturn that makes it a good time to buy. Understanding the paradox of the local real estate market can prevent you from making costly purchase mistakes.

- Examine each property you plan to buy and be critical. Inspect documents and perform a thorough title search to ensure that there are no existing liens or additional debt against the property. Avoid being caught by surprise with unexpected expenses by having a thorough inspection of every property, preferably by reputable and qualified engineers.

- Perform credit and reference checks on your renters if you're leasing or renting the property. Check court records, call previous landlords, personal and job references. History remains one of the best barometers of a person's ability to pay leasing obligations in a timely manner.

- Research the several possibilities of the ownership structure including the possibility of a limited liability company, particularly if you intend to hold properties over the long term as rental units. Investigate the formation of a limited liability company (a Corporation or a Limited Liability Limited Partnership).

- Don't rely on high levels of appreciation. Don't make the mistake of looking at past history, whether current or not, and assume that the future will produce the same results. Even if the property has been consistently appreciating at a rate of 6% or better for a number of years, expecting this rate to continue is extremely dangerous. It can result in you overpaying for the property as you may be inclined to speculate that you'll make it up eventually with increased appreciation values when it comes time to sell. If this doesn't happen you'll end up suffering a loss or worse, being stuck with the property.

- Don't' set yourself up with high loan payments. It may seem like a great investment to procure a property with a very small down payment, especially if you're looking at the numbers and seeing a high rate of return on your low cash investment. Realistically, this creates a problem, as higher leverage equals higher payments, and should the market soften, or you experience higher vacancy or credit losses than expected, you may find yourself unable to maintain these higher mortgage payments.

- Don't let the availability of good financing result in a careless purchase decision. Just because you can get a property with very little money down doesn't necessarily make it a good investment. Investigate the value of the property as it relates to current market trends. If the property is overpriced, the appreciation will be minimal at best or worse, non-existent. The property may even depreciate, and if the market declines for an extended length of time, you'll risk having to sell it at a loss or, become of market conditions, be unable to sell.

- Remember that cash flow trumps all else. If there's just one piece of advice that you take from this list, then this is it. Mistakes made in one or more areas in this list can be overcome if you have excellent cash flow. If you're realizing a nice cash return to your wallet each month after you've calculated rental income less your mortgage costs and expenses, then the problem of whether your property appreciated in any given year isn't going to be as significant of an issue.

4TH SIN: FAILING TO LOOK AT MORE THAN JUST THE ROI (RETURN ON INVESTMENT), OR RETURNS ON THE PROPERTY

We have clients frequently that bring in several investment opportunities for review and advice and some automatically lean toward the project with the highest ROI without a closer inspection of other factors.

Since the four ways to earn money in real estate are cash flow, appreciation, equity growth and tax benefits, looking at just the potential return is a mistake you can't afford to make. Investors often focus entirely on ROI, though ROE (return on equity) provides a better indication of wealth making and the use of tax benefits.

To maximize cash flow, you can create ways to decrease expenses and/or increase revenue. To manage the expense side, you can look at maintenance costs, management fees and other expenses and implement ways to reduce these expenses. With regard to the revenue side, you can explore whether the lease rate can be increased, what can be done to decrease vacancy rates, whether additional leasable space can be added and whether additional streams of income can be added from external sources like cell phone tower leases, leasing of parking or other possible property leases.

In the area of appreciation, since you have no control over the general market, it's helpful to review those areas of appreciation which can be controlled. As an example, if the property includes some vacant land or if the parking ratio is significantly higher than needed, you may explore the possibility of adding other facilities such as a bank drive-thru, pad site, additional parking, or some other development. Furthermore, if it's possible to increase rental rates when tenants move out, this is another area in your control which will contribute to the appreciation of the property.

When determining potential equity growth, it's best to review your financing and determine if the mortgage payment is just paying the interest or if it includes principal plus interest. Then determine what amortization schedule is being used to calculate the payments. Equity growth is best built by making principal and interest payments on the mortgage over a shorter amortization period of say 10 to 15 years, although for cash flow purposes, a 25 to 30 year amortization may be a consideration as well.

Investors will not only receive predictable tax benefits based upon physical assets, but mortgage payments as well. On the opposite end of the scale, investors may also receive what is termed "phantom income". What this means is that projects can generate "phantom income" when they create taxable income for investors without generating cash flow, usually because all or part of the operating income is used to make principal payments. Unlike most interest payments, these principal payments are not tax deductible. Consequently, an investor will owe tax on this income even though no actual cash has been received. It is important that you know if "phantom income" is likely to be received in a specific project and what plans are in place to diminish this issue for the investors. This is a complex issue that makes it all the more important to engage a competent attorney well versed in commercial real estate.

5TH SIN: FAILING TO HIRE THE RIGHT PROFESSIONALS

As you've probably ascertained from the preceding paragraphs, there are many areas of concern that require the skill of a seasoned professional to ensure that your investment is as secure as possible. The professionals that you're going to need during the process will include building inspectors, engineers, attorneys, bankers, an insurance agent, and a management company to name a few. The type of building or development that you're considering will determine the extent of professionals that you'll need to assist you in making the right decisions. Hiring any professional without performing certain background checks can result in the payment of more money than necessary or worse, could make you liable for the errors of under qualified advisors.

Mistakes can be avoided by working with an attorney who clearly understands the legal issues that investors face when investing in commercial real estate. Taking the time to find an attorney who understands these issues can help minimize the risks associated with investing and is possibly the best investment you'll ever make. They'll be able to ensure that you file the proper forms, assist in conducting land title searches and may also be able to refer you to other professionals in the field, such as an insurance agent, engineer or property inspector.

In the area of an insurance agent, it's equally important that you find one who is experienced, knowledgeable, and understands the various risks associated with building ownership. Commercial insurance is tricky and you'll need a seasoned professional to explain what your options are and advise you regarding essential coverage. Failing to put the proper coverage in place can result in financial loss.

Utilizing qualified engineers – soil, structural, electrical, mechanical and experienced property inspectors can also help to minimize your risk, as they'll be able to determine potential problems that have to do with areas in the building structure that may not be evident without a close and detailed inspection. They'll also be able to advise you of upcoming repairs or updating of essential services, like wiring, plumbing, heating or upgrades that by code may be necessary.

6TH SIN: CHOOSING EXOTIC INVESTMENTS INSTEAD OF FOCUSING ON PRIMARY NEEDS

The glamour or status of owning property which is exotic or specialized may seem attractive at first and perhaps even prestigious, but it's important to realize that the downside of choosing exotic investments is that by their very nature, these investments are only going to attract a certain type of tenant due to the fact that the property is unique. Having an exotic property makes it difficult to build equity if you can't find the right type of tenant to occupy the building, and this in turn may end up causing vacancies that may make it difficult to maintain your mortgage payments. Investing in an exotic property will also make it more difficult to sell, as there will only be a certain class of buyers who are interested in the property. You're much better off to focus on properties that hold greater appeal to a larger number of people. As a result you will be less likely to have the property vacancies.

7TH SIN: NOT SELECTING A QUALITY PROPERTY MANAGEMENT COMPANY TO MANAGE REAL ESTATE INVESTMENT PROPERTY

An experienced property management / leasing firm will pay for themselves, as they have procedures and checklists in place that will help mitigate losses including rigid tenant screening processes and scheduled maintenance checks that will anticipate potential problems before they become an expensive issue. A competent firm has access to a database of clients and will be able to match your property with the appropriate tenant.

Spend time researching the property management / leasing company that you're considering. Ask them for some references or testimonials from other clients and if at all possible, speak with some of their other clients directly. In the hands of a good management / leasing firm, concerns over property ownership will be greatly relieved. Referral is one of the best sources of good business.

STAY SIN FREE!

We would like to reduce your exposure to these sins (or other concerns) by supporting you to make wise Commercial Real Estate Investments that are worry free and grow your assets. Please call Michael Bittner at Bittner Commercial Advisors to answer any of your questions.

HERE'S HOW TO GET STARTED

Please call Michael Bittner at Bittner Commercial Advisors at **303-442-6565** if we can answer any of your questions.

Or send me an email at **michael@bittnercom.com** with a question or to schedule an appointment

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"I would not hesitate to recommend Bittner Commercial Advisors to anyone that is looking for a commercial real estate broker that is knowledgeable, ethical, and professional to help guide them in their investments. " **Steve Tebo, owner of Tebo Development**

