

# Minimizing the Risks of Purchasing Commercial Real Estate

By Larry N. Murnane\*

Almost everyone is familiar with the three cardinal rules of real estate investment: "Location, Location and Location." Although property well situated certainly has fewer risks, an investor must carefully consider other ways to minimize the risks involved in the purchase of commercial real estate.

## **Focusing the Search**

Commercial real estate includes apartment, office, industrial, retail and other income properties. Each of these property types has different advantages and disadvantages, risks and opportunities. Most commercial real estate brokers specialize in a particular property type for a particular area, because it is difficult to stay abreast of the issues and trends in multiple markets and industries. Similarly, most investors lack the time or resources to develop and maintain a thorough understanding of many different types of properties in different areas. Therefore, after conducting some basic research about the current and future strengths and weaknesses of different types of properties for a particular area, using local real estate forecasters, brokerage companies, universities and other sources, it would be wise to focus on a particular type of property in order to develop some expertise as an investor.

## **Analyzing Financial Information**

Although "comparable sales" and "replacement cost" data provide some help in assessing value, most commercial real estate investment property is appraised on the capitalization of income it produces. Generally, this method of valuation is based on the present value of future cash flows, and assumes no growth in the future cash flows. This rate is typically referred to in the industry as the "cap rate." The cap rate can be described as the investor's required rate of return based upon the perceived level of risk being accepted. It includes both a return on invested principal and a return of principal as the investment is amortized over time. For example, a 9% cap rate might include a 6% return on investment, and a 3% return of investment. The choice of the appropriate cap rate is critical to the correct estimate of value, as even small differences in cap rates can lead to large changes in market value.

The purchaser desires a higher cap rate, and thus a better return on and of his or her investment, and the seller desires a lower cap rate, and thus a higher sale price. Although the price (and cap rate) is negotiable, in recent years the cap rates on commercial properties have been coming down considerably, primarily because low interest rates and poor investment alternatives have caused a significant increase in the demand for investment properties, thereby driving up the prices.

Different types of commercial properties, and different locations, may also have different cap rates. For example, apartment buildings may have lower cap rates (e.g., 5%) in areas where tenant demand for apartments is high, and strip shopping centers may have higher cap rates (e.g., 8%) in areas where retail space is plentiful. Retail properties with more national or regional credit tenants like Starbucks and Jack in the Box are generally

lower risk investments and thus warrant lower cap rates than centers consisting primarily of less stable or secure “mom & pop” stores. Therefore, cap rates are generally determined by comparisons with other similar properties recently sold. Most active commercial real estate brokers in a particular area can tell a potential investor what the market range of cap rates is for particular types of properties in that area.

Because the cap rate calculation is dependent upon a property’s income and expenses, there are many variables that can significantly impact these analyses. For example, if net income from the property decreases due to more tenant vacancies or increased expenses, then the effective cap rate will diminish as well.

In performing any economic analysis, a potential investor should not take the seller’s income and expense figures and assumptions at face value, as closer scrutiny often reveals that the actual cap rate is lower than represented. For example, the seller’s stated rental income may not be based upon current actual figures, but on future projected figures (after rent increases), or it may fail to include a reasonable vacancy factor, a post-sale reassessment of property taxes that will not be reimbursed by tenants under gross rent leases, a reasonable sum for property management fees, potential percentage or abated rents, or other income and expenses. Thus, the investor should always look for hidden risks (and opportunities) by conducting his own investigation and analysis, which will require a careful review of the rent roll, operating statements, leases, loan documents, and maintenance records.

## **Contracting**

Assuming the property can be purchased at a reasonable price, the next step is to make a formal written offer to purchase, usually through a broker, with the assistance of a lawyer. It should be noted that contract forms vary widely, and there is not much “standard” about them, despite the title or the source of the form. Further, most brokers are not particularly skilled in the art of drafting contracts and protecting buyers. The contract will govern the parties’ rights, obligations and remedies throughout the transaction, and therefore, the importance of it should not be underestimated. Purchasers of commercial property generally have fewer legal protections than homebuyers, as the parties are presumed to have relatively equal bargaining power and sophistication in commerce. Therefore, a prudent buyer should usually have an experienced real estate lawyer review the contract before submitting it for the seller’s consideration.

Ideally, the contract should include some basic representations and warranties by the seller concerning the condition of the property, as well as some buyer contingencies for such things as approval of title, leases, physical inspections, and financing. At a minimum, the contract should provide for a reasonable “due diligence” period (generally between 15-45 days), during which the purchaser can have the property physically inspected, review the leases, operating and financial statements, rent roll, title report, service contracts and any environmental reports, as well as consult with a loan broker or lender to verify available financing. If this investigation reveals anything of concern during the due diligence period, the buyer should then have the ability to either terminate the contract and receive a full refund of his or her deposit, or renegotiate for additional time, a price reduction, seller repairs, or other concessions.

## **Inspecting and Investigating**

Unless the buyer has some construction expertise, he or she would be well advised to hire a competent inspector. The physical inspection should include the roof, mechanical and electrical systems, as well as the structural integrity of the buildings and the need for any Americans With Disabilities Act compliance work (e.g., parking lot spaces, striping, signage, and ramps) or deferred maintenance work in common areas, such as painting, resurfacing the parking lot, and replacing heating, venting and air conditioning units that are not the responsibility of tenants under the leases. If the property has any potential history of contamination with hazardous materials (e.g., asbestos floor tiles or ceilings, on-site dry cleaners, lead paint, petroleum products from nearby gas stations, pesticides, solvents, or chemicals stored, used or disposed of on or near the property), the buyer should conduct an appropriate environmental assessment, which would include a Phase I report, and possibly a Phase II investigation. This assessment is necessary to protect the buyer from potential cleanup liability after the purchase.

Other basic due diligence tasks should include: (1) early contact with an experienced commercial loan broker or lender for loan possibilities and application, as it generally takes at least 30 days to get formal loan approval; (2) a legal review of (i) the preliminary title report for potentially problematic easements, liens or encumbrances, (ii) the loan documents for things like recourse obligations, lock-out periods and prepayment penalties, and (iii) the leases to confirm that they include appropriate landlord remedies and protections; (3) review of tenant estoppel certificates for consistency with the rent roll and leases; (4) review of service contracts for the maintenance and management of the property; (5) investigation with the city's development planning department concerning any proposed development in the area that may impact the property (e.g., street widening, competing stores, rezoning, etc.); and (6) some casual discussions with particular tenants about how well their businesses are doing, and any future plans they might have to renew their leases or to expand, close or relocate. Although the broker should help with some of the due diligence investigation, ultimately the buyer should assume responsibility.

## **Limiting Personal Liability**

Prior to closing escrow, and depending upon various other considerations that may involve other investors, potential tax consequences, and the lender's requirements, the buyer should generally form a limited liability company or other asset protection entity (not a corporation) to hold title and shield the buyer from personal liability for such things as injuries on the property, hazardous materials on the property, and contracts like the loan agreement, leases, and service agreements for the property. Some lenders may still require the buyer to personally guaranty the loan if the buyer uses an entity to take title, but the added liability protection afforded by the entity is almost always worth the extra paperwork and costs. In any event, the buyer should definitely consult with an experienced insurance broker about obtaining adequate coverage for appropriate risks, consistent with the lender's requirements, and should make sure that policy covers the correct parties upon the closing.

## **Monitoring the Operation**

The buyer should take steps to insure a smooth transition upon the close of escrow and change of ownership by making sure that utilities will be transferred without interruption, all necessary insurance is in place, a property manager has been hired, and all keys and other items needed for operation of the property have been transferred. The buyer and the property manager should promptly visit with each tenant to introduce themselves and to deliver written notice of where to send future rent checks and who to contact with any questions or problems. By promptly addressing any significant deferred maintenance issues such as a leaky roof, the new owner may also engender some good will with the tenants and avoid some future headaches.

Although most commercial properties are professionally managed for the owners, particularly if the leases obligate the tenants to pay for this cost, an owner would still be well advised to periodically inspect his or her property to see how well it is being maintained and to keep abreast of any significant tenant concerns. The owner should also carefully review the monthly financial reports and cash distributions from the property manager for accuracy, as common mistakes or discrepancies include such things as ambiguous expenses and failure to bill tenants for scheduled rent increases or common area maintenance charges. A watchful owner can also make sure that the manager aggressively works to fill tenant vacancies as they occur, in order to maximize the owner's return on investment and to benefit the remaining tenants with more customer traffic.

In short, property managers typically handle numerous properties at any given time and, therefore, do not always give any one property the attention it requires. Therefore, it pays for an owner to monitor the manager and the property.

## **An Ounce of Prevention**

As illustrated above, the process of identifying, evaluating, purchasing and owning commercial real estate is not overly complicated, but a buyer should certainly minimize the risks involved by consulting with a knowledgeable and experienced broker and real estate attorney.

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