Wealth Opportunities in Commercial Real Estate

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MANAGEMENT, FINANCING, AND MARKETING OF INVESTMENT PROPERTIES

Gary Grabel

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This book is dedicated to
Mark Hamermesh and Aric Browne:
Without their efforts and drive,
this book would not have been possible.
By taking on their shoulders
many of the day-to-day problems and concerns
associated with running a real estate company,
which owns and operates
several million square feet of shopping centers,
medical office buildings, and apartment units,
they made it possible for the author
to focus on writing these pages.

This book is also dedicated to my wife, Rosanna,
who has put up with my quirks
and idiosyncrasies for over 30 years,
especially when I wanted to work
on this book rather than spend time
in some more enjoyable pastime.

Contents

List of Abbreviations

Act	The Securities Act of 1933
Cap X	Capital Expenditures
CFBT	Cash Flow before Taxes
Code	Internal Revenue Code
DCR	Debt Coverage Ratio
FMV	Fair Market Value
IRR	Internal Rate of Return
LLC	Limited Liability Company
LP	Limited Partnership
LTV	Loan to Value
NOI	Net Operating Income
NPV	Net Present Value
NRSF	Net Rentable Square Foot
PSA	Purchase and Sale Agreement
PSF	Per Square Foot
PV	Present Value
ROA	Return on Assets
ROE	Return on Equity
SEC	Securities and Exchange Commission
1031	Section 1031 of the Internal Revenue Code

Introduction

This book is the result of many people asking me "How can I buy income-producing property? How can I get into the game?" The underlying purpose in this book is to set forth a practical step-by-step process on how to acquire commercial real estate and through a real estate vehicle build significant wealth over time. The discussion runs from sourcing a real estate transaction to analyzing the deal to acquiring the sticks and stones to managing real property to improving its value and finally to taking steps to preserve the value created and hopefully passing a good part of it on to your children and your children's children.

Unfortunately, there is a wealth of books on real estate that in essence say, "You can't lose. Go out and buy real estate!" You can lose in real estate just as in any other business. I usually buy from someone who has "lost"; that is, the value of the property and their equity therein has decreased from the date of their purchase. It is therefore essential to understand the fundamentals of the real estate game, including how to evaluate a real estate transaction and how to create value before you take the plunge and start to buy.

The text is geared to the novice who wants to understand commercial real estate as well as the seasoned professional who desires to enhance his knowledge. One of the key teaching tools revolves around setting forth a hypothetical that starts with the basics and then continually builds on the fact pattern to demonstrate real estate principles and theory and enhance the project analysis.

Although the concepts herein can be applied to all types of real estate, the focus is directed toward a project size of 30,000 to 150,000 square feet as is typically found in a neighborhood shopping center rather than a huge office building or a complex of over 500,000 square feet that might be found in a downtown high rise tower or a regional shopping mall.

Many individuals in the real estate field specialize in one area and therefore have a difficult time understanding and learning practical knowledge about other areas of real estate ownership. This text attempts, to some extent, to fill this gap. By covering a broad range of real estate topics from basic terminology and analysis to leasing, financing, marketing, management, structuring a partnership, real estate tax consequences, buying and selling real property, and the steps to take to preserve wealth, hopefully the reader can focus on the areas of his or her deficiencies.

Although I am an attorney by background, *Wealth Opportunities in Commercial Real Estate* is not intended as a legal treatise; rather, its focus is directed to the practical, day-to-day business aspects of acquiring, owning, and managing commercial real estate. I strongly recommend consulting with an attorney, accountant, and other professionals when entering into a lease, a purchase and sale agreement, or when any technical issues arise.

A thank you to ARGUS Software, who graciously supplied their proprietary software for use in connection with the Cash Flow spreadsheets for this book. These, among other Appendices, can be found at the companion website, www.wiley.com/go/wealthopportunities. This supplementary material will surely provide you with a wealth of examples to review as you read through the book.

Wealth Opportunities in Commercial Real Estate

Wealth Opportunities in Commercial Real Estate: Management, Financing, and Marketing of Investment Properties
By Gary Grabel

CHAPTER 1

An Overview of the Problem, a Solution, and a Game Plan

The Problem

If you are like 99 percent of the people on this planet, you have a problem: Namely, you must work to make money to eat and live.

It is a vicious cycle. You get up at 7:00 A.M., get out the door by 8:00 A.M., arrive at work at 9:00 A.M., push paper around all day, and leave at 5:00 or 6:00 P.M. You follow the same routine day after day. Your net pay is, say, $70,000 per year, you give 20 to 25 percent away to Uncle Sam, and your annual living expenses eat up the remaining money. The net result at the end of the year is no savings—zero, a goose egg, *nada.*

The next year you get a big promotion and an accompanying raise of 5 to 10 percent (if you are lucky). You have been waiting all year for this big raise. Your family has grown from husband and wife to husband, wife, and baby, and now you are expecting your second child. All year you have been putting off buying the new, latest and greatest big-screen television system and the much-needed trip to Hawaii, not to mention replacing that overused, tired Acura with a new Mercedes. What do you do to satisfy these pent-up demands? How do you satisfy these desires that have driven you for the past couple of years? The answer is that you move out of that cramped 1,500- to 2,000-square-foot apartment into a "decent" 3,000- to 4,000-square-foot home with a real backyard, you buy on credit the big screen "deal," you take the family on the long-delayed vacation to Hawaii, you lease a new car, and so on. The point is that you find a way to spend your increased wages and, with inflation, you are back in the same breakeven position you were in when you started a year ago, or even worse, since you have significantly increased your debt position.

We have identified The Problem, the cycle: You are working to meet the necessities of life including paying your silent partners (the state and federal governments), and you are consuming any remaining cash to satisfy pent-up demands for goods and services.

The Solution

The question becomes, how do you break this cycle? What is The Solution?

There is no single right answer to this question. There are several solutions to The Problem. The best solution I have found lies within the realm of real estate. You buy a *value-added property,* by which I mean a property that through your focused efforts can be improved and enhanced so it is worth significantly more after your efforts than when you acquired the asset. Your efforts usually revolve around increasing occupancy, but it can be a myriad of other tasks such as improving the overall appeal of the property through structural or cosmetic changes or changing the tenants by bringing in more viable businesses or more synergistic users, and so forth. Let's call your first acquisition "Property Number 1." You then:

- Acquire Property Number 1.
- Lease up or otherwise improve Property Number 1.
- Refinance Property Number 1, pulling out monies in excess of the existing debt at least equal to the original equity invested.
- Invest the refinance proceeds into another property (Property Number 2).
- Continue to manage Property Number 1, reaping the benefit of the positive cash flow and earning a management fee.
- Lease up or otherwise improve Property Number 2.
- Refinance Property Number 2, pulling out monies in excess of the existing debt at least equal to the original equity invested.

- Invest the refinance proceeds into another property (Property Number 3).
- Continue to manage Properties Number 1 and Number 2, reaping the benefit of their positive cash flow and earning a management fee.
- Lease up or otherwise improve Property Number 3, and so forth.

Four Key Elements in the Solution

Why does this Solution break the cycle? Because of four key elements.

Key Element Number 1

First, you are no longer limited in your earning potential by your salary or by your professional endeavors; rather, you have become an investor. You have converted active income into passive income. When you sleep at night, when you go on a vacation, you continue to make money. Your assets appreciate (hopefully) in value over time and in the normal course of events each month you build equity by paying down the principal on your mortgage. A mortgage usually contains an amortization feature; therefore a portion of each payment reduces the outstanding loan balance and consequently increases your equity, everything else being unchanged.

Usually the individual caught in the cycle is employed, earning a good living, but his livelihood is based upon his own individual capacity to do a job and get paid for that work. The basis of The Solution is a move to a business model that has the capacity to create wealth, not only from individual effort, but also based upon market forces. If you correctly analyze the market and correctly perceive that *capitalization rates* or *cap rates* (the rate of return an investor requires to induce him to purchase a property for all cash without regard to financing) will likely fall from 10 percent to 7 percent, then, even if no other change occurs in the real property investment, your property value will increase significantly. Market forces have resulted in a value shift. Similarly, if you purchase a property in a growth community and the resulting population growth fuels an increased demand for goods and services, that results in an upward push in rents, which translates into a higher net operating income, and therefore an increased property value. Again, market forces have driven value upward.

It is important to understand the difference between *active income* and *passive income*.

Active income is income earned through services rendered or goods sold. What is meant by "services rendered"? The concept of services for hire includes the broad area that comprises everything from practicing medicine to providing janitorial services. "Goods sold" refers to any product sold, from real estate to pencils.

The more difficult and more esoteric question is: What is *passive income*? Simply put, what I mean by passive income is income earned *not* by rendering services or selling goods. This does not mean that you do not have to work to make passive income, but rather that your work is of a different nature. Owning stock in a company, or for that matter owning the company itself, is an example of creating passive income. The employees of the company perform the functions that generate profits and dividends for its shareholders. The point is that the owner of the stock did not actually have to perform "labor" to receive the dividends paid. Similarly, the owner of real estate earns profits from rents, yet he does not actually provide services to the public or sell goods to the public. The delivery of services or the sale of goods is the function of his underlying tenants.

I want to emphasize once more that earning passive income does not mean that you do not have to work. The stockowner must spend time researching or hiring someone to research profitable stock selections and the monitoring thereof. Also, the real estate entrepreneur must operate his properties or employ a property manager. It can be demanding to invest in the stock market or to own and manage real estate. The individual who establishes a profitable stock portfolio did his research or had research done on his behalf. He verified that the company whose stock was purchased has a good management team, reasonable liquidity to survive tough times, growing sales, and net profits. He might also have an insight into the industry trends relating to the applicable field. Similarly, owning and managing real estate is a business. It requires insight to know when to buy and when to sell, as well as where to buy and where not to buy. Once a property is acquired, someone must invoice the tenants, collect the rents, coordinate vendors, and deliver services to tenants to ensure efficient operation of the asset. Someone must lease-up vacant space and make strategic decisions ranging from tenant mix to the overall look of the property to whether or not to expand the project by building-out additional leasable square footage to whether to refinance or sell. If a decision is made to refinance or sell, an individual must decide under what terms to borrow or under what terms to sell.

Notwithstanding the above, being a stock investor or a real estate owner is, in general, more akin to managing an investment as opposed to running an operating business that might require hundreds of employees. Yes, to be successful you need insight into what to buy, but you can to a large extent outsource the selection of the asset, as well as its care and feeding thereafter. That said, a good full-time investor will, at a minimum, manage his managers, and a superior full-time investor will take an active role in his business even though his business is not, in general, a labor-intensive one.

Rule Number 1

Convert active income into passive income.

Key Element Number 2

The second crucial step in breaking the cycle is to create a cash-flow model that generates consistent monthly dollars that can be built upon so that within a certain time frame the monthly cash flow equals $2X.

In other words, relating this step back to The Solution, if, for example, Property Number 1 generates $10,000 per month in revenue, then acquiring and leasing-up Property Number 2, which generates $10,000 per month in revenue, results in a cumulative cash flow of $20,000 per month. Acquiring and working Property Number 3 results in another $10,000 per month in net cash flow for a cumulative $30,000 per month.

Obviously, stating the objective is quite a lot easier than locating a property and executing a game plan that will generate a significant positive cash flow. However, the important point is that, yes, it is important to build value, but it is also important to build monthly cash flow.

Rule Number 2

Create a monthly cash flow model and build upon that model.

Key Element Number 3

The third key element in breaking the cycle is knowing that size matters. It is simple math. If your profit is $50,000 per year on Property Number 1 and Property Number 2 is 10 times as large as Property Number 1 then, everything else being equal, Property Number 2 will generate $500,000 in profits per year! The potential profit is ten times that of the smaller project, but usually not ten times the amount of work.

I have also found that there is more "wiggle room" in larger transactions. When you are working with a small real-estate project, the potential options to make money typically are not as readily available when compared to a much larger investment. For example, in a large real property project there might be excess land, which might allow you to build additional improvements or increase the size of the existing structures. Parking and its relationship to the net rentable square feet of the project is crucial when analyzing the allowable square-foot size of a development. The parking requirements for medical office projects typically require five parking spaces for each one thousand square feet of office space. Consequently, if you have a 60,000-square-foot medical office building the required parking would be 300 spaces, that is, 60,000 divided by 1,000 equals 60 times 5 equals 300 spaces. If you in fact have 400 parking spaces, 100 "excess" spaces, you have ample parking to support an additional 20,000 square feet of improvements without having to add more parking. Assuming a parking ratio of five spaces per thousand square feet, the calculation is reflected in the following formula:

$$\frac{X(5)}{1{,}000} = 100 \text{ spaces}$$

"X" represents the amount of additional square footage you can build. To solve for "X" you would divide by 5 and multiply by 1,000.

$$\frac{X\,(5)1{,}000}{(5)1{,}000} = \frac{100(1{,}000)}{5}$$
$$X = 20(1{,}000) = 20{,}000$$

In a recent project in which I was involved, I had excess parking and so was able to expand the project size by enclosing balconies. On other projects the excess parking allowed me to build an additional structure on the medical building campus and, in the case of a retail development, on an "out-pad" (a parcel removed from the in-line retail shops). Alternatively, you could possibly lease any extra parking spaces to an outside user, such as a local restaurant or a car dealer.

Rule Number 3

Size matters. If possible, work on large projects.

Key Element Number 4

Lastly, in our capitalist society the trick is to be able to expand your real estate portfolio so that you can create an infrastructure that allows you to employ individuals still trapped in the cycle. Going back to the model, The Solution builds in growth. You buy Property Number 1, lease it up or otherwise create value, refinance it, buy Property Number 2, continue to manage Property Number 1, reaping the benefits of the positive cash flow and the management fee, lease up or otherwise create value in Property Number 2, refinance it, buy Property Number 3, continue to manage Properties Number 1 and Number 2, reaping the benefits of their positive cash flow and management fees, and so on. Growth is implicit in the model. You acquire additional properties and manage the new properties acquired as well as the previously acquired properties. It is therefore important to hire personnel who can competently run the properties once you acquire them. Delegation is crucial. How can you search for Property Number 4 if you have to focus all of your energy on managing Properties 1, 2, and 3?

In the long run, my philosophy and opinion is that in order to keep valuable employees/partners you must involve them in the business so that they have the opportunity to participate in the company's growth and success and thereby also break out of the cycle.

Rule Number 4

Create an economic environment that allows your employees, your team, to become invested in the future success of your company and allows them the means to be able to eventually break out of the cycle.

Concerns about the Solution

Keep in mind that no solution is a panacea. If you find yourself at a cocktail party and hear someone saying, “Buy real estate, you can’t lose!” know that they are not telling the whole story, or that they have had one too many martinis. *Caveat emptor.* Care must be taken when purchasing real property. Buying real estate does not guarantee a profit. You can also lose money! If you purchase properties that have problems or that develop issues, your result may be a negative cash flow. Real property value is based upon rents derived from the project. If major tenants do not renew their leases or if they breach their leases and vacate the property, the resulting cash-flow disruption usually translates into problems. You can end up feeding the property instead of reaping a positive cash flow. What is more, purchasing marginal properties with marginal returns does not result in wealth creation. It results in marginal returns or even in losses if something goes wrong, which it often does. In part, proper due diligence procedures and follow-up on your part will avoid these results, but ultimately it is your execution of a viable game plan and your vision and foresight that will make the difference between winning or losing.

There is also the question of how to get started. When discussing The Solution with individuals seeking to escape the earn-pay tax-spend cycle, the first and foremost comment I often hear is: “I can’t achieve this. I can’t afford the down payment to buy this.” I believe a lack of capital can be overcome. However, I want to make it clear that I am not an advocate of the “nothing down” purchase. First of all, usually there is something wrong with these types of transactions: too much unperceived risk, undisclosed problems, and so forth. Second, even if this can be accomplished, it places too much burden on cash flow and greatly increases your risk of default.

The way to overcome a lack of capital is through firsthand knowledge and experience. The individual who applies himself through study and through practical work experience in the real estate field should be able to partner with a capital source. In order to be successful in this approach you should, ideally, move beyond obtaining your college degree in real estate, beyond securing your real estate license, and beyond accumulating professional experience in a real estate field such as real estate investment sales, financing, or appraisals. What is most useful is to specialize in a specific product type in a specific local geographic area or areas. By focusing on a specific product in a specific area, you gain the market knowledge you need to be able to identify undervalued projects as well as to develop a strategy whereby you may execute and create value through management skills and contacts you have nurtured. The key is to gain the know-how and the knowledge to understand whether one transaction or another will result in a superior return and to know how to move an investment from a marginally performing property to a phenomenally performing asset.

Acquiring the Skill Set to End the Cycle

Ideally, in order to break out of the cycle, you should focus on five areas. First, you need a basic understanding of accounting. Accounting is the language of business. This is not to suggest that you have to become a CPA, but an understanding that goes beyond college courses, a practical understanding, is helpful. Second, it is necessary to have an understanding of legal principles. Contract real estate law is a recurring element in real estate transactions. A lease, which is a binding legal contract between the landlord and the tenant, governs the economics of a project. Third, it is crucial to have a practical knowledge of real estate financing, since financing is usually 50 to 80 percent of a real estate transaction. Next, it is essential to understand the basic concepts of the field on which you are focusing. In real estate, it is important to have a grasp of basic real estate principles, for example, knowing the difference between a fee simple estate and a leasehold estate. It is necessary to be able to answer relevant questions such as, *If the property to be purchased is a leasehold, what provisions must be in the lease to make it mortgageable?* Lastly, you must know how to structure a transaction. This knowledge usually comes from a number of sources: experience, discussions with senior people in the field who have put transactions together, and studying Chapter 11 in this text!

A Game Plan to Achieve the Solution

In subsequent chapters of this book, I discuss The Solution in greater depth, but at this point it is important to understand the basic principles underlying The Solution:

- Converting active income into passive income.
- Establishing a monthly cash flow model.
- Understanding that size matters.
- Understanding that an infrastructure, a team, should be created to capitalize on investment opportunities that arise.

I have identified The Problem and The Solution. The next logical question is: How do you achieve The Solution? I could discuss taking responsibility for one's actions, and having a positive attitude. I could offer case studies showing ordinary people accomplishing seemingly impossible tasks. These elements are important and discussing them can be motivational, but my approach is, I believe, less theoretical and "heady." It is more practical and down to earth.

The objective in the balance of this book is to create a framework to achieve The Solution.

I set forth an outline, which I call a business plan. I then identify concrete goals and actions items or "to dos" that, when fulfilled, will allow you, over time, to carry out your business plan. To some extent, your business plan and your goals may overlap and the goals may be incorporated into the business plan. The distinction is that although the business plan may, at times, be lofty, its goals and action items are always detailed and specific. I call this methodology of achieving The Solution "The Game Plan."

The Business Plan

One of the product types I have specialized in is medical office buildings. Part of my time is spent counseling my doctor tenants on how to run their businesses. Medical schools do not, but should, teach doctors how to run a small business. To be successful, solo practitioners must understand where their lead sources come from and how to solicit these leads. They must also understand contracting, collections, personnel issues, and more. These subjects are not part of the medical school curriculum.

The first question I ask a doctor when I sit down with him or her is: Do you have a written business plan? Invariably the answer is "no." It is a mistake not to have a written business plan, especially for doctors who are just starting out in their practice. Established doctors usually have solidified their referral sources. Doctors that are just starting their practice usually have not created a solid referral base. By committing the business plan to writing it can be more systematically and logically analyzed and therefore improved upon, so a plan of action can be more effectively implemented.

My number one objective in a business plan is to bring out issues so they can be reflected upon and so that creative methods of dealing with these issues may be identified. I attempt to think outside the box.

There is no set format for a business plan. I prefer a written narrative business plan rather than bullet points. I find that a narrative generates thought and analysis rather than cursory conclusions. Suggested topics to cover in a business plan may be found in books devoted to this subject or even on the Internet. My narrative business plan attempts to cover the following nine areas.

1. **A short summary of what the business is all about.** What are you trying to accomplish? This section summarizes the entire plan. For example: *Purchase 50 million square feet of neighborhood shopping centers nationwide under centralized common ownership and management and then take the venture public by forming a real estate investment trust.*
2. **A description of the business.** Where is the business to be based? What product or service is to be provided? Who are the target customers? What price range is the focus?
3. **The philosophical viewpoint of the business.** The fundamental core values go beyond making money. Of course, the objective in a for-profit business is to make money, but this part of the plan should focus on ethics and assist in creating an ethical guide for the company.
4. **An organizational guide.** An organizational guide covers legal structure, percentage ownership, the composition of the management team including the function of each member, compensation, and an organizational chart indicating who reports to whom. In the context of a real estate company, the structure of the property management team should be addressed and possible anticipated staffing needs might be covered.
5. **Product or service?** This section contains a detailed description of the product or service to be delivered. Again, in the real estate context, such issues as the company's acquisition

criteria including size, location, product type, number of tenants, vacancy factor, capitalization rate, internal rate of return over a 10-year period, and so forth, may be covered. Part of the plan should also cover existing owned product—for example, steps needed to enhance existing owned shopping centers might be covered.

6. **Marketing.** In the real estate context, this section should cover both the acquisition of new product as well as the lease-up of existing owned projects. Should your acquisition efforts be geared to working with brokers, direct advertisements, cold calls, or a combination of these methods? Should filling vacant space be done through working with outside brokers, internal staff, or a combination of these two approaches? Extensive thought and effort should be placed in this section since marketing is pivotal between sterling success and mediocre results. (Please refer to Chapter 10 for additional comments regarding designing a marketing program for the lease-up of a project.)
7. **Financial analysis.** How is the company doing overall? What does the income and expenses of each project look like? Annual budgets should be generated for each project with comparison columns to last year's results. This section might also cover funding needs for the company as well as possible sources of capital.
8. **Future strategies.** Strategies for expansion and issues surrounding growth might be covered in this portion of the business plan.
9. **Miscellaneous.** This is a general catch-all category of broad and specific company issues and matters not specifically covered above, such as ways to improve employee and organizational performance.

Goals

Regarding goals, I set annual goals and long-term goals, that is, things I want to accomplish within the year and objectives for five-plus years out. My personal system is to write up my goals mid-year in June or July and then revise, update, and finalize my goals late December through New Year's Day.

I feel it is important not to have a thousand goals. It is my belief that if you have too many goals, your energy is dissipated and you accomplish nothing. I attempt to limit my goals to 10, with an absolute maximum of 12.

After I have written and revised my goals I post them at my bedside. I read them when I go to bed at night and again when I wake up in the morning. Consequently, they are constantly in my mind's eye. If you desire to accomplish something, focusing unwaveringly on that task is the best way to achieve the desired result. If you wish to own and operate your own trash removal business, if you get up each day and labor hard, working the same route, picking up the trash and driving the truck to the dump, thinking *how quickly can I get this over with?* you will never reach your objective. However, by contrast, if you get up each day saying *I want to own my own garbage disposal company* and follow the logical action items necessary to get there—namely, obtaining an understanding of how business works through college and practical work experiences and saving enough capital to buy your first truck—and if you couple this with working in the business from the trash pickup end through the administrative end, the likelihood of reaching your goal becomes highly probable.

Action Items or "To Dos"

In addition to the overall business goals mentioned above, I also view each property as a business and therefore set forth specific goals for each property.

Once the business plan and goals are established, I list detailed action items to enable me to reach my goals. In my real estate business, I first list on a separate piece of paper every property I own. Under the various properties, I specify "To Dos."

I have found that there are matters that do not fit into specific property categories. Therefore, I create what I call Special Project Lists to catch the other areas outside specific property action items.

Gary's Lists

The projects "To Dos" are then prioritized into a First Priority List and a Second Priority List. The task is to rank, in order of importance, the tasks to be accomplished. My First Priority List consists of matters of utmost importance that should be focused on immediately and completed immediately. The Second Priority List is important, but not, obviously, as important as the First Priority List.

I keep the lists on my computer, which facilitates the updating process. My daily review of the priority lists is cursory, because I want to get going, accomplishing the tasks on the list.

I also write up a daily To Do list. The Daily List usually contains a few items from the First Priority List and a few items from the Second Priority List, as well as other things that can be accomplished relatively quickly. The Daily List consists of things that must be done that day, for example, returning specific telephone calls, as well as work that must be furthered that day, such as finalizing a lease or a Purchase and Sale Agreement. The Daily List is made of the crucial items on the Priority Lists plus items that can be addressed and disposed of quickly.

After I have created a Daily List, I select the most important items that must be focused on immediately. I refer to these items as my Short List. These are no more than five items that must be substantially completed by the next business day. I always work on these items first when I walk into the office.

The key for me is to review and update my lists for at least 30 to 60 minutes every weekend, usually Sunday night, and then take one item at a time, going down the list and getting one item completed so it can be removed from the List or at least put into play so that it can be worked on until accomplished.

Please refer to Exhibit 1.1 for a graphic illustration of The Game Plan. The Game Plan is organized from the bottom up. The business plan serves as the foundation, and then the goals are established. The "To Dos" build upon the goals, for it is through accomplishing the "To Dos" that the goals are achieved. Lastly the "To Dos" are pared down and prioritized until you come to the Priority Lists and the Daily List and Short List of super-important items that must be worked on immediately.

Rule Number 5

Think out and commit to paper what you wish to accomplish. Keep detailed lists of action items.

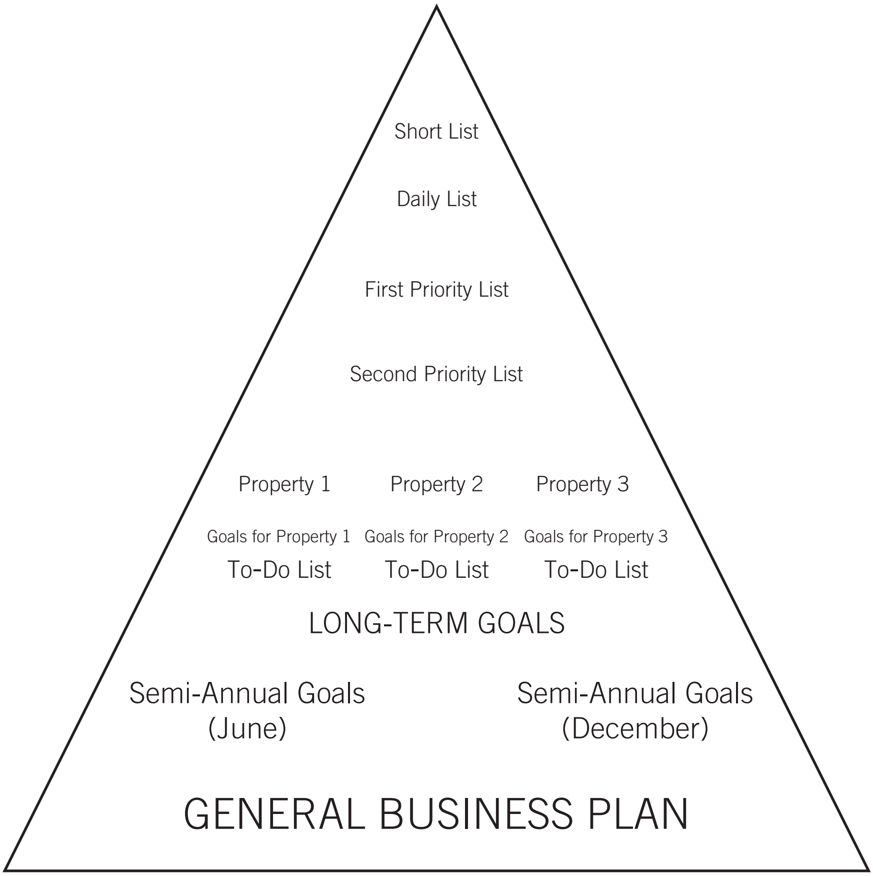


Exhibit 1.1 The Game Plan

If you can envision how to get from point A to point Z, that is, from an underperforming property to a fully leased successful transaction, that is half of the battle. The other half, however, is execution: doing the tasks necessary to get there. Execution can encompass everything from negotiating and consummating leases to hiring excellent vendors to servicing your complex. Without execution, vision falls short. Following through on the "To Dos" translates into execution.

Rule Number 6

Success equals vision with execution.

Focus, Focus, Focus

Another key to success, one that has more of an effect on success than education, capital, experience, desire, or personality type, is focus. Focus has two subcategories: concentration and discipline.

No Flip-Flopping

If you start out in business as a mortgage broker and then, after two years, decide you want to be a stock-broker, and then after two more years decide you want to sell insurance, your success ratio will probably not be very high. Hopscotching from one business to another results in failing to become an expert on anything. The consequence is that you never develop a clientele, never develop a network for referrals, vendors, and colleagues. You never develop a success formula if you keep switching from one field to another.

Stick with the Task at Hand

Develop discipline to concentrate on the task at hand no matter how unpleasant it might be or how much you would rather watch a television program or a movie, take a nap, or go for a walk in the park.

Rule Number 7

Focus on one field, no flip-flopping. Focus on one task at a time and get that task done before moving on to task number 2.

Please note that sticking with the task at hand does not mean devoting more time to it than it requires. I was recently having dinner with a couple and the wife bemoaned the fact that her husband worked so hard. She kept complaining that they had no family life because her husband constantly worked to pay the bills. It is not how many hours you put in that counts; it is results that matter. You measure achievement by results, not the length of time you work on a project. Often the more time and effort you put into a task translates into accomplishment, but not necessarily. If you get the job done and it takes one hour, isn't that more impressive than if you worked all night on the project? The "kill yourself" work ethic makes no sense. Results speak for themselves.

Rule Number 8

Judge yourself by your results, not by how long or hard you work.

Risk versus Reward

Every investor knows, or should know, that there are risks involved in a real estate investment. The general rule is that there is an inverse relationship between risk and reward: the greater the risk, the greater the return. Conversely, the rule states that the lower the risk, the lower the return. The trick is to identify the risks and then balance risk and reward by eliminating as much of the risk as possible while still achieving an acceptable return. Risk management is inherent in any investment, including a real estate project. The successful real estate entrepreneur focuses on the downside and structures the transaction to minimize the risk factors.

Rule Number 9

Look at the downside. Identify the risk areas in a project and put in place a strategy to cushion these risks, to the extent possible.

Identifying Opportunities

Assume there are two shopping centers in close proximity to each other. Both centers are about the same size, 150,000 net rentable square feet, and in comparable condition. Center A is 100 percent leased and occupied, while Center B is 50 percent leased and occupied. Center A is being offered for sale at \$15,000,000 (\$100 per square foot) while Center B is being sold for \$7,500,000 (\$50 per square foot). Which is the better buy? This is a trick question. There is no clear-cut answer. Most important, there is not sufficient information to make an informed decision.

You do not know, among other things, the income and expenses of the centers. The underlying credit behind the rental income might be far stronger in one or the other center. You also do not know the maturity date of the existing leases or the rent escalation schedules or the tenants' payment history. Nor do you know how well the tenants are doing, what is happening in the local community that might affect each project, or the overall strength of the leasing market.

In general, however, your decision depends to a large extent on your financial goals and risk posture. If you manage a large pension fund, then Center A, if it meets your yield criteria, would probably be your selection. It is fully leased, so it probably generates a stable cash flow. By contrast, if you are entrepreneurial, Center B is probably your choice, given its upside potential. It is only 50 percent leased so as you lease additional space, value is created.

This Book Is about Center B Properties

The focus of this book is value-added properties: Identifying value-added real estate, discovering creative strategies to enhance the value of a project, and executing those strategies. Usually, everything else being equal, the property with vacant space will sell for a higher *cap rate* than the real estate that is fully leased. The seller will argue that, given the upside potential in Center B, the buyer should pay a higher price. In a 100-percent-leased center the only way to go is down, in other words, to lose occupancy.

Again, in this example, there is not enough information about the two centers to make an informed decision. Possibly Center A is also a value-added B type of property. For example, possibly the rents are significantly under market so as to afford a buyer the opportunity to work the center when leases turn to significantly increase cash flow. However, in general, it is Center B that has the clear potential to grow and increase its value through leasing the vacant space.

Typically, when a property comes on the market, multiple potential buyers view the offering. The successful real estate player analyzes the project, figures out a game plan to increase cash flow, and then, taking the cost of his strategy into account and factoring in an acceptable yield, makes an appropriate offer.

The strategy to enhance cash flow might involve altering the physical elements of the project. The alterations might be as simple as adding attractive new paint colors and fresh landscaping or as extensive as a full exterior stucco remodel, with a change in the project's physical orientation.

The success of a retail project is often heavily dependent on the availability of convenient and ample parking. Envision a major box tenant with limited parking on the north side of the building. The developer acquires an acre of land on the south side of the building and reorients the entrance so that customers enter the store from the south side where there is an abundance of paved parking. Similarly, envision a movie theater operator whose business has adequate parking, but the location of parking is undesirable, since it is subterranean and tandem in nature (i.e., cars are parked so that one car might block another car). To enhance the desirability of his theater, the movie theater operator may enter into an agreement with the adjacent medical building owner so that his customers may use the extensive surface parking from the medical building lot after 5:00 P.M., when most doctors are no longer seeing patients.

A change in the nature of the tenants may dramatically affect the success of a center. A reorientation of tenants in a center from those that have nothing in common to those that have a synergistic relationship and can cross-refer clients may dramatically improve a property. Replacing weak mom-and-pop tenants with strong credit tenants might improve the financial performance of the project.

Change, whether it is a governmental rule and regulation change, or a change relating to the business climate in general, equals opportunity. The key is to be aware of the change and to take advantage of the opportunity that it offers. If you are considering building an assisted living facility and the state significantly increases the density requirements, altering your plans to take advantage of these developments might have a significant positive effect on profitability. Similarly, in a recessionary environment, players who are capital rich are usually able to take advantage of advantageous pricing. Should not purchases be made when values are depressed? Of course! Often, however, the difficulty is in determining when to buy. Will values continue to fall? Where is the bottom? This is where your knowledge, your research, and your strategizing come in. Remember, hearing opportunity knock is one thing; knowing when to open the door is another.

Rule Number 10

To effectively play the real estate game, it is crucial to identify opportunities and figure out strategies to take advantage of these opportunities.

Wealth Opportunities in Commercial Real Estate: Management, Financing, and Marketing of Investment Properties
By Gary Grabel

CHAPTER 2

The Basics

In order to accomplish The Solution through real estate it is essential that you have a grasp of the economic fundamentals that drive a real estate transaction. This chapter and the next start to build a foundation by explaining how to analyze a real estate deal.

Gross Income: The Starting Point

Determining gross income is the starting point when analyzing a real estate project. *Gross income* is the money received by the owner of the property, the landlord, from the tenant(s), and from any other source, such as parking revenues or vending machine income.

Let us assume you want to analyze a 60,000-net-rentable-square-foot medical office building (MOB) called the Diamond Medical Center, located on Diamond Road in Diamond Bar, California. Let us also assume, for purposes of this example, that the gross income of the Diamond Medical Center is $1,440,000.

Vacancy and Collection Loss: Gross Income Reducers

A *vacancy factor* reduces gross income by an amount, usually expressed as a percentage, in recognition of the fact that a project's occupancy is typically less than 100 percent over the long run. You must take a vacancy into consideration, even if occupancy is 100 percent at the time your analysis is being conducted.

You must also consider a *collection loss amount*. A collection loss amount recognizes that not all tenants honor their contractual lease obligations. In other words, despite the tenant's written obligation to pay rent, a certain percentage of the tenants will default, whether because of a failed business or some other reason.

Even if the project is 100 percent leased to a long-term credit tenant, investors and lenders will, for valuation and underwriting purposes, require that vacancy and collection loss factors be inserted into the analysis. A standard vacancy and collection loss figure is 5 percent of gross income, but this amount may vary depending on market conditions and on the actual leases in place. If a 5 percent factor is used in our hypothetical model, the vacancy and collection loss would be calculated as follows:

$$\text{Gross Income} \times \text{Vacancy and Collection Loss Factor} = \text{Vacancy and Collection Loss}$$

$$\$1{,}440{,}000 \times 5\% = \$72{,}000$$

The vacancy and collection loss factor can be expressed in ratio form as follows:

$$\text{Vacancy and Collection Loss Factor} = \frac{\text{Vacancy and Collection Loss}}{\text{Gross Income}}$$

The vacancy and collection loss factor is a deduction from gross income. After you reduce gross income by the applicable vacancy and collection loss factor to get to the adjusted gross income, your analysis of the Diamond Medical Center would look like this:

Gross Income	$1,440,000
Vacancy and Collection Loss	(72,000)
Adjusted Gross Income	$1,368,000

Appraisers determine the vacancy factor that will apply to a property by looking at all of the similar projects in the subject property's competitive marketplace and determining occupancy rates for those projects. This factor is then applied to the project under consideration. If comparable office buildings have a 10 percent vacancy and collection loss then, logically, a 10 percent factor should be considered for the subject property. However, each project should be reviewed on a case-by-case basis. For example, if 70 percent of a project is leased on a long-term basis to a credit tenant, then arguably the 10 percent factor might be applied only to the other tenant(s)' income, excluding the income attributable to that of the long-term credit tenant.

Operating Expenses and Net Operating Income

When you subtract from adjusted gross income the expenses of running the property you are left with *net operating income* (NOI). For example:

Gross Income	$1,440,000
Vacancy and Collection Loss	(72,000)
Adjusted Gross Income	$1,368,000
Operating Expenses	(450,000)
Net Operating Income	$ 918,000

Please note NOI is calculated *before debt service.* This is because, as a cost of capital, interest is not an operating expense incurred for the care and maintenance of the property. The analysis used to calculate NOI is conducted as if the property is owned free and clear of any mortgage, or as if the property is being purchased for all cash.

Also, when calculating NOI, the standard is not to reduce the cash flow by depreciation. *Depreciation* is a non-cash deduction that is used for income tax purposes, but is not deducted from *adjusted gross income* (AGI) to determine NOI. Again, depreciation, like interest, is not related to property operations.

Furthermore, please note that both state and federal income taxes are not included in Operating Expenses and hence do not reduce AGI when calculating NOI.

From these basic numbers you can derive certain conclusions. First of all, if the Diamond Medical Center is 60,000 square feet and the gross income is $1,440,000, then the tenants are paying on average $24 per square foot on an annual basis or $2 per square foot on a monthly basis.

$$\frac{\$1{,}440{,}000}{60{,}000 \text{ square feet}} = \$24.00 \text{ per square foot on an annual basis}$$

or

$$\frac{\$24.00}{12 \text{ months}} = \$2.00 \text{ per square foot per month}$$

Also, on a per-square-foot basis, the operating expenses are running annually \$7.50 or \$.625 per square foot per month.

$$\frac{\$450{,}000}{60{,}000 \text{ square feet}} = \$7.50 \text{ per square foot on an annual basis}$$

or

$$\frac{\$7.50}{12} = \$.625 \text{ per square foot per month}$$

Both *rent per square foot* and *expenses per square foot* are significant numbers in the context of analyzing a project or in a lease or sale negotiation.

Fair Market Value and Capitalization Rate: What's It Worth?

A property's value is often a crucial factor in buying, selling, or obtaining financing. What the property is worth obviously becomes relevant if you are a potential buyer or seller. Similarly, if you are considering originating a loan secured by the property, it is important to understand the property's value. One of the main tests in loan origination is to limit the debt to a percentage of the property's value. If a lender miscalculates the property's value it may extend credit far in excess of its intended ratio, resulting in little equity remaining in the property and, hence, a smaller cushion for error.

Fair market value (FMV) is essentially the price at which a willing buyer and a willing seller agree to buy or sell the property. According to the Uniform Standards of Professional Appraisal Practice, implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under the following six conditions.

1. The buyer and seller are acting prudently and knowledgably and are typically motivated.
2. The buyer and seller are not affected by undue stimulus.
3. Both parties are well informed or well advised, and acting in what they consider their best interests.
4. A reasonable time is allowed for exposure in the open market.
5. Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto.

6. The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

A concept that is inherent in the definition of fair market value is the *capitalization rate* (Cap Rate). The Cap Rate is essentially equivalent to a yield or rate of return on the asset's value. It is the percentage rate of return that a willing buyer would require at this time to induce him to purchase the subject property, given the then current market climate including current interest rates and the rate of return achievable on alternative investments. The terms *Cap Rate* and *return on assets* (ROA) are often used interchangeably.

From the basic hypothetical numbers and an understanding of NOI and Cap Rate, the fair market value of a property can be determined.

A key formula can be derived from the relationship between NOI, Cap Rate, and FMV; namely:

$$\text{FMV} = \frac{\text{NOI}}{\text{Cap Rate}}$$

If you know two of the three variables, the third factor can be determined. In the previous example, if we assume the Cap Rate is 9 percent and the NOI is $918,000, then the project FMV equals $10,200,000.

Applying the formula, the result is as follows:

$$\text{FMV} = \frac{\$918{,}000}{.09} = \$10{,}200{,}000$$

Gross Rent Multiplier

Another valuation rule of thumb is the *gross rent multiplier* (GRM). It asks the question: *Gross income times what number equals fair market value?* In other words, if you divide fair market value by gross income, what is the resulting number? In formula form, the GRM looks like this:

$$\text{GRM} = \frac{\text{FMV}}{\text{Gross Income}}$$

Applying this formula to our model of the Diamond Medical Center, assuming the FMV equals $10,200,000, the result is a GRM of 7.08 or, to round it off, a 7-times factor. Inserting the figures in the formula the equation looks as follows:

$$\text{GRM} = \frac{\$10,200,000}{\$1,440,000} = 7.08$$

Conversely, if you know that comparable properties are selling at a GRM of seven times to derive FMV, you would multiply the project's gross income by seven.

GRMs are most commonly used in connection with apartment project values.

The biggest problem with this rule of thumb is that it ignores variations in vacancy and collection losses as well as differences in operating costs. It can really only be used to compare similar property types since the expense factor can vary so dramatically between, for example, an apartment complex that might have a 30 percent operating expense factor versus a hotel project with 90 percent of its gross income offset by operating expenses.

Value per Square Foot versus Reproduction Cost per Square Foot

With the knowledge that the project's fair market value is $10,200,000, another key ratio, *value per square foot,* can be calculated. This ratio is derived by taking the FMV and dividing by the project's square footage.

$$\text{Project's value per square foot} = \frac{\text{FMV}}{\text{Project's Size}}$$

Applying the Diamond Medical Center project numbers to the formula, the result is a project value per square foot of $170 as shown here:

$$\frac{\$10,200,000}{60,000 \text{ square feet}} = \$170 \text{ per square foot}$$

Why is this statistic significant? As discussed next, when evaluating a project, the project's value per square foot when compared to *reproduction cost* per square foot is an important figure to understand, both from an existing ownership viewpoint as well as through the eyes of a buyer.

Reproduction cost, as the name implies, is the cost associated with building the project beginning with vacant land acquisition. When figuring reproduction cost you must understand how your property was constructed. Costs will vary depending on the construction materials used. Stick-built construction (wood-frame) with stucco is far less expensive than a steel structure with a glass skin and subterranean parking. In addition to on-site construction costs, you also have off-site expenses such as streets, curbs, gutters, sewers, landscaping, site preparation, and drainage issues, and so forth. Is surface parking available or must a parking structure be built? If surface parking is available does it have to be paved and striped? You must also figure the contractor's profit into your equation. Soft costs, such as city permits and other fees, must be factored in as well as architectural expenses and financing costs, such as loan points and interest carry.

I want to stress the point that attempting to calculate reproduction cost does not equate simply to the sticks and stones of a project, but includes the land cost, any architectural and engineering expenses, legal costs, financing charges, landscaping, and all offsite expenses. What is the fair market value of the land? What is comparable land selling for? What kind of a tenant improvement allowance is generally given in this market, if any? (Please refer to Chapter 9 for a detailed discussion of the construction costs in connection with a ground-up development.)

Why is it so important to calculate reproduction costs? It is important to understand how your project might relate to potential competition. If the cost of reproducing the project far exceeds the current per-square-foot value, then it is less likely that competitors will come in with new construction and offer a better mousetrap, inducing your existing tenants to leave your project or to attract new prospects to locate in their bright, shiny, new project across the way. Put another way, if it cost $15,000,000 to build a new comparable 60,000-square-foot project ($250 per square foot), then your hypothetical competitor will have to charge a significantly higher rent per square foot to achieve a comparable return.

Let us assume your competitor desires to achieve a 9 percent return on their investment and also assume, for simplicity's sake, that they are going to build the project for cash. In order to determine their rental amount you must charge to hit that target yield, a relatively easy method is to essentially start from that conclusion and work backward. Therefore, to reach the 9 percent return on a \$15,000,000 project, the NOI must be \$1,350,000 as shown here:

$$\$15{,}000{,}000 \times 9\% = \$1{,}350{,}000 \text{ NOI}$$

Assuming operating expenses for the new project are comparable to operating expenses for your Diamond Medical Center project, your competitor would need an adjusted gross income of \$2,100,000 to reach the NOI goal.

$$\$1{,}350{,}000 \text{ NOI plus } \$450{,}000 \text{ operating expenses} = \$2{,}100{,}000 \text{ AGI}$$

Assuming a 5 percent vacancy and collection loss factor, gross income would be calculated by inserting in the following simple algebraic equation the known numbers.

$$\begin{aligned}
\text{Gross Income} - \text{Vacancy and Collection Loss} &= \text{AGI} \\
\text{Gross Income} - (5\%)\ \text{Gross Income} &= \text{AGI} \\
(100\%)\ \text{Gross Income} - (5\%)\ \text{Gross Income} &= \text{AGI} \\
(95\%)\ \text{Gross Income} &= \text{AGI} \\
(95\%)\ \text{Gross Income} &= \$2{,}100{,}000 \\
\text{Gross Income} &= \frac{\$2{,}100{,}000}{0.95} \\
\text{Gross Income} &= \$2{,}210{,}526
\end{aligned}$$

If you translate the gross income into rent per square foot, the result is an annual per square foot rent target of \$36.84, or a rental amount of \$3.07 per square foot per month.

$$\frac{\$2{,}210{,}526 \text{ gross income}}{60{,}000 \text{ square feet}} = \$36.84 \text{ annual average rent charge per square foot}$$

The point is that the new building will have to charge significantly higher rents, \$3.07 per square foot per month versus your

$2.00 per square foot per month, in order to achieve a comparable yield. Since the new building is at a huge competitive disadvantage, you, as an existing owner or potential buyer, should be more comfortable with your investment.

Inverse Relationship between Cap Rate and FMV

If everything else remains constant and if the general market cap rates increase, which means essentially that investors demand a higher yield, what happens to value? There is an inverse relationship between Cap Rate and FMV. As Cap Rates increase, FMV decreases. The logic is simple. If you demand a higher return, yet all other factors, that is, NOI, have not changed, you must receive a reduced price to achieve the higher yield. In our example, if the Cap Rate increases to 10 percent, the FMV is reduced from $10,200,000 to $9,180,000.

$$\frac{\text{FMV} = \$918{,}000}{0.10 = \$9{,}180{,}000}$$

Initial Determination of Value

If you know the sales price of a project (its fair market value) and the project's NOI, you can find what yield the buyer was willing to pay, the Cap Rate, by inverting the formula as follows:

$$\text{Cap Rate} = \frac{\text{NOI}}{\text{FMV}}$$

As a cursory initial determination of value, this formula can be used to determine the market cap rate from comparable projects and then that market cap rate can be applied to a specific project's NOI to find that particular project's value.

The formula should only be used as a starting point in the analysis, an initial indication of value, since the formula does not take into account, among other things, variations in NOI over time. In Chapter 3 we discuss in more detail how to determine value by spreading the project's income and expenses over a 10-year period through a discounted cash flow analysis and thereby gaining a more accurate indication of value.

Leveraged Return and Return on Equity

In our example, because NOI is computed before debt service is taken out (that is, before the income stream is reduced by any loan payments), the Cap Rate is an unleveraged yield. It is as if the property is being purchased for all cash. This is also called a *free and clear* return.

A *leveraged return* factors in debt. If you are buying the subject property at a 9 percent Cap Rate and can borrow at a rate below this figure, in essence you are replacing part of the equity with debt and will increase your yield on equity due to this positive leverage factor.

Typically, when buying a commercial property, the buyer will fund 20 to 25 percent of the purchase price as his down payment. This ratio is called the *down payment ratio.*

$$\text{Down Payment Ratio} = \frac{\text{Down Payment}}{\text{FMV}}$$

The companion ratio to the Down Payment Ratio is the Loan-to-Value Ratio (LTV). If the Down Payment Ratio is 25 percent, then the Loan-to-Value Ratio would be 75 percent. The logic is that either the project's funding will come from the owner's own resources or that he will borrow the funds. The Loan-to-Value ratio expressed as a percentage would be the following:

$$\text{Loan-to-Value Ratio} = \frac{\text{Loan Amount}}{\text{FMV}}$$

To continue our example, let us assume that Diamond Jack (hereafter known as DJ) is purchasing the project, Diamond Medical Center, for $10,200,000 with a close of escrow scheduled for November 1, 2010. If we assume a 75 percent Loan-to-Value, the loan amount would be $7,650,000 ($10,200,000 × .75). Furthermore, if we assume a first trust deed with a 7.5 percent interest rate and a 30-year amortization period, the numbers would look as follows:

Gross Income	$1,440,000
Vacancy and Collection Loss	(72,000)
Adjusted Gross Income	1,368,000
Operating Expenses	(450,000)
Net Operating Income	918,000
First Trust Deed of $7,650,000 @ 7.5%	
30-Year Amortization	(637,892)
Net Cash Flow	$280,108

The cash equity or the down payment needed for the purchase would be $2,550,000; that is, the FMV or purchase price of $10,200,000 less the loan amount of $7,650,000.

Diamond Jack wished to measure how well he was doing. He wanted to understand what the return was on his investment. The *return on equity* (ROE) calculation asks the question, if your investment equals the cash down payment what monies did you get back during the year? The following formula answers this question:

$$\text{Return on Equity} = \frac{\text{Net Cash Flow}}{\text{Equity}}$$

Plugging in the applicable numbers, the leveraged yield is approximately 11 percent, much higher than the all-cash, unleveraged yield of 9 percent.

Return on Equity = $280,108/$2,550,000 = 10.99% = approximately 11%.

It should be recognized that the above ratio calculation does not adjust for amortization. In other words, the net cash flow is derived after the income is reduced by debt service. In our example, part of the debt service is being applied to reduce the principle of the loan. It is not a 100 percent interest payment. A pay-down in principle is not the same as a janitorial expense. When you reduce the loan balance through a principle payment, everything else staying the same, you have increased the project's equity. If you expend money to pay for the cleaning service once the cleaning is completed and paid for, there is no further benefit. The return on equity calculation is an easy "quick test." A more accurate analysis would add back the principle payments to derive net cash flow. When comparing investments, it is important to compare apples to apples. Hence, if in one investment the debt service is interest only and in another there is a heavy amortization, the return calculation should be adjusted to factor in this difference.

Cash Flow before Taxes (CFBT)

In the above example, *Net Cash Flow* is also known as *net spendable*, or *Cash Flow before Taxes* (CFBT). CFBT is derived by reducing the NOI by the mortgage payments. Obviously, if the property is purchased for all cash, then the NOI and the CFBT are the same since there are no deductions for mortgage payments.

Reserves/Impound Accounts

It is important to understand what, if any, additional monies a lender may insist be set aside by the owner/borrower. The concept of setting aside funds each month to pay anticipated project expenses is referred to as reserves or as an "impound."

What does it mean to create a reserve or an "impound account"? The lender requires that a certain amount of money is paid to the lender each month, in addition to the monthly principal and interest payments, to cover anticipated expenses. This is also referred to as "filling up the buckets."

Taxes and Insurance Impounds

As an example, it is standard practice for lenders to create an impound account for real estate taxes and insurance. To illustrate, if annual real estate taxes for the project equal 1.22 percent of its value, then using the above illustration, 1.22 percent of $10,200,000 equals $124,440. Therefore, on a monthly basis, in addition to the scheduled principle and interest payments, the lender would require the borrower to fund to the lender $10,370 per month to build-up a sufficient amount of cash so that the real estate tax bill can be paid in full when due. In California, real estate taxes are paid on a semiannual basis. The first installment is due November 1 and is considered delinquent December 10 of the year in which the taxes are incurred, and the second installment is due February 1 of the next calendar year and is considered delinquent the following April 10.

A similar analysis would be undertaken for insurance premiums. Real estate taxes and insurance are operating expenses that should be accounted for in the expense line items above net operating income—that is, within the $450,000 budgeted operating expenses shown in the examples. Consequently, since these expenses are already accounted for in the operating expenses, you would not want to double-count them. Therefore the cash flow should not be further reduced by the amounts deposited into the tax and insurance impound accounts. However, as mentioned next, there are certain reserves that may be imposed by the lender that are not accounted for within the operating expense category.

Cap X, TIs, and Leasing Commissions

It is important to anticipate that in conjunction with commercial projects lenders today typically require, in addition to impound accounts for taxes and insurance, reserves for projected *capital expenditures* (Cap X) as well as for *tenant improvements* (TIs) and leasing commissions.

The questions become, are these reserves monies that the borrower reasonably anticipates to spend or are they funds set aside by the lender because the lender is overly cautious? If a certain amount is going to be spent year after year, maybe this amount should fall within the category of normal and usual business expenses and be part of the operating expense line items. If, on the other hand, these monies will not be spent consistently, year after year, possibly they should be viewed as one-time expenditures and not affect NOI (and therefore not affect value). The expense would then be accounted for as a below-the-line deduction—that is, a deduction from NOI rather than deductions to calculate NOI. This distinction becomes important when a third-party lender is involved.

As is discussed in Chapter 5, lenders will usually reduce NOI by their estimate of needed reserves to derive funds available to service the debt or *cash flow from operations* (CFO) before the applicable debt coverage ratio is applied. Similarly, when attempting to determine value, it would seem more accurate to use CFO rather than NOI divided by the applicable cap rate or, as mentioned above, to reduce NOI by anticipated recurring reserves before dividing by the cap rate to determine FMV. In any event, whether included within operating expenses or as a separate reserve category, after NOI is calculated the deduction affects cash flow and hence the project's return, as discussed further on.

These reserves are the owner/borrower's money, yet in order to access the funds after the loan is originated, the owner must spend in the applicable category, apply to the servicing agent to obtain reimbursement, and forward a copy of the appropriate documentation that includes, among other things, a copy of the cancelled payment check, a copy of the applicable contract, and appropriate lien releases. The lender might additionally require inspections to verify that the work was actually completed. Depending on the efficiency of the lender's loan processing department, this process can take over a month to complete from the time the borrower submits the applicable documentation to the time the borrower actually receives its own money back from the impound account.

The size of the reserve for Cap X, tenant improvements, and leasing commissions depends on the condition of the project and the maturity date of existing leases, as well as the extent to which the project is vacant. Although this money, as stated earlier, consists of the borrower's funds and may be used to improve the property and facilitate the project lease-up, the lender's imposition of a reserve requirement can have a significant impact on cash flow and can result in unexpected negative consequences if the borrower does not have a clear understanding of the lender's requirements.

For illustration purposes, let us assume the lender requires $.30 per square foot for Cap X expenses and an additional $1 per square foot for tenant improvements and leasing commissions. In other words, for this 60,000-square-foot Diamond Medical Center project, $18,000 (60,000 × $.30) would have to be set aside annually for Cap X reserves and $60,000 (60,000 × $1) for tenant improvements and leasing commissions. One-twelfth of these reserve monies are usually collected monthly.

Our cash flow model now appears as follows.

Gross Income	$1,440,000
Vacancy and Collection Loss	(72,000)
Adjusted Gross Income	$1,368,000
Operating Expenses	(450,000)
Net Operating Income	918,000
First Trust Deed of $7,650,000 @ 7.5% 30-Year Amortization	(637,892)
Cap X Reserves	(18,000)
Tenant Improvements & Leasing Commissions	(60,000)
Net Cash Flow	$202,108

It is important to recognize that the assumed reserves for Cap X, tenant improvements, and leasing commissions are negotiated lender estimates. The actual expenses for Cap X, TIs, and leasing commissions may far exceed the estimate. This may occur, for example, if there is a major uninsured catastrophe or if a major tenant files for bankruptcy protection. Similarly, the reserve may consistently fall short of the monthly charge, thereby building up the reserve account so that the categories are never exceeded. For the purpose of our hypothetical, let us assume that the reserves are adequate to cover the actual Cap X, TI, and leasing commission costs.

The yield calculation after reserves are taken into consideration is shown as follows:

$$\text{Yield} = \frac{\$202{,}108}{2{,}550{,}000} = 7.9\%$$

This yield calculation after reducing the NOI by debt service and reserves is usually referred to as the *cash-on-cash return*. Some texts calculate the cash on cash return without reducing the cash flow by the lender's reserves, but these costs have a direct impact on what the owner puts into his pocketbook and therefore should reduce the cash flow prior to the return calculation. The calculation can be expressed by the following equation:

$$\text{Cash-on-Cash Return} = \frac{\text{Net Cash Flow after Debt Service and Reserves}}{\text{Equity}}$$

Typically, lenders establish the Cap X reserves based upon a property condition report that is generated by a third-party vendor during the lender's underwriting process. The tenant improvement and leasing commission reserve is based upon a schedule showing maturing leases and assumptions regarding the cost to place a new tenant in the suite, including the applicable leasing brokerage fee.

The amount of reserves is often a negotiated item. Also, an attempt might be made by the borrower to place a ceiling on the cumulative reserve build-up, arguing that if the reserves are not used at some point in time they will be adequate to cover these potential expenses and a further build-up is not warranted.

Reserves vary greatly depending on the nature of the project and the lender's underwriting criteria. For example, if a major tenant lease is to expire during the loan term, it is common for the lender to require that a special reserve be built up to address the potential for extensive tenant improvements, leasing commissions, and the possibility of down time during the re-leasing phase. If the expiring lease represents 50 percent or more of the project cash flow, the lender might require a cash-flow sweep in the months preceding the lease termination date. A cash-flow sweep results in all available funds going into the reserve account after payment of ordinary operating expenses and debt service. Essentially the lender is creating a sinking fund, that is, monies set aside to address a particular, possible event. A target budget is estimated that will be needed to address the potential problem. The lender then calculates the size of the payments required to be set aside at regular intervals, usually monthly, so that the funds will accumulate to the desired future value.

In today's climate of securitized lending, the typical procedure is for a lender to originate a loan that is sold in the secondary market and to outsource the loan-servicing function. The loan-servicing function becomes a fiduciary obligation wherein the loan-servicing personnel attempt to strictly follow the loan documents, whether they then make sense or not. Zero flexibility is built into the process after the loan closes. For example, assume DJ purchases the 60,000-square-foot medical office building in our hypothetical fact pattern. DJ then begins a renovation campaign, upgrading the landscaping (the "hardscape"), replacing outdated signage, painting the exterior of the building, putting new carpet in the interior hallways, bringing up to code the public restrooms, and so on. DJ spends $1,000,000 on the renovation. The project looks great. The lender's servicer sends out an inspector who has never seen the property before. He did not see the project when it was in need of repair, so the only thing he views is the fixed-up medical office building. He has with him a copy of the property condition report that was prepared prior to loan funding and he notes that it cited as an "immediate repair" replacing a specific ramp so that it would comply with the Americans with Disabilities Act (ADA) standards for slope, yet the ramp in question is still in its pre-loan condition and does not comply. DJ mentions to him that he just spent $1,000,000 in renovating the project, including installing a new handicap ramp which is far better located than the old ramp for egress and ingress and that this improvement results in the project complying with ADA regulations. Mr. Inspector writes the project up for failure to comply with the terms of the loan agreement, insisting that the old handicap ramp comply with code. The moral of the story is: *The loan servicer is inflexible.* Make sure you fulfill your obligations under the loan documents first and then, as funds permit, prioritize and complete your desired additional improvements.

Given that the servicing agent will strictly follow the agreed-upon terms for disbursement of impounded monies, even though these monies are the borrower's funds, it is important to understand the terms of the reserve accounts and under what circumstances you may tap into the reserves. It is common practice for lenders to condition disbursement of tenant improvement dollars from the reserve account on the applicable tenant being in place and paying rent. Therefore, let us assume you have accumulated $500,000 in your TI and leasing commission bucket and you lease 10,000 square feet to a surgery center with a $50 per square foot tenant improvement allowance. It takes five months to build out the surgical center and you have disbursed the full $500,000 in accordance with your allowance (10,000 square feet times $50 per square foot). Now the tenant is in place, starting to perform surgeries, but it takes time to ramp-up enough volume to make the center profitable. Understanding the ramp-up time frame, you agreed to give the tenant 10 months of free rent. You request reimbursement from the reserve account. The servicer's response is "You have to wait 10 months, until the tenant starts paying rent." If you had anticipated this issue you might have structured the free-rent clause as 20 months of one-half rent or some other variation to address the requirement that the TI reserve is disbursed only when the tenant is paying rent.

In our hypothetical example there is a large disparity between the impound amount for Cap X—$18,000 per year—and the requirement for TIs and leasing commissions—$60,000 per year. The result may be that the Cap X reserve is relatively small while the TI and leasing commission reserves are much larger. The problem is that the servicer, strictly following the loan document language, will not allow you to dip into the TI and leasing commission impound account for a capital-repair item. You might try to draft your leases around this problem by doing such things as building in a landlord responsibility to fix up a certain portion of the project and then characterizing this expense as a tenant improvement. This solution is cumbersome and may not work. The point is to anticipate the problem at the loan origination stage and negotiate, if possible, more flexibility in commingling the buckets. For example, you might create just one reserve account that includes all of these categories or possibly adjust the numbers so that there is not such a disparity between the Cap X reserve amount and the TI and leasing commission monthly impound.

Devil in the Details: Over Simplified Analysis

When reflecting on the above simple analysis, the expression "the devil is in the details" comes to mind. What I mean is that each step in this analysis must be taken apart, examined, and refined to verify its accuracy and to ensure that the underlying assumptions are not flawed.

The following questions, all of which you should posit before undertaking a project, illustrate why the simplified analysis in this chapter is merely a starting point toward a fuller understanding of a commercial real estate transaction.

- During which time frame do the income and expense figures relate? Are they from the past calendar year's numbers, the past trailing 12 months' figures, the current income and expenses annualized, or the projected next 12 months' base rent, based upon contractual agreements in place plus assumptions for renewals and the lease-up of vacant space? Are these numbers based upon monthly figures or annual results?
- Are the numbers actual income and expense numbers or are they "scheduled" figures? Is there any expense recapture included?
- What is the composition of gross income? Is certain revenue excluded, such as percentage rent? Should certain revenue items be excluded?
- Is the vacancy and collection loss factor at the appropriate level?
- What costs go into the operating expense line items? Is the subject expense an ordinary and necessary cost to be expensed in the year incurred, or is it a capital charge to be spread over its useful life? (In other words, are some of the operating expenses really nonrecurring capital costs?)

- Have the expense numbers been adjusted to correspond to the transaction facts? For example, on a sale the real estate taxes may have to be brought to market based upon the mill rate.
- Do any of the tenants pay all or part of the operating expenses directly?
- Is ownership distribution a below-the-line item, that is, paid out from net operating income?
- Are certain expenditures included in "operating expenses"?
- Are there nonrecoverable expenses that must be factored in?
- Are there any potential events, such as maturing leases or competitive projects under construction that could significantly affect cash flow?
- Have rent escalations as well as anticipated expense increases been taken into account?
- At some point in time, does the loan amortization change from, for example, interest-only to a 30-year principal and interest payment schedule? When does the loan mature? At loan maturity, will the underwriting support the existing debt amount, an increased debt load, or must the owner come up with funds to gap a loan pay-down? At loan maturity, what will be the then market interest rate?
- What is a reasonable inflation assumption that will affect both income and expenses?

As can be seen from the foregoing questions, the property analysis process has just begun. Chapter 3 continues the discussion and delves into more depth concerning each of the line items in the analysis.

Wealth Opportunities in Commercial Real Estate: Management, Financing, and Marketing of Investment Properties
By Gary Grabel

CHAPTER 3

Detailed Financial Analysis

The following discussion starts with the basic formula to derive net cash flow:

Gross Income – Vacancy and Collection Loss = Adjusted Gross Income – Operating Expenses = Net Operating Income – Mortgage Payments and Reserves = Net Cash Flow

The chapter discusses each line item, in depth, and relates the analysis to the various types of leases that, in turn, may affect the cash flow analysis. This chapter also attempts to expand the analysis over a time line to better refine the cash flow and valuation conclusions.

Gross Income

Gross income is money received by the landlord from any source whatsoever, including rents received and interest income. Gross income also includes miscellaneous revenues such as income earned from late charges, vending machines, laundry machines and services, and from storage rentals. It also would include revenue earned from employee services for work performed for tenants, provided the work is within the scope of the employee's duties. Additional sources of income for the owner might include parking revenue, lockers, directories, remetered utilities, long-distance telephone revenue, equipment rental, cell-tower site income, advertising revenue, such as monies derived from billboard and monument advertisements, and so on. Gross income would also include nonrecurring income such as monies received for a lease termination fee or the landlord's participation in rentals over a tenant's contractual rent in the event of sublease or assignment.

In our discussion we will assume that we are evaluating a *leased-fee estate*. It is primarily the income from tenant leases that composes the gross income. Does the gross income change if the tenant is hugely profitable or has a bad year? The answer, in general, is no, because the landlord does not benefit or suffer from the tenant's operations. The landlord receives the contractual rent regardless of the ups and downs of the tenant's business. However, there are exceptions to this rule.

First of all, the lease may specify that the landlord does, in fact, participate in the tenant's income. This is called a *percentage rent provision*. This type of clause says, in essence, that the landlord is entitled to additional rent of a specified percentage of the tenant's sales. Obviously, the specific language must be scrutinized. Is the percentage a percentage of the gross sales or net sales? Is there a floor or a ceiling? For example, "Landlord shall receive 3 percent of gross sales in excess of $5,000,000 and less than $10,000,000," or "3 percent of gross sales in excess of $5,000,000 less the Minimum Annual Base Rent." This type of percentage clause is often found in restaurant leases.

Secondly, when evaluating certain property types such as hotels, skilled nursing homes or other medical facilities, and entertainment complexes, it might be appropriate to view the actual monies received from the end-users. The analysis is more akin to reviewing an operating business rather than a pure real estate transaction. Of course, if the real estate is net leased to an operator, then if the lease income from the operator to the owner is solely analyzed, rather than the underlying income from customers or patients, again we have an investment more in line with a leased fee real estate transaction as discussed in this text.

An issue that must be addressed is, should actual or scheduled rents be used in the analysis? Actual rents are what are, in fact, collected by the landlord. Actual rent income is derived from contractual leases in place. In contrast, scheduled rents are a reflection of market rents, that is, what a reasonable tenant would pay for the applicable space. Logically, both actual and scheduled rents should be utilized. Actual rents are used for leases in place, yet scheduled rents are used for vacant space and lease rollovers. The discounted cash flow model set forth in this chapter illustrates how actual and scheduled rents are integrated.

At times tenants may request to prepay their rental obligation. This often occurs in December since it is then that tenants frequently address ways to lower their taxable income by increasing their tax deductions. There is nothing illegal or improper in accommodating a tenant in this manner; however, care must be taken because usually the lender's loan documents will prohibit the owner from taking prepaid interest for more than one month. The lender's prohibition stems from concerns that an unscrupulous borrower who has become financially strapped might enter into agreements with multiple tenants to induce them to pay rent early, then pocket the cash and flee to Buenos Aires. If a tenant has prepaid rent and a lender takes back the security, the lender will have a difficult time enforcing the terms of the lease for the period for which the rent was prepaid because the tenant will respond: "I have already paid the rent for the entire year!" At least by including language in the deed of trust that prohibits the borrower from accepting prepaid rent, the lender will have personal recourse against the borrower.

Vacancy and Collection Loss

A vacancy and collection loss factor should take into account lost rent due to tenant turnover as well as uncollected monies because of tenant defaults. The vacancy and collection loss factor should be based upon historical project results as tempered by vacancy and collection results for similarly situated projects.

If a tenant fails to pay his rent, can you deduct the contractual lost rent on your tax return? No. As a cash-basis taxpayer you have the "advantage" that you do not include in income monies not received, but also it would be improper to take a deduction for a bad debt expense. No monies were spent to service or improve the property, and therefore no deduction was created.

Operating Expenses

Operating expenses include all of the costs associated with running the property. Using the analysis developed in the prior chapter and adding specific operating cost line items, the chart might look as follows:

Gross Income		**$1,440,000**
Vacancy and Collection Loss		(72,000)
Adjusted Gross Income		$1,368,000
Operating Expenses		
Elevator Contract	(11,197)	
HVAC Maintenance Contract and Repair	(5,413)	
Insurance	(5,000)	
Janitorial Contracts	(52,600)	
Landscaping	(6,410)	
Property Taxes	(97,067)	
Property Management Fee	(43,200)	
Repairs and Maintenance	(13,470)	
Security and Fire	(27,931)	
Taxes and Licenses	(420)	
Trash Disposal	(6,336)	
Utilities	(180,956)	
Total Operating Expenses		**(450,000)**
Net Operating Income		**918,000**
First Trust Deed of $7,650,000 @ 7.5% 30-Year Amortization		(637,892)
Cap X Reserves		(18,000)
Tenant Improvements and Leasing Commissions		(60,000)
Net Cash Flow		$202,108

The following observations serve to clarify some of the operating expense line items.

Real property taxes are being shown as actual current charges. In California, Proposition 13 and Proposition 8 have significantly affected property taxation. Under Proposition 13, the annual real estate tax is limited to 1 percent of its assessed value. The "assessed value" may be increased only by a maximum of 2 percent per year, except if the property undergoes a change in ownership, or new construction occurs. At the time of the change in ownership, the assessed value may be reassessed to the full current market value which most likely will result in a new base year value for the property. Similarly, if the property is improved, the value of the improvements would be added to derive a new base year value. Future assessments, however, are restricted to the 2 percent annual maximum increase on the new base year value. Proposition 8 amended Proposition 13 to provide for a reduction in the assessed value if the market value of the property declines below its assessed value.

In our hypothetical scenario, if real property taxes were brought to market due to a sale at $10,200,000 the real estate tax expense would be $102,000 based upon 1 percent of the property's value ($10,200,000 × .01).

In California, actual real estate taxes have been kept artificially low due to Proposition 13. Given the current real estate slump, Proposition 8 will further reduce tax collections.

If the property is in California or a state with similar laws, and the subject property is being analyzed for an acquisition, the real property taxes should be increased based upon fair market value, which usually equates to the sales price.

The management fee is calculated at 3 percent of the gross income. Translating the percentage into the suggested fee results in a $43,200 disbursement as compensation to run the project on an annual basis. Is this fee a reasonable amount? Would a third-party management firm undertake to manage the project for this annual compensation? The answer is, "Maybe." You must inquire what services are to be provided for the $43,200. Will there be an on-site manager? Will the manager be full time or part time, splitting his duties between this project and other projects? Does the management fee include leasing activities or will there be additional compensation for this task? Does the management fee include construction management if tenant improvement build-outs are contemplated? Are there accounting services built into the charge? Are there legal services built into the fee? Will day porter or handyman services be included? The point is that if some of these other functions are not included in the 3 percent figure, then possibly the management line item is being understated and should be increased or additional operating costs added to the expenses.

When reviewing operating expenses, a good method of evaluating the reasonableness of the expenses is to convert the expense line items into a per-square-foot number. Statistics can then be assembled to show what usual costs are for this expense for this real estate product type, and conclusions can be drawn as to whether or not this expense is out of line when compared to the norm. For example, typical janitorial costs for medical buildings run $.07 to $.08 per square foot per month. In our hypothetical scenario, the expense is $52,600 per year, or $.88 per square feet per year ($52,600/60,000 square feet), or about $.073 per square foot per month. This figure is within the normal and usual cost range for janitorial expenses for this type of property. Professional real estate groups such as the Building Owners and Managers Association (BOMA) and the Institute of Real Estate Management (IREM) collect data from their members, aggregate this data, and then publish it so that their members may access the information for the purpose of making comparisons as outlined above.

The overall operating cost per square foot to run this medical building is $7.50 ($450,000/60,000 square feet). This is a good statistic to keep in mind when viewing other similar investments in order to understand the reasonableness of the presentation. If an investment package suggests the seller is running his medical building at $5.00 per square foot when your comparable medical properties are costing you $7.50 to $12.00 per square foot per year to run, then something is not kosher. If the cost to operate the project is substantially below the norm for this product type, it becomes essential to ask probing questions when analyzing the project. Is the owner not properly maintaining the property? Are the tenants picking up certain operating expenses, such as utilities? A square-foot operating expense discrepancy as compared to the norm clearly cries out for further inquiry.

Four Basic Types of Leases

Leases are contractual binding agreements between a landlord and a tenant. The lease document controls the rights and liabilities between the parties. Unless there is a reason to believe otherwise, the contractual rent and the other contractual obligations of the tenants should be used as the basis for analysis.

You must understand the nature or type of lease you are dealing with. The leases should be reviewed and summarized or briefed. A procedure should be established to process a lease once it is executed so that billing is accurately handled and lease administration is otherwise properly taken care of. See Chapter 10 for a more thorough discussion of this topic. It is important to clearly understand what the monthly/yearly base rent is, how much and when the rental adjustments are, and who bears the various operating cost burden as between the landlord and the tenant. These obligations will directly affect project cash flow and return.

There are, in general, four types of leases: the gross lease, the modified gross lease (or net lease), the triple net lease, and the bond lease. The main differences between these lease types concern which party will be responsible for the monetary obligations associated with the operation of the subject property and what, if any, obligations the tenant has regarding the mechanical systems, the roof, and the exterior walls of the project.

Gross Lease

In a *gross lease*, the operating expenses such as utilities, janitorial, landscaping, trash pick-up, management fees, and so forth are typically contracted and paid for by the landlord. A gross lease is usually found in office buildings, although the type of lease used for a particular project is more often governed by the landlord's philosophy and market factors such as what has been the prior custom and usage as well as what competing facilities in the area utilize.

Although in a gross lease the landlord covers the basic operating expenses, it is, nevertheless, customary to include an *expense stop*. An expense stop passes the cost of operating expenses over a specified level to the tenants. Typical lease language might indicate that: "Tenant shall pay its pro rata share of Operating Costs and Taxes over Base Year Operating Costs and Taxes." ("Base Year" is usually defined as a specific calendar year.)

The idea is that historical operating expenses serve as a floor over which the tenant participates based upon its pro rata share of the building expenses. For example, if it is agreed that calendar year 2010 will be the "Base Year" and operating expenses for that year were $100,000, then to the extent operating expenses for subsequent years exceed this amount the tenant pays its pro rata share of the excess costs. If we assume that the 2011 operating costs were $120,000 and the tenant's percentage of the project is 10 percent, then that tenant would pay as additional rent an annual charge of $2,000. The additional rent is calculated by multiplying the excess expenses over base expenses of $20,000 by the tenant's percentage of the building's square footage, or in this case 10 percent. As a shorthand abbreviation, tenant's obligation to pay expenses over a Base Year are often referred to as *common area maintenance charges* (CAM) expenses.

Of course, the Base Year may differ for different leases, given that the leases are entered into at different times. The effect of the expense stop is that part of the operating expenses are potentially passed on to the tenants. Using the above analysis and layering in a line for the expense recapture under the assumption that the landlord will recapture 4 percent of the operating expenses ($\$450{,}000 \times .04 = \$18{,}000$), the result is as follows:

Gross Income		**$1,440,000**
Expense Reimbursement		18,000
Total Gross Income		$1,458,000
Vacancy and Collection Loss		(72,900)
Adjusted Gross Income		$1,385,100
Operating Expenses		
Elevator Contract	(11,197)	
HVAC Maintenance Contract and Repair	(5,413)	
Insurance	(5,000)	
Janitorial Contracts	(52,600)	
Landscaping	(6,410)	
Property Taxes	(97,067)	
Property Management Fee	(43,740)	
Repairs and Maintenance	(13,470)	
Security and Fire	(27,931)	
Taxes and Licenses	(420)	
Trash Disposal	(6,336)	
Utilities	(180,956)	
Total Operating Expenses		**(450,540)**
Net Operating Income		**934,560**
First Trust Deed of $7,650,000 @ 7.5% 30-Year Amortization		(637,892)
Cap X Reserves		(18,000)
Tenant Improvements and Leasing Commissions		(60,000)
Net Cash Flow		**$218,668**

The result is additional income and, of course, this income flows to the bottom line in the form of increased net cash flow. A 4 percent expense recapture of expenses over base year is on the low side for gross leases. This would lead to the conclusion that several of the leases did not have an expense stop, or that the recapture in the leases was capped, or possibly that the leases were recently entered into and therefore the pass-through of expenses has not as yet occurred, or a combination of these factors. An examination of the leases and/or the rent roll should clarify the reason for the low percentage recapture.

Please note that since we are assuming that the property management fee is a percentage of the gross income, then this cost will increase as the gross income increases, unless excluded in the management agreement.

It should be recognized that collecting operating expense pass-through charges over base year is much more difficult than collecting rent or even collecting direct pass-through charges, such as when a tenant pays all or a part of its pro rata share of operating expenses as a direct expense, not over a base amount. Tenants clearly understand that it is their obligation to pay monthly rent. They also can readily follow that if they are obligated to pay their share of a monthly operating expense, such as utilities, and if they receive a bill each month for this charge, and assuming the charge is within an expected range each month, the expense becomes a normal expected and accepted expense. However, the concept of paying expenses over a base year level is much more difficult to understand and accept. Part of the problem is that in practice, often the tenant is billed only once a year for this charge. The landlord does not know the amount of the charge or even if there is going to be a charge until after the end of the year. The process is for the year to pass and then in January, February, or March, the landlord determines the expenses for the year that just expired and compares that amount to the Base Year operating expenses. If and only if the operating expenses for the year that has just passed exceeds the operating expenses for the Base Year, will the tenant pay their pro rata share of the excess to the landlord. The billing occurs once a year and the tenant does not know what to expect. Due to the unusual nature of the billing process, the tenant often does not view this bill as the same as rent, and consequently the percentage rate of collection for the operating expenses over base year tends to be significantly lower than usual and recurring invoices.

Given the unusual nature of the billing and the consequent difficulty of collection, a landlord might use the charge over Base Year as a bargaining chip in lease renewals. "If you renew for another five (5) years I will waive the outstanding pass-through balance." Alternatively, the landlord could, in a way similar to that used in triple net CAM reconciliations, build in a monthly impound system based upon prior years' results with a year-end reconciliation. If the billing is monthly, tenants tend to view the charge as a normal and standard fee. A process has been set up to pay the charge each month, the tenant gets in the habit of paying this bill like all other bills, and the result is fewer CAM delinquencies.

In the typical gross lease, the tenant is responsible for maintaining and repairing its premises, but the landlord retains most of the incidents of ownership, the responsibility to maintain and repair the project systems such as heating, air conditioning, and ventilating (HVAC), the common areas, the exterior walls, and the roof.

Modified Gross Lease

In a *modified gross lease* certain operating costs, usually utilities and janitorial expenses, are passed on as a direct expense to the tenant. With electric charges increasingly becoming unpredictable, landlords are pushing these charges over to the tenant as a direct expense. Also, when a specific tenant has an extraordinary requirement for a particular usage, such as the electrical usage associated with a radiology practice, it is common to pass this expense directly to the tenant.

Lease language covering this charge might be as follows: "Tenant shall pay as Additional Rent, without any right of deduction or offset, the actual charge for utility usage for the Premises. The utilities shall be placed in Tenant's name and billing shall be made directly to Tenant. In the event that the utilities cannot be reasonably placed in Tenant's name with direct billing, then Tenant shall pay for its utility usage based upon the reading of a submeter or, if a submeter is impracticable, Tenant shall pay its pro rata share of the Project's utilities on a monthly basis and Landlord shall invoice Tenant accordingly. Landlord shall have the same rights with respect to nonpayment of Additional Rent hereunder as it has with respect to nonpayment of any other amounts due hereunder." The utility charge is often viewed as a "consumable." The concept is that the amount of utility service consumed by the tenant is the direct charge that that tenant bears. If a swimming pool training facility or a hair salon or a restaurant uses more water than other tenants, should they not be charged for their usage?

When reviewing a project's leases, care should be taken to determine if all of the operating expenses are lumped into the CAM category or if a segregation has been made. Categories that are often broken out from the general CAM expenses include utilities, real estate taxes, and insurance. An economic reason that a landlord might want to break out these costs separately is that one category might increase while other categories decrease. If both categories are direct charges wherein the tenant is obligated to pay its pro rata share, then there is no difference if they are combined or in separate categories. However, if one expense is a direct charge and the other is over a base year, there could be a charge in one category while there is no charge in the other box. If an expense goes below a base year, typically the landlord does not impose a charge, but the tenant does not receive a credit.

For example, assume the general economy goes into a tailspin so that real estate values significantly decrease, which allows the owner to successfully appeal the assessed value upon which the real estate taxes are based, resulting in a $100,000 decrease in annual real estate taxes. Assume further, however, that due to other global pressures, the overall CAM expenses have increased $100,000. If all of the expenses were allocated to CAM charges, then the increase in CAM expenses would be offset by the decrease in real estate tax charges and the net effect would be a wash, no overage billing to the tenant. On the other hand, if the two categories are segregated, the tenants would have to bear their pro rata share of the $100,000 increased CAM expense and, if real estate taxes are a direct expense, rather than over a base year expense, the tenants would also be obligated to pay their pro rata share of the tax bill. Although the tax bill is reduced, it still would be an expense to the tenants.

In our hypothetical scenario, we assumed full service gross leases. Based upon expense stops in the leases we added an income line item entitled "expense reimbursement." This expense was dependent upon a comparison between the base year expenses and the current year expenses. If the current year expenses were less than the base year expenses, then there would be no expense reimbursement. With a modified gross lease, if the pass-through charge is utilities, as long as the tenant is in business, he must pay for his usage, so there always will be a charge to the tenant associated with that expense item.

The cost recapture under a modified gross lease might also be labeled "expense reimbursement" or simply "Utilities" after the type of expense that is being paid for by the tenant.

If we assume that several of the tenants in our hypothetical example pay a portion of the project's utility expense in addition to or in lieu of pass-through over base year expenses, our financial model might look as follows:

Gross Income		**$1,440,000**
Expense Reimbursement		
Recapture over Base Year	18,000	
Utility Recapture	76,800	
Total Expense Reimbursement		94,800
Total Gross Income		$1,534,800
Vacancy and Collection Loss		(76,740)
Adjusted Gross Income		$1,458,060
Operating Expenses		
Elevator Contract	(11,197)	
HVAC Maintenance Contract and Repair	(5,413)	
Insurance	(5,000)	
Janitorial Contracts	(52,600)	
Landscaping	(6,410)	
Property Taxes	(97,067)	
Property Management Fee	(46,044)	
Repairs and Maintenance	(13,470)	
Security and Fire	(27,931)	
Taxes and Licenses	(420)	
Trash Disposal	(6,336)	
Utilities	(180,956)	
Total Operating Expenses		(452,844)
Net Operating Income		1,005,216
First Trust Deed of $7,650,000 @ 7.5% 30-Year Amortization		(637,892)
Cap X Reserves		(18,000)
Tenant Improvements and Leasing Commissions		(60,000)
Net Cash Flow		**289,324**

The maintenance and repair obligations under a modified gross lease are usually similar to those in a full service gross lease except, depending upon the project layout, the tenant may be responsible for maintaining the HVAC units. To clarify, if the utility expense is passed on directly to the tenants, then the obligation to maintain and repair the applicable HVAC unit is usually passed on to the tenant. This becomes practicable if the unit serves only the tenant, but if the heating and air conditioning unit provides heat and cooling to multiple suites, then the landlord usually retains the maintenance and repair obligation.

Triple Net Lease

In contrast to a gross lease and a modified gross lease, a *triple net lease* requires the tenant to pay its pro rata share of operating expenses, not over a base year amount nor limited to certain operating costs, but rather to pay 100 percent of the actual operating costs associated with his percentage of the project. In other words, to the extent the property is leased, all of the operating costs are borne by the tenants. This type of lease is commonly found in a retail shopping center.

At first blush, it appears that the gross lease with an expense stop or a modified gross lease is much more tenant favorable when compared to a triple net lease, since all of the expenses are passed on to the tenant in a triple net lease. From an economic standpoint, however, these different types of leases can be structured to look identical. For example, if you price the gross lease at $1 per square foot with no expense recapture and charge the tenants $.70 per square foot with a triple net lease, the economics are similar if the operating expenses are $.30 per square foot. If we assume a tenant occupies 1,000 square feet, then the gross lease tenant pays $1,000 per month (1,000 square feet at $1 per square foot) and pays no extra monies for property operations, while the triple net tenant also pays $1,000 per month: rent of $700 (1,000 square feet times $.70 per square foot) plus an operating expense charge of $300 (1,000 square feet times the CAM charge of $.30 per square foot). At the end of the day, both the gross lease tenant and the triple net tenant have paid $1,000 per month. If there are any operating expenses over the $.30 per square foot amount, the gross lease tenant might pay this amount as a charge over base year while the triple net tenant pays it as part of his obligation to pay his percentage of operating expenses.

Nonetheless, often the perception is that the triple net lease tenant will pay more rent than the full service gross tenant. This perception may be accurate, especially if the landlord's lease negotiation pattern is to change the base year to a current year, for example, as part of a lease renewal.

Going back to our hypothetical example, let us assume that the ground floor of our medical office building contains a surgical center whose contractual obligation is based upon a triple net lease. The analysis might appear as follows:

Gross Income		**$1,440,000**
Expense Reimbursement		
Recapture over Base Year	18,000	
Utility Recapture	76,800	
Triple Net Charges	121,836	
Total Expense Reimbursement		216,636
Total Gross Income		$1,656,636
Vacancy and Collection Loss		(82,832)
Adjusted Gross Income		$1,573,804
Operating Expenses		
Elevator Contract	(11,197)	
HVAC Maintenance Contract and Repair	(5,413)	
Insurance	(5,000)	
Janitorial Contracts	(52,600)	
Landscaping	(6,410)	
Property Taxes	(97,067)	
Property Management Fee	(49,699)	
Repairs and Maintenance	(13,470)	
Security and Fire	(27,931)	
Taxes and Licenses	(420)	
Trash Disposal	(6,336)	
Utilities	(180,956)	
Total Operating Expenses		(456,499)
Net Operating Income		1,117,305
First Trust Deed of $7,650,000 @ 7.5% 30-Year Amortization		(637,892)
Cap X Reserves		(18,000)
Tenant Improvements and Leasing Commissions		(60,000)
Net Cash Flow		**$401,413**

Usually, when a real estate income and expense analysis is presented, all of the expense recapture is lumped into one line item. The expense recapture is broken out in the example simply to show the relationship to the lease types discussed in this chapter.

With a triple net lease, the obligations of maintenance and repair will most likely be passed on to the tenant, if that is mechanically feasible. However, usually the obligation to maintain and repair the roof and the structural integrity of the building remains with the landlord.

Bond Lease

Lastly, a *bond lease* has all of the characteristics of a triple net lease, yet continues to shift the responsibilities relating to the incidents of ownership to the tenant. Bond leases usually involve single tenant assets such as in a sale-leaseback situation where the lease is structured essentially as a financing vehicle.

In a bond lease, the tenant is not only responsible for the maintenance of the interior leased area, but usually is also responsible to maintain and replace, if necessary, the building systems, as well as to repair any damage that occurs to the exterior, including the roof and the structural components of the project. The destruction and condemnation risk is passed on to the tenant. Hence, if the building is destroyed by an earthquake, even if the tenant did not carry earthquake insurance, the tenant must continue to pay rent and must rebuild the structure!

In the previous lease types discussed here, there was no recapture of any of the expenses relating to Cap X, Tenant Improvements, or Leasing Commissions. With a bond lease, it would be expected that the tenant is obligated for the Cap X expenses since they relate to maintaining the physical integrity of the building. Also, with a bond lease it would be expected that the landlord would pass to the tenant 100 percent of the cost of the tenant improvements and leasing commissions, if any.

Since a bond lease is unusual, and essentially a financing vehicle, the hypothetical will not be modified to accommodate changes that would be expected for this lease type.

Nonrecoverable Expenses

As shown above, usually there is not a one-to-one correspondence between the total operating expenses and the operating expenses paid by the tenants. Usually there is some "slippage." In our hypothetical example, the total operating expenses are $456,499, yet the total expense reimbursement comes to $216,636.

In addition, there are often some expenses that are not recoverable expenses. For example, national tenant leases will often exclude management supervision as a recoverable expense. Also, the costs associated with running the owner's business are not expenses recoverable by the landlord. These expenses do not relate directly to operating the real estate asset and vary greatly depending upon the nature of the owner's operation. Consequently, these expenses are usually not reflected in a broker's sales package. Typical nonrecoverable expenses include administrative and office expenses, postage, office supplies, FedEx and courier charges, and legal and accounting services.

Given the reasons outlined above, the nonrecoverable expenses are not shown in the hypothetical example, but they should not be ignored. They are a real cost of doing business. It should be understood, however, that the management fee may absorb in part or in full the cost of the nonrecoverable expenses associated with running the owner's business.

Time-Frame Assumptions

It is crucial to determine the time frame within which the analysis is being conducted. The standard assumption is that the income and expense analysis is being generated on an annual basis; that is, each line item reflects an applicable annual figure. Hence, for example, the gross income figure of $1,440,000 represents income taken in over a complete fiscal year. The assumption is that the numbers represent annual figures since the project's value is typically determined by using annual numbers.

The problem is that nowhere in the analysis or the discussion is it stated that these figures represent income or expenses accumulated over an annual period. If the above numbers were based on monthly figures, then annualizing the monthly $1,117,305 NOI figure would result in an approximate $13.4 million annual NOI and an approximate $149 million fair market value at a 9 percent capitalization rate.

The point is that you should be keenly aware of the time frame in which the figures are generated so that the analysis can expressly and properly reflect the assumptions. Usually, if nothing is otherwise stated, NOI is expressed as an annual amount.

Static versus Active Analysis

Our analysis so far shows the results of one year of income and expenses. The problem is that using a one-year snapshot might be a good rough and quick determination of value and the project's prospects, yet it does not fully and completely reflect an evaluation of the potential investment, especially if the project is in a state of flux.

Why does an analysis based upon one year of income and expense results probably fall short of clearly setting forth a complete understanding of the project?

If the goal is to determine the stabilized value of the subject property and, if the project is in a lease-up mode, it would be misleading to use only actual figures for leases in place. Assumptions have to be made as to the rate of absorption and the market rate to be achieved. A construction project is an even more extreme example. Assuming no preleasing, when the construction is complete it will have no income, so does it therefore have no value? Of course this is inaccurate. You will need to make assumptions as to achievable market rent, the lease-up time frame, the cost to accomplish the fill-up, and the capitalization rate once you achieve stabilized occupancy.

Let us assume that the project is an existing real estate project with 85 percent of the potential rentable space leased and occupied, yet a major tenant's lease or several tenant's leases expire in the next two years. Does the hypothetical analysis constructed so far account for these types of assumptions? It does not address the potentially disastrous effect of losing a major tenant or, for that matter, of losing any tenant, nor does it cover the possibility of gaining additional value as the result of leasing-up the remaining vacant space or gaining value due to increases in rental income, given that lease rates typically adjust upwards annually.

Our analysis so far is a static analysis reflecting one year's operating results at a particular point in time. A more complete model spreads the income and expenses over several years to show operational changes and makes assumptions as to what will occur at crucial junctures, such as when leases mature.

The model should reflect what contractually happens during each lease's lifetime. In other words, it should reflect rent escalations and expense increases. When analyzing a transaction to determine value or upside potential, a 10-year financial projection is typically created. When doing so, the gross income is spread, lease-by-lease, month-by-month over the time frame. Each lease is reviewed to determine what, if any, increases are built into the agreement. Usually a lease will have an annual adjustment. The nature of the adjustment must be reflected in the projections. Is the adjustment based upon a fixed percentage increase, for example, 3 percent, or upon a per square foot increase, for example, $.05 per square foot? Alternatively, the adjustment may be based upon changes in the consumer price index (CPI). If so, is there a floor or a ceiling or both? When does the adjustment occur? Does the adjustment occur annually or on a "stepped" basis? When an adjustment is set on a stepped basis, it is flat for a few years, then an increase occurs, then the rent is flat for a few years again, then another increase occurs, and so on. The timing of the increase has to be built into the model. Does the change take place on the anniversary of the lease or as of January 1 of each year?

In addition to the base rent adjustments, changes in expense reimbursements such as CAMs over base year, utility and/or janitorial pass-throughs, and triple net charges must be scrutinized. The analysis should take into account when the reimbursement occurs and the amount of the recovery that should be guided by historical expense levels and the historical expense recovery figures. Care must also be taken to recognize any cap on the expense reimbursement. Caps can take the form, for example, of a maximum percentage increase from the prior year, a dollar cap, or a cap based upon the monthly base rent, such as "Tenant to pay its pro rata share of utilities for the Project not to exceed on an annual basis the Monthly Base Rent in December of the applicable year."

Operating expenses change over time. It is a relatively easy task to inflate expenses by 3 percent each year for analysis purposes. The computer can do that function in a matter of seconds. The issue remains, however, whether this is the proper assumption. It is simple to calculate, but not necessarily accurate. A better approach might be to use a rule of thumb, but also to look at individual line items and make appropriate corrections where applicable.

Compounding

It is important to understand the concept of compounding and its applicability to a real estate investment analysis. One dollar invested in a saving account earning 3 percent would increase to $1.03 by the end of the year. The same account at the end of year two would be worth approximately $1.0609. The crucial factor is that the growth in the account is from the $1.03 starting point, and not from the original dollar. You earn interest on the interest.

Similarly, in the real estate rental context, if year one base rent is $1,000 per month and the adjustment is 5 percent, then the year two base rent is $1,050 per month. At the beginning of year three, the base rent becomes $1,102.50 per month. To calculate the rent increase you multiply 5 percent times the immediately prior monthly rent of $1,050 and then add that amount to the base rent. The point is that by contract you usually do not go back to the original base rent of $1,000 and determine the increase by multiplying 5 percent times the original base rent. If you went back to the original base rent, the result would be a $50 increase per year, which when added to year two base rent would result in a base monthly rent of $1,100 rather than $1,102.50. You calculate the third-year rent amount based upon the immediately preceding year's rent, not on the original rent level. The effect is not dramatic in the above example since the rental amount and the percentage increase is relatively small, yet if the base rent is larger or, even more to the point, if you calculate the increase on the entire project's gross rents, and especially if you are calculating year 10's escalation, the compounding effect can be very significant. The combination of base rent adjustments and the compounding factor result in increased income and therefore in increased project value.

Rent Roll

A review of a current rent roll is a logical starting point when analyzing a project. Please refer to Exhibit A.1 in the companion website, located at www.wiley.com/go/wealthopportunities, which illustrates a comprehensive rent roll for the Diamond Medical Center. The rent roll not only sets forth the Base Rent, but also indicates, among other things, operating expenses paid by tenants as well as the dates of the next rent increase and of lease expirations.

A review of the rent roll leads to several conclusions about our hypothetical fact situation:

- The Rent Roll is "As of November 1, 2007." This date becomes important as it relates to the financial information, for example, rent escalation dates and expense charges over base year.
- The medical building is a multitenant project.
- The project is 100 percent leased.

- There are staggered lease terms with the largest concentration of maturing leases in 2010.
- Approximately one-third of the tenant leases expire in 2010.
- The ground floor surgical center is the main tenant occupying about 17 percent of the building by size and 22 percent of the total revenue.
- The lease type varies significantly from triple net for the surgery center to modified gross for Jones Pharmacy, Inc., Healthcare Associates, Inc., Dr. Payne, Tom Murphy, Dr. Patterson, and The Nip/Tuck Plastic Surgeons to full-service gross leases for Dr. Orr, Dr. Lumer, Walter & Fritz, Alfred P. Shrink, Oncology Associates, Inc., Dr. Tooth, and Dr. Surgery. Both Children's Urgent Care and Hip, Knee, Shoulders Group, LLC, are full-service gross leases without any expense recapture. There are also leases that contain both direct pass-throughs and expense recapture over base year, such as Dr. Miller, Dr. Slipdisky, Dr. Foote, and Dr. Vision.
- There are expense recapture caps in some of the leases as set forth in the comment section of the rent roll.

Argus Ten-Year Discounted Cash Flow Model

Our analysis so far is a comprehensive breakdown of the yearly income and expenses generated for a real estate project but, as previously indicated, it is a relatively static analysis. It fails to take into account what happens to the financial numbers over several years, which can have a profound effect on the project's yield.

A financial model reflecting changes over time is needed. "Argus" is a proprietary computer program for analyzing a real estate project that is designed to spread the leases over time.* The first step in generating an Argus 10-year projection is to input the lease data into the Argus model. Please refer to Exhibit A.2 in the companion website. The amount in parenthesis under the column entitled "Description of Operating Expense Reimbursement" represents the estimated base year expense for the applicable year. The Argus model is based upon contractual lease rates in place. Hence the

*For more information about Argus Software and its software program(s), its training opportunities, and its other services, I suggest viewing its website at www.argussoftware.com or calling 1-888-myargus.

starting point is to use the rent roll to determine gross income, which includes expense reimbursements and increases based upon contractual lease rate adjustments. Over time, changes occur in the economics of the contractual relationship. Over time, lease rents increase and these lease rate changes must be reflected in the model. Similarly, expenses are not fixed, but rather usually increase over time. An inflation assumption must be made to reflect operating expense costs during the period analyzed.

Additionally, leases mature as reflected in the rent roll. Therefore, you must make assumptions as to what the rent will be at lease expiration, what the probability is that the lease will be renewed, how long the unit will be vacant, if applicable, and what the cost will be to release the space in terms of down-time, free rent, leasing commissions, and/or tenant improvements.

The rent roll reflects the term and lease expiration date for each lease. When a lease expires is a crucial piece of information, since usually it is then that either a new lease is negotiated with new rental rates and possibly landlord concessions, including free rent and tenant improvement allowances, or, alternatively, the landlord must seek a new tenant with the consequential downtime, leasing commissions plus possible additional concessions to the tenant, such as free rent and a tenant improvement allowance. Exhibit 3.1 reflects, as labeled, a "Lease Expiration Schedule." Also, Exhibit 3.2 shows the lease expirations by year in graphic form. As can be seen from the expiration schedule and the chart, a large percentage of the tenant leases expire in 2010.

In order to create an Argus spread sheet, numerous assumptions must be made. It is important to clearly understand the assumptions because variations in the assumptions can drastically change the outcome.

In Chapter 2, we assumed a 9 percent cap rate to derive a value of $10,200,000 for the subject property. Based on a 75 percent LTV loan of $7,650,000, we determined that the owner's equity was approximately $2,550,000. Now let us assume the existing owner, Diamond Jack (DJ), has decided to sell the medical office building. Cap rates have decreased. Investors are willing to accept a lower rate of return. Interest rates have also decreased significantly. Alternative investments are perceived to be more risky. The market cap rate for this type of property is now in the 7 to 8 percent range. Also, the gross income has significantly increased since we have added to

Exhibit 3.1 Lease Expiration Schedule

Year	Tenant	Expiration Date	Square Feet	% of Total
2007	Jonathan Y. Lumer, D.D.S.	11/07	2,032	3.39%
			2,032	3.39%
2008	Gene Patterson, M.D.	12/08	1,500	2.50%
			1,500	2.50%
2009	John Payne, M.D.	10/09	4,668	7.78%
	Oncology Associates, Inc.	12/09	3,550	5.92%
			8,218	13.70%
2010	Jones Pharmacy, Inc.	01/10	1,847	3.08%
	Healthcare Associates, Inc.	02/10	5,400	9.00%
	Hip, Knee, Shoulders Group, LLC	02/10	3,020	5.03%
	I. Seymore Vision, M.D.	03/10	2,277	3.80%
	Tom Murphy	06/10	1,760	2.93%
	Children's Urgent Care	12/10	5,200	8.67%
			19,504	32.51%
2011	Sidney Slipdisky, M.D.	01/11	2,000	3.33%
	Alfred P. Shrink, Ph.D.	06/11	1,250	2.08%
	The Nip/Tuck Plastic Surgeons	07/11	1,700	2.83%
			4,950	8.25%
2012	Kevin Toothe, D.D.S	01/12	2,250	3.75%
	Walter & Fritz	05/12	1,300	2.17%
	Lazar I. Surgery, M.D.	08/12	2,850	4.75%
	Alfred Foote, DPM	09/12	1,790	2.98%
			8,190	13.65%
2013	David Miller, M.D., Inc.	09/13	1,923	3.21%
			1,923	3.21%
2014	James R. Orr, M.D.	01/14	2,677	4.46%
			2,677	4.46%
2015	Do It All Surgical, LLC	12/15	10,153	16.92%
			10,153	16.92%
n/a	Management Office		853	1.42%
		Totals	**60,000**	**100.00%**

our hypothetical example recapture of operating expenses. Let us assume that the DJ is under contract to sell the project to Steven Stable for $14,500,000. The terms of the purchase contract require the buyer to put 25 percent down or $3,625,000 and finance the balance of 75 percent or 10,875,000. Given the anticipated change of ownership, the property tax expense must be increased based upon the current value and the applicable mill rate.

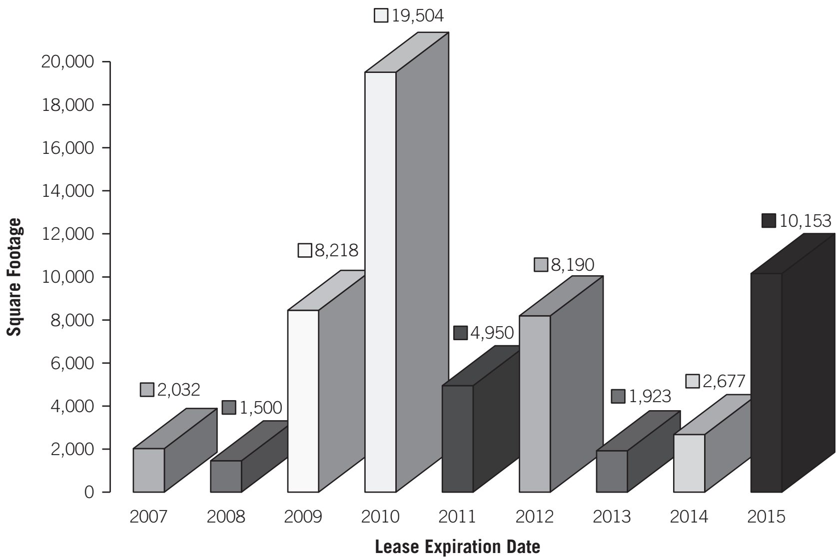


Exhibit 3.2 Lease Expiration in Graph Form

Following are the assumptions built into the Argus analysis.

General Project Assumptions	
Commencement Date of Analysis	November 1, 2007
Length of Analysis	10 years
Building Square Footage	60,000 net rentable square feet
Revenues	
Current Market Base Rent	$2.00 per square foot per month
Market Rent Growth Rate	3%
Other Income Growth Rate	3%
Consumer Price Index (CPI)	3%
Number of Parking Spaces	300
Current Parking Income	None
Parking Income Growth Rate	N/A
Storage Income	Contractual income inflated by 3% No net lease gain or loss
Expenses	
Vacancy and Collection Loss	5%
Operating Expense Growth Rate	3%

General Project Assumptions	
Real Property Taxes Growth Rate	3%
Property Taxes to Be Reassessed?	Yes
If Property Taxes to Be Reassessed, the Mill Rate	1.22%
Management Fee (Percentage of Effective Gross Income)	3%
Capital Reserves	$.30 psf
Tenant Improvement and Leasing Commission Reserves	$1.00 psf
Expense Recovery	Lease type varies from gross to gross without an expense recapture to modified gross to modified-modified gross with a recapture over base year to triple net See rent roll for tenant obligations
Valuation Assumptions	
Going-In Capitalization Rate	7.2%
Residual Capitalization Rate	8%
Residual Cost of Sale	5%
Second Generation Assumptions	
Retention Rate	70%
Releasing Downtime	Under 5,000 square feet: eight (8) months; 5,000 to 10,000 square feet: twelve (12) months; over 10,000 square feet: eighteen (18) months.
Rental Concessions	
Tenant Improvements	Renewal: $10; New Tenant: $20
Free Rent	Renewal: $0; New Tenant: 3 months for first 3 years only, i.e., until October 31, 2010, then $0
Lease Term	5 years
Leasing Commissions	Renewal: 2% New: 6%
Assumptions for Vacant Space	
Amount of Vacant Space as of the Commencement of the Analysis	0
Financing Assumptions	
Loan to Value Ratio	75%
Loan Fee	1%
Debt Coverage Ratio	1.20
Interest Rate	5.50%
Amortization Period	First 3 years I/O, then 30-year amortization.

In addition to the above assumptions, given this specific fact pattern, the following further assumptions must be made:

- The rent roll indicated that the operating expenses for 2007 were $450,000. This number was deflated by 3 percent in order to determine the expense stops for prior years.
- If a tenant was obligated to pay utilities as a direct expense, then utilities were backed out of the Base Year Stop calculation.
- Jonathan Y. Lumer, DDS (Suite 300): Since this tenant is on a month-to-month lease, his lease rate was extended through the first month of the analysis and then rolled to market. His monthly rent is $3,533.57 and recoveries fell well below this number; thus the cap was not reached.
- Walter & Fritz (Suite 310): The only tenant for which the option period rent was calculated given the definiteness with which the option period rent could be determined, that is, a fixed 3 percent annual increase.
- The Nip/Tuck Plastic Surgeons (Suite 550): The CPI increase was assumed to occur annually on January 1 at 3 percent, the floor in the collar.
- Alfred P. Shrink (Suite 410): The option was not modeled, that is, because what the rent will be at the time of the option is uncertain and, of course, it is uncertain whether or not the tenant will exercise the option, the option rent was not included in the analysis or, in other words, the analysis was made as if the option was not exercised.
- Kevin Tooth (Suite 530): The option was not modeled.
- Tom Murphy (Suite 500): The option was not modeled.

The rent roll does not show any recoveries for Children's Urgent Care and Hip, Knee, Shoulders Group, LLC. It was assumed that leases for these tenants are full-service gross with no recoveries.

Analysis Reflecting 100 Percent Occupancy

Please refer to Exhibit B.1 in the companion website, which reflects a 10-year Argus run reflecting how the income and expenses change over time.

A key element in the analysis is the holding period. This Argus spreadsheet assumes that the property is sold at the end of the tenth year.

Reversion

When a real estate asset is purchased, what assumption does the buyer, Steven Stable, make as to how long he is going to hold title to the property? The reversion is the amount of monies received by the owner when the real estate is sold or, for the purposes of evaluating a property's value, the amount of money it is anticipated that the owner would receive if the property were sold. How long should the holding period be? It depends on for whom and for what purpose you are evaluating the property, but usually a 10-year holding period is assumed. The discounted cash flow adds the sum of the present value of the first 10 years NOI and then uses the eleventh year NOI to determine the reversion value. In determining the reversion you are asking the question, what would a buyer pay for the property at the beginning of the eleventh year? Theoretically, it would make sense to do another discounted cash flow model starting in the eleventh year, yet given the uncertainty of these projections, it is far easier and seemingly just as accurate to cap the eleventh-year cash flow.

In order to determine the sales price, the eleventh-year NOI is divided by a capitalization rate. This capitalization rate is usually referred to as the *terminal capitalization rate* or the *"going-out" capitalization rate*. In contrast, if the first year's income is being capped, then the percentage is referred to as the *"going-in" capitalization rate* or, simply, the capitalization rate (Cap Rate). It is common for the going-out capitalization rate to be higher than the cap rate used at the time of acquisition. Typically, the going-out cap rate will be equal to approximately one percent higher than the market cap rate at the time of purchase. Obviously, no one knows what the cap rate for this type of property will be 11 years hence, yet for conservative analysis purposes, it would seem a fair assumption to increase the going-in cap rate to derive the going-out cap rate, given that the further out you go the more uncertain the future.

Hypothetically the going-in Cap Rate is 7.2 percent and the going out Cap Rate is assumed to be 8 percent.

Disposition Costs

After the NOI is capped and a reversion value is determined, the price must be adjusted for a reasonable sales commission. The sales commission is usually expressed as a percentage of the estimated sales price. Typically a 3 percent figure is used; however, on larger properties it is common to use a lower commission percentage or a flat commission amount.

Most analyses reduce the reversion only by the anticipated sales brokerage cost; however, there are other costs that should be anticipated. Most of the other costs in a sales transaction are borne by the buyer; however, a seller will incur closing costs such as legal fees, escrow expenses, title charges, and possibly a defeasance penalty (a charge imposed by the lender due to a premature repayment of the debt).

The Time Value of Money: Present Value and Discounted Cash Flow

The end result in the Argus presentation is a cash flow for each of the next 11 years. How do you then determine value? Do you add up each one of these numbers to arrive at the total value? The answer is no. The answer lies in the concept of the "time value of money."

What would you rather have: a dollar today or a dollar one year from today? Obviously, you would rather have one dollar today, because if you have the dollar today you can invest that dollar and earn a return so that the dollar at the end of the year would be worth one dollar plus three cents, if the rate of return on the investment was 3 percent. The converse also applies; that is, what would you pay today to have one dollar and three cents at the end of one year? If you assume a return of 3 percent, you would pay one dollar today. In the accepted nomenclature, the one dollar is referred to as the *present value*, the three percent is called the *discount rate*, and the one dollar and three cents is the *future value*. The discount rate is essentially the rate of interest, but because the calculation is to reduce value rather than increase value, it is referred to as a "discount rate." The process of determining the present value of a stream of income is referred to as "discounting the cash flow."

Applying the time value of money to our cash flow model involves the concept of discounting the cash flow. The objective is to determine the present value of the cash flow. What is it worth today to receive this cash flow over a 10-year period plus discounting the net sale proceeds in the eleventh year? In order to calculate present value, you apply a factor to the yearly cash flow. The Argus analysis uses a wide range of figures as the discount rate from 5.31

to 15.79 percent. The most difficult portion of this analysis often revolves around determining what discount factor should be used. The factor you select is a function of your perception of alternative investments and market returns.

Net Present Value (NPV)

Net present value (NPV) reflects how well the investment performed in relation to one's target return. After the cash flow is discounted at the given discount rate, the initial investment plus the discounted value of any additional equity infusion is backed out. In other words, discount the cash inflow and compare this figure to the discounted value of the cash outflows. If the result is positive, your target yield has been exceeded; if it is negative, the target yield has not been achieved.

The net present value is calculated as follows:

Net Present Value = Present Value of the Project's Cash Flow – the Initial Investment + the Present Value of Any Additional Capital Contribution

Applying the net present value concept to the hypothetical example, if the discount rate is 8.31 percent, there is a positive NPV. The present value of the cash inflow, equal to approximately $14 million less the initial investment of $3,625,000, is a positive number. The conclusion is, therefore, that Steven Stable will earn more than the 8.31 percent discount rate.

Internal Rate of Return (IRR)

The internal rate of return (IRR) is the discount rate that results when the present value of the project's cash flow equals the initial investment plus the present value of any additional capital contribution. In other words, the IRR for a project is the discount rate when the net present value is zero.

Again, applying this definition to our hypothetical example, at a 13.29 percent IRR, the analysis shows a project value of $3,625,000, which equals the $3,625,000 initial investment.

In Chapter 2 we defined the Cap Rate as the NOI divided by the FMV and Return on Equity as the Net Cash Flow divided by the equity investment. In both of these calculations, the result of one year's figures were used. When calculating IRR, the idea is to look at the cash flow coming from several years and ask the question: what rate of return is required to grow the original investment so that it achieves the given cash flow and return of principle? In other words, what percentage should you use to discount the present value of the income stream so that it equals the original investment plus the present value of any additional investment? You need not discount the original investment since it already is at time period zero.

Rule Number 11

The higher the discount rate, the lower the present value. When buying, seek a high discount rate, a high IRR. When selling, aim at a low discount rate, a low IRR.

As can be seen in Exhibit B.1, there is an inverse relationship between the discount rate and the present value of a stream of cash flow. When you are acquiring property, you want a high IRR because that means that you need a low present value of the cash flow to achieve the present value of the cash investment. Conversely, when you are selling, you seek a low discount rate because hopefully it will far exceed the present value of your investment.

Conclusions from Argus Analysis and the Hypothetical Facts

In our hypothetical scenario, as initially set forth in Chapter 2, Diamond Jack bought Diamond Medical Center for $10,200,000 and is now selling it to Steven Stable for $14,500,000 after a two-year holding period on a cash investment of $2,550,000. Jack's profit is $4,300,000, an 84 percent return per annum! The buyer, Steven Stable, is acquiring the asset at $14,500,000. The Argus run reflects this value if the projected cash flow is discounted at a rate of 7.81 percent. Stable's IRR is 13.29 percent, based upon a cash investment of $3,625,000.

Please note that when determining the Annual Cash Flow to discount, as shown on page 5 of Exhibit B.1, the figures are derived from the Schedule of Prospective Cash Flow found on page 1 of

Exhibit B.1. The Prospective Cash Flow is reduced by Leasing and Capital Costs to arrive at Annual Cash Flow. In other words, the Annual Cash Flow is the cash flow before debt service and before taxes; that is, it is as if the property is being purchased for all cash.

From the buyer's perspective, several conclusions can be drawn from this Argus analysis. First, in the third and ninth year of operations, given the large amount of maturing leases, the projections indicate that the releasing costs will result in a break-even cash flow and a negative cash flow, respectively. Second, based upon an initial capital contribution of $3,625,000, the leveraged cash-on-cash return varies from a negative return when the cash flow is insufficient to meet the tenant improvement, leasing commission, and capital costs to a high return of 12.36 percent. As stated above, the leveraged internal rate of return is shown as 13.29 percent, and Steven Stable is purchasing based upon a discount rate of 7.81 percent. These returns are not exceptionally high, which would be consistent with the 100 percent leased nature of the investment, but they are reasonable given a 7.2 percent going-in cap rate. A major contributing factor to the enhanced yield above the going-in cap rate is the positive leverage resulting from a 5.5 percent interest rate. Lastly, given cap rates and the interest rates, based upon a reasonable discount rate of between 7.31 and 9.31 percent, the FMV varies from approximately 15 million to about 13 million.

Analysis Reflecting a Large Vacancy after Purchase

Let us assume the same purchase and sale facts as outlined above. The medical office building was purchased for $14,500,000. The down payment or equity was 25 percent of the sales price, or $3,625,000. The purchase money mortgage was 75 percent of the sales price or $10,875,000; during escrow, Mr. Stable approved the buyer's contingencies, yet did not lock in his interest rate until three days before closing. Unfortunately, the interest rate spiked upward between the time he "went hard" on the purchase and when the lender fixed the loan interest rate. The purchase was closed with a loan interest rate of 7 percent for a 10-year term, interest-only for the first three years then a 30-year amortization. Equally unfortunate, within a short time frame from close of escrow a significant number of tenants did not renew their leases or defaulted and vacated their suites.

A revised rent roll—see Exhibit A.3 in the companion website—reflects a large vacancy of 17,723 square feet, approximately 30 percent of the total square and about 34 percent of the scheduled income. The revised rent roll assumes that the surgical tenant's leases in suites 550, 610, and 620 expired and that these tenants left the project to form their own surgery center. It is also assumed that with the mass exodus of the surgeons, the business volume of the Surgical Center located on the ground floor collapsed, and the tenant vacated and filed for bankruptcy.

A quick-and-dirty approach to determine value in a project that has a large vacancy—or to state the problem in more positive terms, a lease-up challenge—would be to compute the income and expense analysis based upon scheduled rents for the vacant space and then cap the NOI at a reasonable level. The resulting amount would then be reduced by the cost to get there, that is, by the estimated cost to lease-up the vacant space to achieve stabilized occupancy. In our example, starting with an NOI of $1,047,891, which represents stabilized occupancy as shown in year 1 of the Exhibit B.1 Argus model, and capping this amount at 7 percent results in a value of $14,969,871 (see all exhibits on the companion website). If we assume that it will take 14 months to lease-up the large ground floor space plus an additional four months of free rent, the result would be lost income of $365,508 (10,153 square feet @ $24 per square foot divided by 12 × 18). As to the balance of the smaller vacant space, if we assume that it will take eight months to lease it up, plus two months of free rent, the result is $151,400 of lost income (7,570 squarer feet @ $24 per square foot divided by 12 × 10). If we assume that the average tenant improvement cost will be $37 per square foot, this concession comes to $655,751 (17,723 square feet @ $37 per square foot). Furthermore, if we assume the leasing was accomplished in part by outside brokers and in part by the owner and therefore the brokerage cost was on the average 4 percent of the gross income, excluding annual escalations, on five-year leases the cost would be $85,070 (17,723 square feet @ $24 per square foot × five years × 4 percent). The result is a rough estimate of value of approximately $13,712,142 ($14,969,871 less $1,257,729).

Let's see how this quick-and-dirty approach compares to the more detailed Argus model. Let us assume as to the vacant space the following:

Releasing Down-Time	Under 5,000 square feet: 8 months; 5,000 to 10,000 square feet: 12 months; over 10,000 square feet: 18 months
Rental Concessions	
Tenant Improvements	0 to 10,000 square feet: $20 per square foot Over 10,000 square feet: $50 per square foot
Free Rent	0 to 10,000 square feet: 3 months free
	Over 10,000 square feet: 6 months free
Lease Term	0 to 10,000 square feet: 5 years
	Over 10,000 square feet: 10 years
Leasing Commissions:	6%

The Argus run reflected in Exhibit B.2, found on the companion website, assumes the same initial investment of $3,625,000, as was assumed in Exhibit B.1. The major differences between the two scenarios are 100 percent occupancy versus 70 percent occupancy and a 5.50 percent interest rate versus a 7 percent rate. The leveraged cash-on-cash return is negative during the first three years and never exceeds 8.13 percent except in the year of sale.

The leveraged IRR is 7.92 percent, lower than the assumed exit cap rate. The return is a disaster. You purchased the property with the intention of maintaining the going in cash flow and if possible improving it, yet in fact what happened is that you lost a large portion of your tenant base. Putting this result into technical terms, it is called *losing money*. The project value decreased from $14,500,000 to $13,943,000 if you assume a 7.81 percent discount rate. The $13,943,000 value is fairly close to the $13,712,142 value obtained using the above quick-and-dirty approach.

Analysis Reflecting a Large Vacancy with a Tenant in Tow

Why does one party perceive that a certain real estate investment is a good buy while another party feels it is overpriced? The answer usually revolves around one's perception of how to create value, or to put a label on the concept of "vision." One party envisions how he can create value while the other party might see dangers and pitfalls.

Let us assume the rent roll is as shown in Exhibit A.3 in the companion website, with a 17,723 square foot vacancy. A new buyer, Smart Investor, paying market value based on the current occupancy contracts to buy the project for $12,000,000, which is a 5.15 percent Cap Rate on the existing NOI of $618,420 as shown in Exhibit B.2 The Cap Rate is quite low. No income is attributed to the vacant space in determining NOI. Consequently, Smart Investor has a large upside if he can execute and create value by leasing up the vacant space. The purchase price is at $200 per square foot ($12,000,000/60,000 square feet). This figure is significantly below replacement cost for a quality medical building with internal tenant improvements in place. Assuming Smart Investor's down payment is 25 percent of the purchase price, the initial investment is $3,000,000 with financing of a first trust deed of $9,000,000 at 5.50 percent interest-only for the first three years, then 30-year amortization.

Let us further assume that our prospective buyer owns and operates surgical centers, so that upon acquisition it will put a surgical center in the ground floor and doctors affiliated with the surgical center will use the office space in suites 550, 610, and 620. There is no leasing downtime, no free rent, and zero leasing commissions. The only rental concession is a tenant improvement allowance of $20 per square foot.

Exhibit B.3, on the companion website, shows an Argus run based upon the above assumptions. Smart Investor's leveraged cash-on-cash return to his equity investment varies from 3.21 percent to 22.7 percent, and the annual leveraged IRR over the 10-year holding period is 19.14 percent. Smart Investor paid $12,000,000 for the property and, per the Argus analysis, the FMV is approximately $14,000,000 at a 7.81 percent discount rate. The 7.81 percent discount rate is utilized since it was used in the other examples given earlier. The result is the immediate value creation of $2,000,000. Unlike the prior example of losing money, this factual situation illustrates "value creation." Smart Investor paid a price for the real estate based upon income in place, giving no value for vacant suites, and then shortly after close of escrow filled the vacancies at market rent with minimal concessions. Smart Investor took a reasoned and calculated risk and hit a home run.

What can be concluded from the three Argus scenarios, an analysis wherein the properties are (1) a stabilized 100 percent leased property, (2) a purchase of a fully leased property that then develops a severe vacancy and delinquency problem, and (3) a purchase of a property that has a large vacancy, but the buyer has a tenant in tow that immediately fills the vacancy? My conclusions are as follows.

- You can lose money as well as make money in commercial real estate.
- You should judge a real estate investment in terms of your appetite for risk. One property might contain credit tenants

on long-term leases, while another property might have local mom-and-pop tenants on short-term leases. An investment in one of the properties might make sense for one party but not another individual, and vice versa.

- Vision, strategy, and execution are the crucial elements in creating value in a successful real estate project.

Wealth Opportunities in Commercial Real Estate: Management, Financing, and Marketing of Investment Properties
By Gary Grabel

CHAPTER 4

Lease Analysis

The Importance of Basic Lease Provisions

To gain a complete understanding of commercial real estate, learning about the basic lease provisions that drive a transaction's economics is crucial.

When acquiring commercial real estate, or acting as an owner of commercial real estate, you are typically purchasing or owning a "leased fee estate." You will either take title or hold title subject to existing leases, or you will be negotiating new leases. It is therefore critical to understand the leasing game:

- What are the key economic lease provisions?
- What do the important lease paragraphs mean?
- What provisions are essential to include in the lease?
- What matters are usually excluded from the lease?
- What are the typical parameters acceptable for negotiation?

This chapter does not attempt a paragraph-by-paragraph analysis of each and every clause typically found in a lease, but rather discusses key economic provisions and problem areas on which to focus, as well as provisions that are most commonly negotiated. It should be emphasized that there are a multitude of legal issues contained in a lease that are not addressed in this chapter. These include issues concerning security, environmental problems (such as disposal of hazardous waste), insurance, eminent domain, casualties, estoppel (tenant representations that can be relied upon) language, subordination, nondisturbance and attornment (tenant agreeing under certain circumstances to accept another party, usually the lender, as the landlord) provisions, Americans with Disabilities Act matters, and default language and remedies. Again, the focus here is on key business points and areas that are often heavily negotiated in a lease.

In discussing the economic provisions found in a lease, it should be kept in mind that these provisions are often interrelated. In other words, one matter might significantly affect another provision. For example, a tenant who seeks a submarket rent, a short-term one-year lease, and major lease concessions relating to tenant improvements and free rent is probably going to be shown the door. If the landlord is going to make a significant investment in the tenant's space, the trade-off is to build in a rental amount or term, or both, that allows the landlord to recover his costs and hopefully make a profit. Similarly, if a prospective tenant has a weak financial statement, the landlord may be hesitant to fund extensive tenant improvement dollars and may seek an enhanced security deposit.

It is also important to understand that although the lease provisions form the basis for the contractual rights and liabilities between the landlord and the tenant, there is an overall business relationship between the parties. The relationship is an interdependent one. The landlord depends on the tenant to keep his building leased and cash flow coming in, and the tenant depends on the landlord to maintain the physical structure and the common areas, and to provide the necessary services, such as janitorial, air conditioning, and elevator service.

What happens if one of the tenant's patrons spills coffee on the waiting room carpet? The tenant asks the landlord to have the janitorial crew attempt to remove the stain. What happens if the tenant's cabinet-latch breaks? The tenant requests that the landlord's day porter or handyman attempt to fix the latch. A strict reading of the provisions in the lease might reveal that shampooing the carpet constitutes an extra charge and fixing the latch is outside the scope of the landlord's obligations. Nevertheless, in order to maintain and foster good relations with the tenant—providing the landlord feels that the tenant has not continually abused his goodwill—the landlord may address these issues without charging the tenant. The landlord is already paying for janitorial services. The handyman is already receiving a monthly paycheck. There is no additional charge to the landlord if he allocates an hour of the day porter's time and energy to fixing the latch. If there is a cost to the landlord, it would probably be a small incremental charge. This is the subjective area of lease administration: balancing expenses versus fostering a good relationship with clients. There is no right answer, but I would suggest that a rigid "no" policy is not in the landlord's long-term best interest. On the other hand, being too soft and always saying "yes" does not work either. Each property is a business unto itself, and if the landlord continually grants concessions outside of the scope of the contract, the operating expenses can get way out of line. A balance must be maintained. If, for example, the tenant's request to install new carpet is extremely important to the tenant, then possibly a compromise can be reached wherein the cost of the materials and labor is split between the parties.

In negotiating the provisions discussed herein, the role of counsel should be mentioned. Representation by an attorney is essential. Commercial lease provisions can be technical and confusing. Everyone has heard the adage, "If you represent yourself, you have a fool for a client." An attorney who specializes in transactional lease matters can be invaluable in the negotiation and drafting of the lease.

It is always preferable to start with your lease form, if possible. However, major tenants will often dictate that their own lease form be used. In any event, the crucial element is which party drafts the changes. The party who controls the drafting, the side who is willing to spend the time, money, and energy to make the proposed or agreed-upon changes, is the side that usually has the upper hand.

Rule Number 12

The side that drafts the lease changes wins.

Twelve Key Economic Ingredients in a Lease

The following 12 provisions should be understood to properly grasp the economics of a lease transaction:

1. **Type of Lease**: Is the lease a gross, modified gross, triple net, or bond lease? An understanding of the lease type will shed light on which party bears the cost burden and/or the responsibility for various operating services. Please refer to

Chapter 3 for an explanation of the differences among the provisions typically contained in these various lease types.

2. **The Parties/Liability**: Is the tenant signing individually or is another legal entity executing as the tenant? Often this issue arises when a potential tenant is asked who is going to be the obligor on the lease and the response is "Smith's Bakery." Most likely "Smith's Bakery" is a fictitious business name for the bakery company. John Smith is doing business as (dba) "Smith's Bakery." In this event, John is conducting business as a sole proprietorship and refers to his business as "Smith's Bakery," but "Smith's Bakery" is not a legal entity. Legal entities other than an individual include a corporation, a partnership, and a limited liability company, but not a "dba." Further inquiry into the organizational documentation surrounding John's business should reveal who is the real owner of the business. Asking John to submit his certificate of formation and/or tax returns should help to clarify the issue of how title is held.

   If an entity, as opposed to an individual, is the tenant, then you, as the landlord, may want a guaranty. Care must be taken to understand who the tenant is as well as the tenant's financial strength. A subsidiary of a large public company's signing the lease does not obligate the parent company. The subsidiary might be a shell company. You might want to seek the guaranty of the parent. If guaranties are required, is there a limitation on personal liability? If the tenant has been in business for a long time and/or is financially strong, a compromise position might be to limit the guaranty to the unamortized cost of any concessions granted to the tenant (such as free rent or tenant improvements), plus any unamortized brokerage commissions, and also possibly a dollar amount sufficient to cover the landlord's down-time while the space is being rented to a replacement tenant. (For large tenants, the estimated time frame to release the premises could easily be from six months to one year). In addition, the tenant should be responsible for all costs associated with enforcing the guaranty, including attorney's fees.

   Please note that if a party signs the lease as an individual, you will achieve no enhanced liability by securing an additional personal guaranty. The tenant, as an individual, is already 100 percent personally liable on the lease.

We have discussed the landlord's need to understand the tenant's financial strength, but it should not be overlooked that once the lease is signed, the tenant is dependent upon the landlord to provide necessary services. If the landlord does not maintain the elevator or the air conditioning system, it is still difficult for the tenant to get out of the lease without negative ramifications. What is the landlord's financial strength? It is unusual for a prospective tenant to ask this question, but if the landlord is near bankruptcy, they can be assured that the property will suffer. It is prudent for a prospective tenant to examine how a landlord is maintaining the subject building and other properties that he owns. A tenant considering renting a particular suite should conduct due diligence to determine what other tenants think about the landlord meeting his responsibilities. The tenant does not want to be surprised after an agreement is reached.

3. **The Premises**. It is important to clearly identify the leased premises. If a space in a shopping center is being leased, it is typical for a site plan of the shopping center to be attached as "Exhibit A" and the specific leased area to be cross-hatched and possibly labeled "Exhibit A-1." Similarly, if space in an office building is being leased, the entire floor might be shown and the leased suite space cross-hatched. The point is that if you are attempting to clearly identify the leased premises, it is best to show the space in relation to other space in the project rather than showing an "as built" view of the premises alone. Given that the diagram is usually not drawn with 100 percent accuracy, it is also important to recite a disclaimer to that effect, so that a tenant cannot later claim detrimental reliance in an attempt to break the lease. Language to insert in the lease to protect the landlord might be:

    This Exhibit "A" is for information purposes, is not drawn to scale, and is intended only as a general description of existing (but not represented, covenanted, or warranted) improvements, which are a part of the shopping center. Specific names, locations, dimensions of space or buildings, entrances, or improvements are not intended to be (nor should they be) relied upon as the same, are subject to change, modification, and deletion by Landlord

> and/or other parties, and are not in any way to be construed as a representation, covenant, or warranty as to the opening or continued operation of any store or occupancy named or depicted on said Exhibit.

After the premises are clearly identified, it is necessary to quantify the size of the leased space. The question becomes, is the tenant renting based upon usable or rentable square feet?

In order to answer this question, it is necessary first to understand the difference between gross, rentable, and usable square footage. The *gross building area* is the total constructed area of a building. The gross building area includes the entire dimensions of the building. It does not include parking areas or loading docks outside the building line. *Rentable square footage* equals the gross building area less any vertical penetrations, which include stairs, elevator shafts, flues, pipe shafts, vertical ducts, and the like, as well as the enclosing walls associated therewith. Rentable square feet includes the building common areas such as the lobby, interior hallways, public bathrooms, atrium spaces at the level of the finished floor, concierge areas or security desks, conference rooms, lounges or vending areas, food service facilities, health or fitness centers, day care facilities, locker or shower facilities, mail rooms, fire control rooms, fully enclosed courtyards outside the exterior walls, and building core and service areas, for example, fully enclosed mechanical or equipment rooms. *Usable square footage* consists of the space within the four walls of the suite. Therefore, when a tenant is renting based upon rentable square footage, he is leasing the space within the suite plus the applicable pro rata share of the project's common area. The difference between usable and rentable square footage depends upon the building's efficiency, but as a rule of thumb a 15 percent spread is typical.

Regardless of whether usable or rentable square footage is used for the leasing parameters, the premises are usually measured based upon Building Owners and Managers Association (BOMA) standards. BOMA is a real estate trade organization that puts forth codes and standards for, among other things, measuring the floor area of a suite. The above definitions for gross, rentable, and usable square footage are based upon BOMA's published definitions. The BOMA standards are very technical. For example, BOMA standards dictate that when measuring the dimensions within a suite, you measure to the furthest glass or wall, to the middle of a demising wall between suites, and to the finished surface of a wall if the wall separates the suite from the common hallway. Support columns are included if within the suite.

The difference between the rentable square footage and the usable square footage is often referred to as the load factor. The *load factor* is the building's interior common area divided by the total usable square footage for the project. A landlord who is basing the lease on rentable square footage should consider disclosing what the load factor is for the leased premises. If this is not disclosed, the tenant should inquire what load factor is being used. How do you verify that the load factor for the building is correct? From a tenant's perspective, it is one thing to measure the interior of the leased premises, but it is quite another task to measure the entire building. One solution to this problem is to inquire whether the building has been professionally measured. If it has been, then a review of that analysis should satisfy the tenant. If the building has not been professionally measured, making the decision to have an architect or a service that specializes in that task measure the entire building is usually a function of the size of the tenant versus the building size. If the tenant represents a significant portion of the project, the landlord will probably acquiesce and have the building square footage verified. If, however, the tenant is relatively small compared to the building size (say, 10 percent or less), most likely the landlord will not measure, unless this issue becomes a deal-breaker.

From an owner's perspective, it is important to clearly agree with the tenant on the size of the premises. Landlords want to avoid the possible argument that: "I've been renting this space for five years and the accurate square footage is 2,000 square feet, not 2,500 square feet. You have been overcharging me for five years. You owe me $1,000 for sixty months—$60,000!" In order to avoid this type of an argument, it is important to insert in the lease verbiage to the effect that "Landlord and Tenant have each had an opportunity to measure the Premises and have agreed upon the rentable square footage, which shall not be subject to later measurement, confirmation, or adjustment."

What happens, however, if you cannot determine what the exact square footage will be when the lease is entered into? For example, assume a suite is to be divided and shared between two tenants and only when a demising wall is actually constructed can a precise measurement be made to determine each tenant's suite size. A solution to this problem can be found in drafting appropriate language to cover this issue such as:

> **FLOOR AREA OF PREMISES**: Approximately _____ net rentable square feet ("Estimated Square Footage"). The exact square footage shall be determined by Landlord based upon BOMA standards once the demising wall splitting off a part of the existing suite has been constructed ("As-Built Square Footage"). Tenant may contest Landlord's determination of the As-Built Square Footage by giving written notice to Landlord within ten (10) days following Landlord's delivery of written notice to Tenant specifying the As-Built Square Footage. If Tenant fails to timely contest Landlord's determination of the As-Built Square Footage, then Landlord's determination of the As-Built Square Footage shall be final and binding upon Landlord and Tenant. If Tenant timely contests Landlord's determination of the As-Built Square Footage, Tenant shall pay Monthly Minimum Rent based upon _____ net rentable square feet until a final agreement as to the As-Built Square Footage is reached by Landlord and Tenant. Once the net rentable square footage has been established, (i) Landlord and Tenant agree to execute an Amendment confirming the As-Built Square Footage, which shall not be subject to later measurement, confirmation, or adjustment, and (ii) any underpayment of Monthly Minimum Rent shall be paid by Tenant within ten (10) days following the final determination of the As-Built Square Footage and any overpayment of Monthly Minimum Rent shall be credited against the next payment of Monthly Rent due following the final determination of the As-Built Square Footage.

If this type of a provision is contained in the lease, a dispute resolution procedure should also be included to settle the square footage issue in the event the tenant does, in fact, contest the landlord's determination of the premises size.

4. **Base Rent or Minimum Base Rent**. The Base Rent, which is sometimes referred to as the Minimum Base Rent, should be understood and expressed both in absolute dollars amounts as well as rent per square foot. When a lease refers to Base Rent or Minimum Base Rent, the reference usually does not include operating pass-through items such as utility expenses, janitorial costs, or common area charges over base year. This distinction can become important in drafting. For example, if the landlord grants a tenant free rent by indicating: "Tenant shall not be obligated to pay Base Rent for the months of January 2010, February 2010, and March 2010," is the tenant obligated to pay CAM charges during this time period? Yes, the landlord has waived only the Base Rent, not the common area maintenance charges for this period.
5. **Adjustments to Base Rent**. Are there adjustments to the Base Rent or is the rental payment flat? If there are adjustments, when are the adjustments scheduled? Annual adjustments are typical, but this provision is subject to negotiation and large, creditworthy tenants are often able to obtain compromises wherein the rent is flat for a period of time prior to an adjustment.

   Upon what are the adjustments based? Are the adjustments based upon fixed increases, the consumer price index (CPI), the CPI with a collar, that is, a floor and a ceiling, or some other standard?

   The lease may be drafted in various ways to reflect the annual adjustment to the Base Rent. The most common is to state the Base Rent and then go on to indicate that the Base Rent is subject to change on each "Adjustment Date."

   If the adjustment is a flat percentage, such as 3 or 4 percent, rather than the result of setting a formula for determining the increases in Base Rent, often the lease will spell out, in specific dollar amounts, what the rent will be for each month and year of the lease. If this is done, it is best, if possible, from a lease administration standpoint, to clearly indicate the time frame that corresponds to the applicable Base Rent. If the lease sets forth the time frame in terms of month 1 to month 12, month 13 to month 24, and so on, the problem is that the individuals monitoring the lease activity, accounting, and property management, must calculate which months are months 6 and 7 when the tenant need pay, for example, only one-half of the Base Rent, which month is month 13 when the parties have agreed first adjustment occurs, which is month 25 when, possibly, one half of the rent is offset against part of the security deposit, and the like. The point is that from an administrative standpoint it is far cleaner and less likely to result in error if a specific month and year is used (e.g., "January 2013" instead of "Month 31").

6. **Additional Rent**. Additional Rent is typically defined as those expense items that are potentially paid by the tenant. This charge therefore ties into our previously discussed item number 1, the Lease Type, and item number 3, the Premises.

   The question becomes: What operating expenses are being passed on to the tenant? This question is the essence of the discussion of item 1, Lease Type. As previously discussed, in a triple net lease all of the operating expenses are passed on to the tenants, and in a modified gross lease, part of the operating expenses are the tenant's direct expense. Even in a gross lease, it is common for the landlord to attempt to pass part of the risk associated with increased costs over to the tenant. Typically, the way in which this is accomplished in a gross lease is to create an *expense stop*. The concept of an expense stop is that base year operating expenses are paid by the landlord; however, in subsequent years, if the operating expenses exceed the base year level each tenant pays its pro rata share of the overage. Usually the base year is set as the year in which the lease is entered into. However, if the lease is cut toward the end of the calendar year, it is standard to use the following calendar year as the base year for purposes of the overage calculation.

   During the lease negotiation, a tenant will frequently ask for certainty as to his potential exposure from the overage charge in a gross lease or, for that matter, from any Additional Rent exposure. A compromise position might result in the landlord inserting an annual cap on this potential cost.

   Please note, my reasoning for stating that Additional Rent ties into item 3, relating to the size of the premises, is because often the expense pass-through is assessed as the tenant's pro rata share of the applicable expense. The tenant's pro rata share is calculated as a fraction. The numerator of the fraction is the tenant's rentable square footage. The denominator of the fraction is the approximate rentable square footage of the building or project.

I indicated in item 3 that from a landlord's perspective the lease should indicate that the premise's square footage is not subject to later measurement, confirmation, or adjustment, but what about the overall building size? What if the landlord constructs an addition to the project or encloses balconies or a patio area? Does that result in an adjustment to the tenant's pro rata share of the building? It should reduce the tenant's pro rata share, but often the lease does not address this possibility.

7. **Term**. The length of time a tenant is willing to commit to leasing a suite is a crucial area. In general, the landlord seeks as long a term as he can obtain; the tenant usually desires to minimize his term and therefore his liability exposure, while possibly cushioning this posture with options to extend the lease. There are exceptions to this general rule, so both the landlord and the tenant should reflect on this issue before committing. The most obvious issue to reflect on is where in the cycle is the lease being cut. If it is perceived that rates are at historic highs it behooves the landlord to push for a long-term lease and the tenant logically should resist. On the other hand, if lease rates are in a slump, the economy is in a recession, and vacancy is at historic highs, the tenant may be able to negotiate a fabulous deal and it makes sense for him to take advantage of this situation by getting the landlord to commit to the low rates for a protracted period of time. But extenuating circumstances can be postulated. For example, on a new development project, the builder might not want to lease-up the project with all five-year leases. Staggering the lease terms avoids the risks associated with a heavy concentration of leases maturing in one year. Staggering the lease expiration dates gives the developer a safety valve in terms of occupancy. It also protects the developer in relationship to additional potential expenses. Usually it is at lease rollover that the tenant can extract concessions from the landlord such as monies to fix up the premises or free rent. By staggering the lease maturities the landlord

is in a better position to absorb the requested concessions. Similarly, a tenant may want a long-term lease due to the nature of his business, for example, if the tenant is a doctor or a dentist who desires long-term stability in his or her office location and is willing to make a large expenditure to customize the suite, he or she may rightly seek to tie up the premises for a protracted period.

Whenever I am asked to quote terms, or if concessions are being discussed, my first question is: How long is the tenant willing to rent the suite? In general, the longer the term, the more committed the tenant is, and therefore the more generous the landlord should be regarding lease terms and concessions. The longer the term, the more opportunity the landlord has to recapture favorable lease terms and concessions.

8. **Commencement Date/Rent Commencement Date**. A distinction should be made between the Commencement Date and the Rent Commencement Date. The Commencement Date is when the lease starts. The relationship between the parties as landlord and tenant begins at that date. In contrast, the Rent Commencement Date starts when the tenant is first obligated to pay rent. The Commencement Date and the Rent Commencement Date are usually the same date, but they need not necessarily be the same date. It is important that the Commencement Date occurs on or before the tenant takes possession of the premises. The landlord wants to ensure that all of the lease provisions, including the tenant's obligation to carry applicable insurance, are in place when occupancy starts. This includes tenant's occupancy for the purpose of building out improvements. As an alternative, the lease may contain an early occupancy provision that allows the tenant to enter the premises for purposes of building out tenant improvements or otherwise readying the space for occupancy prior to the Commencement Date. In this case the early occupancy paragraph should obligate the tenant to obtain the required insurance and cover any other items that the landlord is concerned about, such as the permissible construction time periods.

   It might appear at first blush that the Rent Commencement Date is not an economic matter, but when you reflect on this provision, it clearly affects the economics between the landlord and the tenant. The Rent Commencement Date can be affected by free rent granted by the landlord as discussed further on or by the landlord's inability to deliver the premises, or due to the fact that the tenant is tied up under an existing lease. Usually, however, these events clearly relate to a time frame that can be quantified. The more difficult problem arises when the Rent Commencement Date is tied to completion of tenant improvements. Tenants typically argue that they cannot afford to pay rent until they are in place running their business. The landlord, in contrast, points out that his expenses continue whether the tenant is earning money or not. The landlord might argue that there should be some outside date that rent starts regardless of the tenant's occupancy, especially if the tenant is controlling the build-out.

Please note that often the Rent Commencement Date also triggers other events, such as when leasing brokerage commissions are due and when the borrower is able to obtain reimbursement monies from its lender, that is, tap into its reserve account.

9. **Concessions**. The two main areas of landlord concessions usually revolve around free rent and tenant improvements.

Free rent. To some extent, free rent is a market issue. Is it commonplace in this particular market to grant tenants a break on the monthly rent in terms of no monthly Base Rent for a period of time? If I concede to a free rent period, I usually stagger the time frame, for example, the first and thirteenth months free, and also usually I will grant the free rent in terms of one-half month increments. In other words, instead of granting zero Base Rent for the first three months, I spread out the concession. I would rather contract with the tenant for six months of one-half monthly Base Rent payments. My reasoning for doing this is fourfold: (1) I want to get the tenant to set up and get in the habit of paying regular monthly rent; (2) paying part rent at least covers the operating expenses allocated to this tenant; (3) the monies collected from the tenant can be used to offset part of the tenant improvement expense; and (4) by collecting some rent each month plus the security deposit, at least some monies are received and collected for the landlord's efforts if there is an early default.

As mentioned in Item 4, in drafting the free rent provision it is important to clearly spell out if the waived rent applies to Base Rent only or to Base Rent and any portion of tenant's operating expense obligation. Usually, if abated rent is granted, it applies only to the Base Rent, and is not applicable to tenant's obligations to pay any operating costs such as utilities or expenses over a base year's costs.

Tenant improvements. The amount of tenant improvement monies to be spent by the landlord is, like free rent, a market issue. In addition, however, the amount required to be spent is also governed by the condition of the suite. Depending on market factors, the condition of the suite, and the bargaining power of the parties, the tenant may seek to have the landlord improve the suite concurrent with the execution of a new lease. A tenant may also approach a landlord during the term seeking tenant improvements, usually in return for extending the term or increasing the Base Rent. This is a negotiated process. The landlord may not be willing to expend funds on the suite or may allocate hundreds of thousands of dollars. Usually the tenant improvement package is much smaller for an existing tenant than it is for a new tenant, and the allowance for a second-generation space is usually quite reduced from space that has never been occupied. There is no set formula and every situation must be taken on a case-by-case basis.

One way for a landlord to view the rent/tenant improvement trade off is to set a minimum scheduled rent, which might include some minimal tenant improvements such as painting and carpeting. Today a reasonable allowance to cover painting and carpeting would be \$2.50 per square foot to paint the suite and \$20 per square yard for standard office-grade carpet installed. If the suite is 2,000 square feet, then the approximate paint cost would be \$5,000 (2,000 square feet × \$2.50 = \$5,000) and the approximate carpet allowance would be \$4,444 (2,000/9 = 222.22 square yards × \$20 = \$4,444). A \$9,444 tenant improvement allowance would result in a \$4.72 tenant improvement allowance per square foot (\$9,444/2,000 = \$4.72).

If a tenant sought a larger tenant improvement allowance than the cost of painting and carpeting, of course, the landlord could indicate that any amount over $9,444 would be the tenant's expense. However, another approach might be for the landlord to suggest that the cost of the additional tenant improvements might be factored into the lease rate. In order to make this calculation, you must know the amount you consider as "above standard tenant improvements" and the term of the lease. You must also decide whether an interest factor will be built into the above standard tenant improvement recovery or whether it will be spread over the term without any additional charge.

For example, if the "above standard tenant improvement" amount is $20,000 and the agreed term is five years, then an additional $333.33 ($20,000/60 months) must be added to the monthly Base Rent to compensate the landlord for spending these additional monies. If $333.33 were added to the monthly Base Rent or $.17 per square foot ($333.33/2,000 square feet), then the landlord would recover his additional $20,000, without interest, by the end of the term.

A simple formula for determining the monthly amount that must be added to the monthly Base Rent to amortize the excess tenant improvements is:

$$\frac{\text{Amount to Be Disbursed in Excess of the Standard Tenant Improvement Allowance}}{\text{Number of Months Remaining in the Lease}} = \text{Monthly Amount to Be Added to Base Rent}$$

If the landlord desires to receive a yield on the additional monies expended over the standard tenant improvement allowance, then an interest factor should be built into the formula. In other words, if the landlord feels that an 8 percent return is needed to compensate him for the opportunity cost of disbursing an additional $20,000, then it can easily be calculated that $402.84 must be added monthly to the Base Rent to fully amortize $20,000 over 60 months with an 8 percent interest factor.

One of the important issues surrounding tenant improvements is, Who is going to be responsible for the build-out? One scenario is for both landlord and tenant to agree on a build-out, approve the plans and specifications, and then the landlord has the burden of hiring the contractor and building-out the suite. This is often referred to as a build-to-suit. Another option is that the landlord agrees to disburse a tenant improvement allowance to the tenant who, in turn, has agreed to take on the responsibility for the construction build-out.

10. **Security Deposit**. Usually the tenant posts one month's rent as a security deposit. However, if the prospective tenant is financially weak, the security deposit might be increased to several months' rent to reduce the risk of loss. On the other hand, a strong credit tenant may persuasively argue that they should not be required to post any security deposit. A possible compromise with a strong prospective tenant might be to waive the security deposit conditionally, that is, on the condition that its bond credit rating does not fall below investment grade or that its net worth does not go below an agreed level.

    If the landlord requires as a security deposit an amount equal to one month's rent, does that mean an amount equal to the Base Rent, or does the security deposit additionally include an estimate of the monthly operating expense charge? The answer depends upon the landlord's policy and, of course, on what is ultimately agreed to between the parties. It is important to be sensitive to this distinction. The lease language should clearly indicate the charge. Specifying a specific dollar amount clarifies the agreed amount.

    If a tenant defaults and fails to pay its monthly rent, a quick "remedy" is to apply the security deposit toward the delinquent rent. Most landlords think of the security deposit as a fund that is available when a tenant moves out to ensure that he leaves the premises in good condition. The security deposit clause will typically provide that the monies held by the landlord may be used to repair damage to the premises caused by the tenant or to clean the premises upon termination of the Lease. Nonetheless, usually the security deposit clause is drafted much more broadly so that the monies may be used to cure any default by the tenant. If the security deposit is applied to delinquent rent, this is often referred to as "bagging the security deposit." If the security deposit is applied to delinquent rent or any other default, the landlord usually will demand that the tenant restore the security deposit to its original amount within a short time frame or the tenant will still be considered to be in default.

In general, landlords usually do not agree to keep a specific tenant's security deposit segregated from other monies in the landlord's general account. The security deposit is "commingled" with the landlord's other operating monies. Therefore, if the security deposit is significant in size, the tenant should do sufficient due diligence to ensure that the landlord is solvent. If the landlord files bankruptcy, the tenant could find itself as a general unsecured creditor in its attempt to recover its security deposit.

11. **Parking**. This is an area very often overlooked by prospective tenants in lease negotiations, especially when, at the time the lease in being put in place, the landlord does not charge for parking. If the lease is silent as to parking, tenants should be aware that the landlord has the right, at a later date during the lease term, to enact a policy to charge for parking. The future policy might include a monthly charge for both the tenant and tenant's staff as well as an hourly charge for visitor parking.

    It is important for tenants to understand their long-term parking rights and obligations. Parking issues usually revolve around three areas: (1) the transient and monthly fee; (2) the number of spaces allocated to the tenant; and (3) reserved versus nonreserved spaces.

    Unless the building is a single tenant user, a tenant usually does not have the ability to influence the visitor parking rates. However, landlords, as part of the negotiation process, will frequently permit a tenant to purchase visitor validations at a discount, provided a significant number of validations are purchased per transaction. As for the monthly parking fee, this is usually uniformly priced for the entire building, so negotiation as to the charge does not occur often. However, often the tenant can obtain a certain number of spaces for staff parking free of charge or at a reduced rate.

    It would seem that the fairest way to allocate the number of parking spaces that each tenant receives would be by its "percentage share." In other words, calculate what percentage each tenant represents in the project and multiply that percentage by the number of parking spaces. In reality, all tenants do not have the same need for parking spaces. Some tenants have minimal needs while others have extensive requirements.

It would therefore seem a more reasoned approach to take into account the tenant's needs while keeping code-required parking requirements in mind.

In commercial buildings, the code requirements are often expressed in a number per 1,000 square feet of rentable space. In medical buildings, for example, the requirement is usually that for each 1,000 rentable square feet, the owner is required to have five parking spaces. For shopping centers, the requirements are usually tied to the type of users. The theory is that the center is supposed to have enough parking to accommodate the tenant's employees and its customers. If the center is occupied by tenants that traditionally have more frequent customers, then more parking spaces are required.

For example, let us assume a 40,000-square-foot center has 365 parking spaces. The center currently has seven tenants occupying 37,000 square feet. The tenants are comprised of four restaurants of varying sizes (30,500 square feet in total), a yoga center (2,000 square feet), a karate studio (2,500 square feet), and a computer store (2,000 square feet). The code required parking is 10 spaces for each 1,000 square feet for the restaurants, the yoga center, and the karate studio, and 2.5 spaces for each 1,000 square feet for general retail, such as the computer store. The required number of spaces is therefore 357 spaces (35,000 the number of square feet for restaurants, yoga, and karate/1,000 square feet × 10 = 350 plus 2,500 the number of square feet for standard retail/1,000 square feet × 2.5 = 6.25 = 7, rounded up).

Assume there is a vacant 3,000 square foot space in the "elbow" of the center, the least visible space and therefore the hardest area to lease. It has been vacant since the owner purchased the center over five years ago. The owner of the center is approached by a well-funded dance company that has been in existence for many years that would like to relocate and take the remaining 3,000 square feet. He is ecstatic; finally this suite will be leased and the center will be fully occupied. A long-term lease is entered into, which requires the landlord to build-out improvements including a hardwood dance floor, two bathrooms, and a small office. Plans are drawn and submitted to the city building department. The building department responds with minor corrections, but also asks for the plans to indicate the number of parking spaces and, in a separate analysis, a showing that the center meets the parking code requirements. A dance studio requires 10 parking spaces per 1,000 of leased area. Therefore, the dance studio would require 30 parking spaces in order to satisfy code. The center has 365 spaces, of which 357 are needed to satisfy the current usage. Only 8 spaces remain unused, yet we need 30 to comply with the dance studio usage. Oops, the center is 22 spaces short!

There are several ways to approach such a problem. I have found that the best way is to meet with the city parking-code-enforcement officer and discuss the issue. This is not a unique problem; the code enforcement officer has to deal with this type of a situation frequently. My suggestion is to attempt to get the officer on your side of the table and politely ask for their suggested solution while keeping in mind possible remedies such as restriping to add compact spaces, valet parking, purchasing additional land for parking, or contracting with an adjacent property owner for additional parking. The code enforcement officer has probably confronted this issue many times in the past and therefore probably has some creative solutions. Another alternative approach might be to engage a firm to conduct a parking study to show, if such is the case, that peak parking usage hours for the various tenants does not conflict. If the study reflects that the restaurant's usage is during the day while the karate dojo, the yoga center, and the dance studio will be used primarily after 5:00 P.M., the code enforcement officer may possibly permit the usage or require a variance that might be secured.

Reserved parking can create headaches for landlords, turning them into de facto police officers. If possible, I always lean toward a nonreserved designation. Nonreserved spaces are much more efficient. However, reserved spaces are often needed in large office buildings, especially in mixed-use projects. Envision a large, class A office building mostly occupied by doctors and lawyers, but that also contains a large, busy athletic club. If there are no reserved parking spaces for the doctors and their patients and for the lawyers and their clients and designated athletic club parking, then it could likely happen during peak work-out hours that the patients and clients may have difficulty locating parking spaces, which from a competitive standpoint may adversely affect the doctors' and lawyers' businesses.

Tenants will often focus on the rental amount and adjustments to the rent, yet they will often overlook potential parking charges. As stated above, if the lease is silent on parking, then the landlord may, at a later date, institute parking rules and regulations that include monthly parking fees as well as a charge for visitor parking. If a tenant complains about the new parking rules, a counterargument is that if he cared so much about parking charges he should have bargained for free parking or other concessions regarding parking when the lease was cut. This area is often overlooked because often at the time when the lease is signed neither the landlord nor the surrounding property owners are charging for parking. Nonetheless, if a long-term lease is executed, for example with a 10-year term, the world may change. Circumstances evolve over time. Today, no one in the marketplace may be charging for parking, yet in the future, surrounding buildings or the subject project may find it reasonable to charge.

This type of change in policy can become particularly troublesome to a tenant if its walk-in customers are a significant part of its business, or if its business changes so that walk-in customers become a significant part of the business. The result could be that visitor parking validations become a significant cost of doing business. Imagine that your business is located in a downtown area and that there is ample free street parking as well as a paved vacant lot across the street where visitors may park for free. Now fast-forward five years. The vacant lot is now a 10-story office building, and the city has instituted a parking ordinance that does not allow for off-street parking. Under this type of a scenario the tenant's parking expense could be greater than its monthly base rent.

Certain businesses are more parking intensive than other businesses. In the medical field, for example, a physical therapy tenant typically sees a volume of patients, and usually the same patient returns several times a week for treatment. Similarly, if there is a retail usage in an office or medical office complex, such as a café or a pharmacy that relies on traffic from sources in addition to the guests of tenants in the project, then that retail business could be at a severe disadvantage if its customers must pay for parking (especially if customers at the shopping center down the street park for free). In contrast, a medical billing company would need parking for its employees, yet would see minimal clients, and therefore would not be affected if a visitor parking fee schedule were instituted.

Tenant's parking expense can be more costly than rent if not thought out and controlled. If a parking fee system is not in place when the lease is being negotiated, an attempt might be made to build in free parking during the term of the lease or, at a minimum, to ensure free parking for a certain number of employees. Also, in anticipation of the landlord charging for transient parking, the tenant might seek a discount on parking validations.

12. **Renewal Options and Termination Rights**. Renewal options and termination rights are more fully covered in the next section of this chapter, but I wanted to mention them here since they can have a significant impact on the economics of the lease and the parties should therefore be cognizant of this fact. Usually renewal options and termination rights are drafted to solely benefit the tenant. The tenant has the right to exercise the renewal option or the right to invoke a termination, but the landlord cannot impose or "put" a similar provision on the tenant.

Landlords should be aware that tenants can use these rights as an opportunity to renegotiate the lease terms. Drafting of the provisions therefore becomes critical. For example, in order to obtain significant tenant improvements, a doctor enters into a 10-year lease, but insists that a termination provision be included in the lease since 10 years is a long time and at some point he might decide to retire even though he has no immediate thought of retiring. Two years later, market rates have dropped drastically. The doctor calls the landlord and informs him that he is thinking of exercising the termination provision unless they can sit down and renegotiate the rental amount. The termination provision was not intended to be used as a sword to extract concessions from the landlord, but if it is not narrowly drafted it can very well be used to renegotiate the lease terms. Similarly, assume a doctor rents 7,000 square feet: 5,000 to be used for his general medical practice and 2,000 square feet to be used for clinical trials. The doctor at the time the lease is negotiated indicates that he is not sure if the clinical side of his business is going to work and therefore requests an option to cancel the 2,000-square-foot portion if the economics are not working out. Two years later, even though his clinical business is doing very well, the doctor has located less expensive office space in close proximity, and calls the landlord and asks to revisit the lease's economics for the entire space, since he is considering exercising the termination right. A similar scenario holds true with options to renew. If the option fixes the rent at a level that is below the current market rent when the option is exercised, then the landlord is often faced with the reality that the option will be exercised. If the option rate is at or above market, the tenant will most likely ignore the option and renegotiate the lease terms. Drafting again is the key. Most options to renew consequently usually set forth a market rate standard rather than a fixed amount at renewal to avoid this problem.

The preceding 12 areas are not meant to be an exhaustive list of the business deal points that should be covered. Rather, they focus on key economic matters that should be considered. These lease provisions covering the dollars and cents of the transaction are usually the responsibility of the business individuals involved in the negotiation. The attorney representing his client usually does not strike the agreement covering these key business items, although he should be involved in drafting the lease language. The next section of this chapter covers the most frequently negotiated lease provisions. For these areas it is crucial to have counsel involved at the outset, since such matters are much more subject to legal subtleties and nuances.

Frequently Negotiated Lease Provisions

A typical commercial lease will contain 30 to 40 pages, and we have already discussed several key economic items. Now we will delve into areas that often go beyond the boilerplate provisions and therefore will usually be more heavily negotiated.

Assignment and Subletting

Assignment and subletting provisions are usually lumped together, yet in practice they can be very similar or very different. An *assignment* results when the tenant gives up all of his rights and liabilities under the lease to a successor. In contrast, with a *sublease*, the tenant retains some interest in the tenancy. For example, the tenant may retain the continued right to use a portion of the leased premises. Alternatively, the term of the sublease may not correspond exactly with the term of the lease between the landlord and the tenant/sublessor (Master Lease).

When I mentioned that the provisions could be very similar, I was thinking, for example, of a scenario in which the tenant/sublessor sublets the entire suite for the remaining term, less one day. This sublease looks very much like an assignment. In contrast, if the sublease is for a small portion of the suite, for example, one room on a short-term basis, the sublease is very different from an assignment that gives up all the tenant has since here the tenant/sublessor has given up very little.

The threshold question is whether or not the landlord's consent is required for the assignment or sublease. The lease controls, but if the lease is silent on this issue then in most states the landlord must act reasonably or the landlord's consent is not required in the first place.

Often a distinction is made between an assignment to an affiliate versus an assignment to an unrelated entity. If the assignee or sublessee is an affiliate of the tenant, the landlord is usually more inclined to accommodate the transaction and might even approve that type of transfer when the lease is executed. If there is no release of liability, or if the affiliate has comparable financial strength to the assignor or sublessor, then usually the landlord will view the assignment or sublease as if it is internal to the tenant and will not really affect the landlord. If there is a release of liability, care must be taken. The financial strength of the assignee should be subject to the landlord's consent. A transfer to a shell entity followed by a bankruptcy would surely not be the landlord's intent when permitting an assignment to an affiliate. Usually mergers and acquisitions may be accomplished without the landlord's consent provided, again, that the successor is a viable entity and that prior notice is given.

In determining whether to consent to an assignment or a sublease, the landlord may want to build into the lease the right to consider the nature of the proposed use, the experience of the transferee, the number of locations the transferee has in operation, and the financial strength of the transferee.

There are usually three underlying issues affecting the landlord and the tenant when an assignment or sublease is proposed: (1) use, (2) liability, and (3) the economics surrounding the transaction.

When a landlord leases his project, a key factor in deciding which tenant to lease to revolves around the potential synergy between the various tenants. A food court goes well with a movie theater, a hair salon complements a nail salon, and dental practices may be enhanced if a dental lab is located in the project. If the transaction involves a nail salon assigning its interest to another nail salon, the landlord might be concerned about the credit, financial strength, and experience of the assignee, but since the usage remains the same, the existing tenants should not be affected. In contrast, if a large shopping market seeks to assign its interest to a discounter, a kids' entertainment center, or a telecommunication call center, the landlord's control over the use of its property is jeopardized. It is important for landlords to ensure that tenants will work well together. If side shops are dependent on traffic from an anchor store, a change in usage could well upset this balance. In addition, the landlord must be concerned that its other contractual agreements, such as exclusives (right to be the sole provider of certain goods or services in the center), are not violated.

Probably the most important item concerning assignments and subletting revolves around liability. If there is an assignment or a sublease, the assignor or sublessor may seek to be relieved of liability or, in the case of a sublease, to be partially relieved of liability.

The general rule is that if the lease is silent on this issue, then there is no release of liability. From a tenant's point of view, release of liability, if possible, should be negotiated at the outset. Usually, it is much more difficult to obtain a release at a future date when the issue, from the landlord's perspective, becomes a matter of what consideration the landlord receives in return for releasing a party to the lease. In consideration for the release of liability, is the landlord obtaining more rent, a longer term lease, a termination fee, a more creditworthy tenant, an increased security deposit, or some other benefit?

If the landlord is not receiving any consideration, yet desires to facilitate the transaction, a compromise position might be to agree to a release provided all rental obligations are timely paid for an agreed period, for example, one or two years. Alternatively or in addition, the landlord might seek to modify some of the lease terms by, for example, seeking a higher rent or a longer lease term, which might be more palatable to the assignee.

In drafting an assignment, in addition to consent, usage, and liability, the other key matter to focus on is the economics. There are several economic issues surrounding an assignment or a sublease. One of the issues revolves around the situation when the lease rent is below the market rent. This issue arises in major leases. If the market rental value at the time of the assignment or sublease exceeds the lease rate, which party should be able to capture the lease bonus value? The language in the lease controls this issue. When the lease is being negotiated, the landlord usually argues that the tenant should not participate in the value of the lease in excess of its current rent since its business is to sell widgets, not to benefit from the real estate. In contrast, the tenant usually takes the position that if he has committed to a long-term lease, he is obligated to pay the rent regardless of the success or failure of his business and therefore he should be able to profit from a below market lease value if such is the case. If this matter becomes contested, the smart landlord will usually compromise and build in a benefit to the tenant, since it is too easy for the tenant to circumvent the intent of this provision by, for example, contracting with the assignee for the purchase of all or a part of the assignor's business and increasing the purchase price to cover the lease bonus value.

Other economic terms should be covered when an assignment is being considered. What happens to the security deposit? Must it be returned to the tenant or carried over to satisfy the assignee's requirement to post a security deposit? The answer is that it depends on what the assignor and the assignee have agreed to. The important point is that it should be covered in the assignment so as to avoid any future controversy.

The assignment should also cover any other monetary issues, such as whether or not a fee is to be paid to the landlord, or whether a fee is due a real estate broker, or whether or not there is an outstanding balance that must be paid before the assignment is effective. The most overlooked economic issue is that of Common

Area Maintenance charges. It is fairly easy to obtain a rent status, but often the parties forget that CAM reconciliations are performed at year-end. If this matter is not addressed, the result may be that the assignor owes a significant dollar amount, yet has been released from liability.

Both in an assignment and in a sublease the assignee or sublessee, as applicable, should agree to be bound by all of the terms and conditions of the Master Lease. The assignment or sublease might go on to contain attornment language, indicating that in the event the landlord gives the assignee or sublessee notice that the assignor or sublessor is in default under the lease, the assignee or sublessee agrees to make all future payments directly to landlord and, furthermore, if the Master Lease is terminated the assignee or sublessee agrees to recognize the landlord as the landlord under the Master Lease.

Cap on CAM Charges

Tenants raise the issue of capping CAM charges for several reasons. First, most tenants view CAM charges as a way for the landlord to pass to the tenant the risks associated with running the real estate asset and therefore, by setting a cap on the cost, they are to some extent pushing back and requiring the landlord to share a portion of this risk. Second, most tenants want certainty in terms of their operating costs and a cap gives them some comfort that their costs will not get away from them. In addition, placing a cap on CAMs tends to keep the landlord focused on keeping the operating costs below the cap. At the end of the day, placing a cap on CAMs limits the tenant's exposure and cost. So why would not a tenant request a cap?

If a landlord is willing to grant a cap on CAM expenses, the landlord should realize that if the cap is too low it, in effect, operates to create a fixed rent scenario. In other words, if the cap is always in play, then the tenant's monthly obligation becomes the Base Rent plus CAMs to the cap, which is a fixed amount not subject to fluctuations based upon actual operating results.

Typical negotiated caps include an annual percentage ceiling often equal to the same percentage used to escalate the Base Rent, or language such as "The annual CAM charges may not exceed tenant's Base Rent in December of the applicable year." A negotiating ploy from the landlord's side is to argue that the cap should be cumulative rather than applicable only annually. If CAMs increase only slightly for two years and then pop up significantly, why should the cap apply in the third year? Is it not fairer to average the increase over the three-year period and apply the cap over the entire period, or to employ some similar formula?

Tenants should ask for a detailed breakdown on what the CAM charges have been historically. This gives the tenants a base line for comparison and tends to keep the landlord in line, preventing inflation of the charges.

Continuous Operations Provision

A *continuous operations provision* in the lease requires the tenant to maintain its business presence without interruption or with only a short permissible break for vacation time. This clause is also referred to as the "no dark" provision: If the tenant goes dark and ceases to be in business at this location, it is a default under the lease.

From a landlord's perspective, a continuous operations provision is important because if a major anchor in a shopping center closes, that may have a ripple effect on the other tenants. Often, smaller tenants are dependent on the anchor to draw traffic, and if the anchor closes, the consequence could be that the "shadow anchor" tenants' businesses decrease significantly. There can be other ripple effects if the major store in a center closes. The most obvious is that it can have a chilling effect on the project in general, which results in discouraging other tenants from leasing. It might also cause a loss in percentage rent and ancillary income. Usually a tenant ceases operations because of performance; hence it probably was not paying percentage rent. Of course, this might not be the case, and if a tenant closes its doors, the landlord would be deprived of the expected percentage rent for which it bargained. Ancillary income may be affected if, for example, the property is located in an urban area where it is a common practice to charge for parking. If the major tenant goes dark, the result might be a sudden and dramatic drop in visitor parking income.

As a practical matter, if the tenant prevails and the lease does not require the tenant to operate continuously, then the landlord should at least attempt to obtain a concession such as increased rent to compensate for lost ancillary income and/or a recapture of the unamortized tenant improvements and leasing commissions. Also, arguably, the landlord should have the right to control its space, so if a tenant goes dark the landlord should have the right to terminate the lease.

Major tenants usually have the bargaining power to cease operations at their discretion as long as it is understood that they are still obligated to pay rent. The tenant's argument is that they should be able to control their business and minimize losses if necessary as long as they are honoring the lease terms. The tenants that should be concerned are the adjacent shop space tenants who were induced to come into the center due to the traffic from the fabulous anchor. If the small tenant is dependent upon the anchor to generate traffic, it should attempt to learn how well the anchor is doing financially before entering into the lease, and/or it should negotiate for a cotenancy provision. Most likely, however, the small tenant will not be able to insert a cotenancy clause into the lease, as will be discussed.

Since lease provisions can be interdependent, care must be taken in drafting all the provisions. For example, *a kick-out clause* says, in essence, that if the tenant's sales do not hit a certain level, then the tenant may terminate. The tenant argues for this type of provision asserting that if its sales are below the stated threshold, it cannot profitably operate. But a kick-out clause screams for a continuous lease provision up to the point in time that the kick-out clause may be invoked. Assume a tenant signs a 10-year lease with a kick-out provision in the third lease year. Without a continuous operating clause up to the third year, the tenant could go dark in the second lease year, and therefore obviously not hit the sales target in the third year, and invoke the kick-out clause and terminate.

An *opening covenant* indicates that the tenant agrees to open for business, usually by a certain specified date. A continuous operating clause implies there is an opening covenant. If you agree to continuously operate, by implication you are also obligating yourself to open for doing business. However, the reverse is not necessarily true. An opening covenant does not necessarily imply that you will continually operate. A tenant could open and then close a short time thereafter. It is important, for the sake of clarity, to tie these two provisions together. Hence, the clause usually says "The tenant agrees to open and continuously operate . . ."

Co-Tenancy Clause

Essentially a *co-tenancy clause* says that if a certain key existing tenant, for example, a specific movie theater, closes for business, then the subject tenant, for example, an ice-cream parlor that is adjacent to the theater, has the right to terminate its lease. The idea is that the ice-cream parlor is dependent on the movie theater to generate traffic for its business, and without this traffic its sales will not be sufficient to generate a reasonable profit.

Cotenancy clauses can be based on many different contingencies. For example, the clause might allow lease termination if the center's occupancy falls below a certain percentage level, or if a certain percentage of the center is not open and operating, or if certain types of tenants, such as a supermarket or a gymnasium or health spa, are not in business.

The cotenancy clause is essentially a termination clause and should be strenuously avoided by the landlord, especially if the landlord would have to spend a significant amount of money to place the tenant seeking the cotenancy clause into occupancy. A cotenancy clause can significantly hinder the owner's ability to obtain financing, and if there is an existing lender in place, the loan documents should be checked to verify that the lender's consent is not required prior to entering into a cotenancy provision.

Death and Disability Clause

The objective of a *death and disability clause* is to allow the tenant's representative to terminate the lease in the event the tenant passes away or becomes physically disabled, in which case he does not have the financial means to fulfill the lease obligations. This provision often arises in connection with tenants, such as doctors, lawyers, or accountants, whose livelihood and ability to pay the monthly rental obligation is dependent on their ability to perform personal services.

Interestingly, this type of clause is common in a medical project, but is seldom found in, for example, a shopping center, yet the same type of issues may be present in both types of real estate. Does the sole practitioner in a medical practice have a more compelling need for a death-and-disability provision than does an individual running a mom-and-pop business, such as a small flooring company or a convenience store, in a shopping center?

The main concern surrounding this clause does not revolve around the death portion of the provision, given the certainty surrounding this event. The problem is in defining physical disability and validating its truthfulness. Another matter that must be addressed is whether a disability must be total or whether a partial disability qualifies a tenant's representatives to receive certain benefits.

One way to handle this issue is to stipulate that physical disability is confirmed, in the event the tenant's disability carrier pays a claim for partial or total disability, on a permanent basis, without reservation of rights. If the tenant does not carry disability insurance, the existence of the disability might alternatively be confirmed through a certification by the licensed physician who is treating the tenant—with the landlord retaining the right to select an independent licensed physician to confirm the disability. Usually the opinion of the landlord's physician is controlling.

At times this clause is broadened to include a simple retirement provision allowing the tenant, for example, to terminate the lease if he retires from the active practice of medicine. The landlord must be aware that this type of liberal termination right might result in a lender not counting this rental income in their underwriting process. This type of a provision would normally be fairly heavily negotiated, since it is very unusual. The landlord might want an enhanced termination fee or might ask to recoup on an amortized basis monies spent on the premises (for example, tenant improvement dollars and leasing commissions).

An additional issue arises if the tenant has extensive options to extend. The lease may be assigned, but if there is no release of liability built into the lease, does the tenant's liability extend to the extension periods? In other words, what is the effect on the tenant's liability if he assigns the lease during the primary term, there is no release of liability, the new tenant exercises an extension option, or the tenant dies or becomes physically disabled during the option period. Is the tenant/assignor liable for the rent? In general, the tenant/assignor is only responsible for the lease obligations during the primary term of the lease. If there is any confusion or any issue relating to the assignor's continued liability after the end of the primary term, prudence would dictate that the tenant/assignor give the landlord a written notice stating that his liability ceases at the end of lease term and that, since he is no longer associated with the business, he will not be an obligor in the event the assignee elects to continue the tenancy into an option period (or periods).

Definition of Operating Expenses in a Gross Lease

As discussed in Chapter 3, in a gross lease the landlord pays all of the operating expenses of running the project, but an expense stop is usually built into the lease. The expense stop says, in essence, that the tenant will pay its pro rata share of any expense over the base year. It is common practice to set the base year as the year in which the tenant begins occupancy. If occupancy is taken toward the end of the year, then usually the base year will be the next calendar year.

One of the issues that frequently comes up in drafting a gross lease is the question of what constitutes "Operating Expenses." Operating Expenses are the normal and customary expenses associated with running the building. Usually, there is not much controversy in defining Operating Expenses, which would include such items as garbage and waste collection, real property taxes, insurance, utilities, and janitorial services and supplies. The redrafting typically occurs when counsel for the tenant seeks to clearly spell out what should be excluded from Operating Expenses. Most of the items that are requested to be explicitly excluded are, in practice, actually not included. Technically, counsel for the tenant may have a strong argument to expressly exclude certain items since the language in the lease is typically not very clear on this point. If counsel for the tenant prevails, it is arguably cleaner to expressly exclude certain categories rather than relying on general practice. The result is often a long list of Operating Expense exclusions. The list of exclusions might include some or all of those items set forth in Appendix C in the companion website.

An examination of the list contained in the appendix clearly shows that some of these items should not be included in Operating Expenses (for example, work on specific tenant's suites). If some of the listed exclusions are expenditures that are clearly outside the definition of an operating expense, what is the need for the exclusion? The problem is that some of these items can be debated either way. To a large extent, the important point is consistency. In other words, the reimbursement charge for operating expenses in a gross lease is based upon comparing the base year's expense to the current year's expense. As long as the two years standard is consistent, and categories or items are included or excluded in both the base year and the comparison year, then usually the incremental difference is not so great that the inclusion will prejudice a tenant.

A related issue regarding what should be included in Operating Expenses occurs when a tenant asks if he can take care of an item that the landlord normally provides as part of the usual and customary cost of running the project. The most common service that the tenant asks to be self-administered is janitorial service.

The tenant argues, "Since I am cleaning my own suite, please give me a credit of $.08 per square foot toward rent and exclude janitorial services from the calculation of my share of operating expenses. Why should I have to pay for janitorial services, or potentially be responsible for my pro rata share of the increased cost of janitorial services, when I am cleaning my own suite?" The landlord counters that it is an administrative nightmare to break out one service from all of the operating costs. If the landlord is willing to make this concession, the proper accounting treatment would be to adjust operating expenses to reflect the actual janitorial costs—which does not include any cost associated with the tenant who is providing its own cleaning—and adjust all of the other tenants' pro rata shares for this line item. To use a specific example, if we assume the project is 100,000 square feet and the expense attributable to janitorial services is $.08 per square foot per month, then prior to any adjustment, the monthly janitorial operating cost is $8,000. Assume further that tenant "A," occupying 20 percent of the building, elects to have its own staff clean its premises and the landlord agrees to credit tenant A $1,600 per month (20,000 × $.08) against its rental obligation in lieu of the landlord incurring the janitorial expense for this tenant's premises. Since the landlord's janitorial service is not cleaning A's suite, then the monthly janitorial cost becomes $6,400 (80,000 square feet × $.08). For the purposes of calculating each tenant's share of janitorial services, its pro rata share would be altered, given that for this operating expense the total building square footage is 80,000, not 100,000 (since tenant A's occupancy should be eliminated from the total). The result is that the other tenants are unaffected. Their janitorial charge remains the same. For example, if tenant "B" occupies 4,000 square feet, then its share of janitorial costs before the adjustment would be $320 per month ($8,000 × .04); after the adjustment, it would still be $320 per month ($6,400 × .05). Tenant B's percentage of the project increases proportionally from 4 percent to 5 percent (40,000/80,000) as the expense attributable to the janitorial expense decreases from \$8,000 to \$6,400 (\$8,000 − \$1,600). The point is, is this type of concession worth all of this administrative hassle?

Exclusivity Clause

The *exclusivity clause* says that for this specified use, only this designated tenant may perform these services or sell these types of goods in the project. In a medical complex, for example, it might be appropriate to give an exclusive use to a pharmacy, an aqua or physical therapy clinic, or a café. The argument is that these types of services and the goods sold therein are retail oriented and, depending on the size of the project, allowing more than one of these "retail" uses might result in one tenant cannibalizing the profits of the other, so that neither of the tenants would be able to survive.

Care must be taken when drafting an exclusivity provision. Potential issues should be examined, thought out, and covered in the provision. For example, when does the exclusivity provision take effect? If you write a lease giving a tenant the exclusive right to sell videos in the complex, if there is not a corresponding prohibition in the existing leases barring the sale of videos then you have potentially created a conflict. One way around the potential conflict is to provide that the exclusive right applies only prospectively or, in other words, that the exclusive provision shall be of no force and effect with respect to tenancies currently in effect in the complex.

A landlord might also have to address a quantitative issue. In other words, if a tenant is given an exclusive right to operate a retail pharmacy in the project, is it a violation if another tenant, a dermatologist, sells a prescription face cream in connection with his business? A distinction might be drawn between primary versus ancillary usage. If the sale of pharmaceuticals is ancillary to a doctor's primary business, those types of sales might be an acceptable usage, not in violation of the exclusivity clause.

Inducement Provision *Has the landlord suffered any loss in the following factual situation?*

- Landlord and tenant enter into a lease for five (5) years at \$2.00 per square foot increasing annually by 3 percent (3%).
- Tenant pays his rent timely for six (6) months.

- Beginning the seventh month, tenant informs landlord of his inability to pay the rent.
- The same day, tenant tells landlord he cannot pay his rent, the landlord's cousin agrees to assume the lease.

The answer is No. The landlord continues to receive the benefit of his bargain. The landlord never missed a day of rent, he receives the same income stream that he would have received if the original tenant had honored his rental agreement, and the landlord is not obligated to make any other concessions.

Does the answer to this question change if we alter the facts and assume the following?

- Landlord and tenant enter into a lease for five (5) years at $2.00 per square foot increasing annually by 3 percent (3%).
- Landlord spends $50,000 on tenant improvements, $8,000 on leasing commission, and waives the Base Rent for the first six (6) months of the lease term.
- Beginning the seventh month, tenant informs landlord of his inability to pay the rent.
- The same day tenant tells landlord he cannot pay his rent, the landlord's cousin agrees to assume the lease or, possibly, agrees to pay even more rent than the tenant.

The answer does not change; that is, the landlord still has not suffered any loss. He received the benefit of his bargain. The fact that it cost the landlord up-front money to put the tenant in occupancy is irrelevant. It does not alter the income stream. The fact that the landlord paid tenant improvements, a leasing commission, and gave the tenant free rent does not change the fact that the landlord received exactly the same income stream as if the tenant had not defaulted. In other words, the default did not cause the landlord to expend additional monies for these items; they were already incurred prior to the default.

The problem is that the result does not seem fair, and in reality even if the landlord has no interruption in its income stream, usually he must expend extra time and effort to locate and negotiate with the replacement tenant. The defaulting tenant received a free ride for six months and a lot of money was expended in good faith in the anticipation that the tenant would honor its rental obligations.

A landlord solution to this problem is to include what is referred to as an inducement provision. The *inducement provision* provides that in the event of a default, the landlord has the right to recapture all of the monies expended or concessions made by the landlord to induce the tenant to execute the lease. The recapture usually includes the tenant improvement monies spent, the leasing commission, and any free rent.

The inducement provision, designed to balance the equities, may result in an unfair result favoring the landlord. A compromise position, if the tenant objects, would be to recapture the amortized cost, on a straight line basis, of the monies expended for tenant improvements, leasing commissions, and the dollar equivalent for the free rent given to the tenant.

Percentage Rent Clause

Percentage rent clauses allow the landlord to participate in the success of the tenant's business by providing that over a certain threshold level of gross sales the landlord receives, as additional rent, a specified percentage of the tenant income, usually less the base rent. Percentage rent clauses are not common, but are found most frequently in restaurant leases.

The biggest problem with a percentage rent clause is monitoring its accuracy. For large publicly traded tenants, the risk of "cooking the books" is reduced significantly; however, mom-and-pop operators might forget about some of their sales. A landlord should evaluate whether it is better to have a percentage rent clause or, in lieu of such a provision, keep the lease contract clean and simple and increase the base rent.

Issues that frequently arise in negotiating percentage rent clauses include the following:

- The definition of gross sales. Tenants seek to eliminate from gross sales items such as returned merchandise, sales to employees at a discount, sales taxes, and so forth.
- When the percentage is payable. Tenants seek to base the percentage on annual numbers. Landlords tend to favor a monthly comparison. The difference can be drastic. A tenant may have a strong December, which merits percentage rents, but when the entire year is viewed the threshold sales level is not achieved.

- How a partial year is treated. Fairness, as in the above example, would suggest looking at a full year to determine if the percentage rent clause is applicable.
- Setting the threshold level. The threshold level is frequently calculated by taking the minimum base rent and dividing by the applicable percentage, but this is just a rule of thumb. More likely, industry standards as well as the matter of where the tenant's profitability kicks in are stronger indications of where the level should be set.
- Landlord and tenant must agree on an appropriate percentage to use when calculating the percentage rent. Again, industry standards and the nature of the business tend to dictate this figure. If the industry is a high-volume, low-profit industry (for example, discounters and supermarkets) the percentage tends to be low. In contrast, if the industry is a low-volume, high-profit field (e.g., jewelry stores) the percentage tends to be higher.

Radius Clause

A *radius clause* prohibits the tenant from opening a similar store within an agreed upon distance from the subject location. Landlords insert a radius clause because they fear that the tenant may cannibalize its own store's sales if it opens a similar shop in close proximity. This factor is especially sensitive if the landlord has expended a significant amount of money to improve the premises, if the tenant's operation is unique, and/or if the landlord is expecting percentage rents. The counterargument, from a tenant's perspective, is that the landlord is not in a position to assess sales and profitability. A radius clause potentially cuts into the tenant's overall profitability. Strong national retailers will typically not permit a radius clause. For regional and mom-and-pop operators, the negotiation concerning a radius clause usually boils down to how far from the subject location the tenant will be prohibited from having another outlet. Will it be five miles, three miles, two miles?

Relocation Provisions

A *relocation provision* allows the landlord to move a tenant from one suite to another place in the project, usually at the landlord's cost and expense. In most cases, a relocation provision is not that important to a landlord, yet it can be crucial if the landlord intends to remodel the center or upgrade the quality of its tenants. From a tenant's perspective, even if the landlord agrees to pay all of the cost of the relocation, this clause is troublesome since each site is unique and the tenant is leasing a specific location with its unique characteristics, such as size, access, visibility, traffic, and particular neighbors. Also, these provisions are usually worded very subjectively in the landlord's favor. If the negotiations result in the provision being reworded subjectively in the tenant's favor, for example, the tenant has the absolute right to approve any future location, then the clause has no teeth. If possible, the best compromise position is site specific, thereby in essence the landlord obtains the tenant's consent up-front at lease execution and, of course, prior to the relocation as to where the relocation space will be, in the event the landlord invokes this provision.

Renewal Options

Renewal options allow the tenant to control usage of the leased premises. The options are only in the tenant's favor. In other words, the language gives the tenant the right to extend the lease on specified terms and conditions; it does not grant to the landlord the right to require the tenant to extend the lease.

Most renewal options are drafted so that, in essence, they become an opportunity for the tenant to commence negotiation of a new lease. To explain, most renewal options simply specify when the option must be exercised and either set the new rate or a formula for determining the new rate. The reality, however, might be that after five years, the premises need a new coat of paint and new carpeting, or that the tenant has found through usage that reconfiguring the suite will be more efficient, or that something else should be altered. The option could take into account some of these factors, yet it rarely addresses them. From a tenant's standpoint, certain elements should be built into the option, depending on the length of the initial term. At a minimum, there could be an allowance to freshen up the premises with interior painting and new flooring.

There are four key areas that should be concentrated on in relation to renewal options:

1. **Exclusions.** The renewal option typically will provide that the tenant shall have the option to renew the lease under the same terms and conditions set forth in the lease, with

the exception of specified provisions. Care must be taken to exclude concessions that were initially granted to the tenant that may not be applicable at the time of renewal, such as a tenant improvement allowance or free rent. It is also important to exclude the renewal option itself, or otherwise the tenant can make the argument that the renewal option continues as part of the new lease, since he is renewing under the same terms and conditions. In other words, the tenant might contend that every time the lease expires, he has an option to renew for, say, five years and part of what is carried over is the five-year renewal option, so that at the end of the five years he can renew again for an additional five years. This is a somewhat torturous construction, but the argument can easily be avoided by excluding the option from the renewal. Lastly, of course, the rental amount should be excluded, which is determined as set forth in the option paragraph. In other words, the renewal option indicates that all of the terms and conditions of the existing lease shall remain in effect "except the monthly rent which shall be determined as set forth below." Inadvertently carrying over provisions is more likely to occur when an existing lease is being extended through an amendment with an option to extend clause but, of course, it can also occur in drafting a new lease.

2. **Time Frame to Exercise the Option.** The tenant should be given a window in which to exercise the option. Otherwise, in the event the option is not exercised, the landlord might not have sufficient time to make alternative arrangements. Typical language might indicate that "the Renewal Option may be validly exercised only by notice in writing received by Landlord not earlier than ten (10) months, and not later than six (6) months, prior to commencement of the Option Period."
3. **Setting the Rate.** This is a negotiated provision. The longer out the option, the more uncertain the market rate would be, and therefore the more important it would be for the landlord to control this factor.

   The option language might provide for certainty by indicating "The Monthly Rental during the first year of the Option Period shall be equal to the Monthly Rental in effect immediately prior to the commencement of the Option Period increased by X%." The good news is that this provision avoids controversy. The bad news is that this type of provision is ripe for tenant abuse. If the market rate is higher than the option rate, then the tenant exercises the option. In contrast, if the market rate is lower than the option rate, then the tenant attempts to renegotiate an extension at the lower market rate.

Another method for setting the rate is to place the burden on the landlord to set the rate at market in its reasonable discretion. The obvious problem is that one can differ as to what constitutes a market rate. Also, it is logical and fair to give the tenant an out once the landlord sets the rate. To explain, if the order is "tenant exercises the option, landlord sets the rate," then the tenant should be able to terminate its occupancy if the rate is unacceptable, or another mechanism should be built into the option if the tenant believes the landlord's determination of fair market value is greater than what the market value actually is. A compromise clause gives landlord and tenant a time period during which to agree on what the market rate is, and if they cannot agree, then a methodology is spelled out to determine the monthly rate. Usually, the formula is based upon each party selecting an appraiser or a real estate broker who then attempts to settle on market rate. If they cannot agree, a third party is appointed and that individual selects which fair market rental rate—the landlord's or the tenant's—most approximates the fair market rental rate, and that rate is binding upon the parties.

4. **Adjustments during the Option.** This is a subtle point, but it is important to clearly indicate what, if any, adjustments the Monthly Rental shall be subject to during the Option Period. After the Monthly Rental is set the renewal paragraph must indicate that it is subject to adjustments, such as "The Monthly Rental shall increase by four percent (4%) every 12 months thereafter" or "Annually by a percentage reasonably selected by Landlord."

Right of First Negotiation or First Offer

A *right of first negotiation* is an agreement to agree. It does not give the tenant enforceable contractual rights, but rather it grants the tenant the right to attempt to strike a deal with the landlord.

This type of a provision may be negotiated in lieu of an option to extend or expand or a right of first refusal. Very often it is used in connection with a tenant seeking to expand into additional space within the complex. In other words, a tenant is renting suite 100 and wants the first right to expand into the adjacent suite 101 if and when it becomes available. The right of first negotiation usually obligates the landlord to notify the tenant of the space availability and to give the tenant a specified time frame during which to reach an agreement with the landlord on lease terms for the additional space. If the parties fail to reach an agreement within the time frame, then the tenant's right to lease the adjacent space terminates.

From a landlord's perspective, a right of first negotiation is usually preferable to a right of first refusal, because the right of first refusal places more burdens on the landlord. The landlord must first obtain an offer and then present it to the tenant with the right of first refusal before proceeding. The problem is that knowing a third party has a right of first refusal can often discourage potential bidders. Who wants to waste their time and energy striking a deal only to have it taken away from them by a competitor? If you potentially run the risk of making a market for some other party, it may have a chilling effect on your desire to play the game.

From a practical standpoint, the biggest problem with this type of a provision is setting up a tickler system to remind the landlord of the existence of the right of first negotiation. The landlord's objective should be to tie the right of first negotiation into a specific time frame so that it may be calendared electronically. If this is not possible, several other precautionary measures can be taken. For example, both the lease file for the tenant who is to receive the right of first negotiation and the lease file for the suite to which it applies might be annotated to reflect this provision. Also, as I suggest in Chapter 10, the right of first negotiation should be reflected in the Project Summary Binder.

Self-Help Rights

In general, all leases generated by landlords waive the tenant's *self-help rights*, that is, the tenant's rights to rectify problems. In multitenant buildings, the landlord does not want the tenant to exercise rights to cure problems. This area should be within the landlord's control. The exceptions occur when you have strong national tenants. Landlords will then attempt to limit self-help to emergency situations within the tenant's premises. A key factor that landlords should remember is that landlord warranties can be compromised if vendors, other than the vendor who performed the initial work, subsequently do work on the applicable equipment or material. The two most common areas affected by breach of the warranty are roofing and HVAC systems. If self-help is allowed, an indemnification provision might be inserted to protect the landlord.

Self-Insurance

At times, a financially strong tenant may ask, in lieu of the standard insurance provisions in the lease, for the right to *self-insure*. Such a tenant may suggest, "Our company is a multibillion dollar corporation. We usually just self-insure. If that is okay, let's make it simple and just insert a sentence in the lease that says we can self-insure." This issue and the solution seem simple and logical, but the problem should be addressed in a more thoughtful manner.

First of all, it is important to quantify the actual financial strength of the tenant. The tenant's concept of financial strength and the landlord's concept as to what qualifies as enough financial strength to self-insure might differ. Secondly, it is important for the financially strong tenant to maintain an acceptable net worth in order to be able to maintain a self-insurance program. The lease might provide that "as long as Tenant has a net worth on its most recent financial statements of not less than $________, Tenant may utilize a program of self-insurance." From the landlord's perspective, the objective should be to put the tenant in the same shoes as a third-party insurer. Therefore, the lease should provide that if the tenant self-insures: (1) The minimum limits set forth in the lease must be met, (2) The tenant must pay any amounts due in lieu of the insurance proceeds as required under the Lease, (3) All of the amounts for which the tenant has elected to self-insure shall be subject to the waiver of subrogation provisions in the lease, (4) The tenant's self-insurance should not limit tenant's indemnification obligations set forth in the lease, (5) If an event or claim occurs for which a defense and/or coverage would have been available from the insurance company, the tenant shall (i) undertake the defense of any such claim, including a defense of the landlord, at the tenant's sole cost and expense, and (ii) use tenant's own funds to pay any claim or replace any property or otherwise provide the funding which would have been available from insurance proceeds except for the election to self-insure.

Tenant Improvement Agreements

The tenant improvement area is often heavily negotiated because each build-out is unique and often the lease language must be tailored for each particular situation.

I divide the tenant improvement agreements into three types of agreements: a short-form agreement, an intermediate agreement, and a long-form tenant improvement agreement. The agreement that I use is a function of the amount of dollars involved and of the complexity of the build-out.

In general, if the landlord's commitment is less than $10,000, I use the short form; if the investment is between $10,000 and $50,000, I use the intermediate form; if the landlord is obligated to spend in excess of $50,000, I tend to use the long-form tenant improvement agreement.

The short-form agreement is a one-page document that simply indicates the allowance amount or obligates the landlord to build out the tenant improvements in accordance with an approved attached schematic drawing and budget. The intermediate form contains all of the items in the short form, and then goes on to require that the plans and specifications be approved by the landlord, that the contractor be approved by the landlord and, among other things, sets forth detailed disbursement requirements. Lastly, the long form incorporates all of the prior items and then spells out the approval process for the designer or architect and the contractor, as well as for the working drawings. It also outlines the disbursement process and addresses when the construction may occur, especially if the construction will generate noise or vibrations that might affect neighboring tenants.

Regardless of which form I use, it is crucial to clearly spell out who is going to be responsible for the build-out. Is the landlord obligating himself to build-out the agreed-to tenant improvements, or is the landlord granting a tenant improvement allowance, with the tenant agreeing to take on the burden of overseeing the work? The risk to the landlord is increased exponentially if he takes on the obligation to build-out the improvements, but sometimes the prospective tenant feels he does not have the expertise or the time to dedicate to coordinating the project. If this is the case, the landlord might be left with the choice of handling the coordination or losing the tenant.

The tenant improvement agreement can be a fairly complex document and should be scrutinized carefully. There are many other areas that should be addressed, depending upon the complexity of the build-out. Issues such as whether or not a permit is needed, and if so, who has the responsibility to obtain the permit should be covered. Who is responsible for cost overruns? Who must clear any mechanics liens? Must the contractor be licensed? What type of insurance must be maintained during construction?

Termination Provisions

Typically, *termination provisions* are built into a lease, which allows the tenant to end its tenancy upon the occurrence of certain events. They cover unlikely events such as total condemnation of a property or the occurrence of a casualty in which the landlord is unable to rebuild within the agreed-upon time frame. Although these issues are areas that attorneys fight over, and although they are indeed possible, they are far from probable.

On occasion, a tenant will have a concern about or a fear of a potentially catastrophic event that could destroy its business, and they might therefore request that they have the right to terminate the lease upon the occurrence of such an event. For example, a retailer might want the right to terminate if it experiences a fall in sales so precipitous that the business is no longer profitable; a doctor tenant may want the right to cancel his lease if the adjacent hospital closes; a governmental agency may want the ability to get out of its lease if the legislature cuts off funding for its key program. The landlord's argument that even in these scenarios a termination right is inappropriate is twofold: (1) The issue is really a business decision and a business risk, and the tenant is in the best position to evaluate the likelihood of the event occurring and to bear the risk; and (2) granting the termination right could have a negative effect on the securing of financing. When a lender analyzes the lease, it will discover the termination right and will possibly not count the tenant's income for underwriting purposes.

A termination right granted to a tenant has an extreme consequence: it results, in essence, in the lease being ripped up. This consequence is accentuated if the landlord has expended significant monies to put the tenant in place. If, for example, in relying on the lease, an owner has secured a construction loan and built a building to suit, the result of the tenant's cancellation because the building was a few days past the scheduled completion date could be disastrous. The bottom line is that landlords should be aware of the consequences of granting a termination right and do so with appropriate caution and, if possible, include protective language such as a long period between notice and termination and a monetary cost to the tenant, for example, six months' rent or payment of the unamortized tenant improvement and leasing brokerage cost if the clause is invoked.

As stated in the beginning of this chapter, the leases in place directly affect the income and expenses of the project. Understanding the leases is essential to an understanding of the project economics. In addition, a review of the leases is important to ensure that traps and pitfalls are not overlooked. As pointed out in this chapter, exclusives, cotenancy provisions, termination rights, and so forth can all be problematic and therefore must be considered and addressed.

The next chapter addresses financing. Like the lease analysis, financing is an important part of a commercial real estate transaction and therefore must be fully understood so that an appropriate structure can be formulated.

Wealth Opportunities in Commercial Real Estate: Management, Financing, and Marketing of Investment Properties
By Gary Grabel

CHAPTER 5

Real Estate Financing

Sixty to Eighty Percent of the Game

It is crucial to understand real estate financing for a very compelling reason: Often 60 to 80 percent of a transaction is debt. I have seen projects achieve great success through a well-thought-out financing structure, and I have witnessed disastrous results when an owner or buyer does not structure the financing so that it is in tune with his financial goals.

For example, if you intend to sell a $20 million office building in the near future, it might be a mistake to originate a $10 million long-term first mortgage. If the new debt prohibits secondary financing, which is usually the case, your buyer will have to come up with $10 million to acquire the asset. If, on other hand, the seller allows the buyer to place his own financing on the property at acquisition, the buyer can seek a 75 percent loan-to-value (LTV) mortgage, a $15 million first-trust deed. The result is that the buyer's up-front equity commitment has been cut in half, from $10 million to $5 million. This factor could have a dramatic effect on the number of available buyers. Additionally, depending on the debt cost, the amount of financing encumbering the property might significantly affect the return on equity and therefore, again, affect the number of interested buyers.

The above example must be tempered with the knowledge that the financial crisis of 2008 to the present has resulted in lenders taking a conservative debt posture, so that as I write this, the standard LTV is closer to 60 rather than 75 percent. However, I anticipate and hope that as the economy recovers, the "bellwether" 75 percent LTV will again become the norm.

In addition to the amount of equity required, the buyer's motivation and vision for how he intends to create value may also differ from that of the seller. The buyer's motivation and vision might tie into the financing structure. This might allow the buyer to justify the seemingly outrageous purchase price the seller wants for the project. For example, the buyer's strategy may be to sell off part of the asset, such as to peddle the out-pads in a shopping center, or to "map" the property so that individual buildings or units in an office project can be sold as commercial condominiums. In such instances the financing structure becomes crucial, since in order to spin off the out-pads or "condominimize" the project, release provisions must be built into the encumbrance or the lender's mortgage must be written in such a way as to not encumber the property to be sold.

Types of Financing

In general, there are three types of financing: fixed-rate loans, variable-rate loans, and hybrid loans. The type of loan should not be confused with the loan's amortization. *Type of loan* refers to the overall structure of the financing, while *amortization* relates to how quickly the principle of the loan is repaid. In other words, you can have an interest-only or a 30-year amortizing fixed-rate loan and, similarly, have an interest-only or 30-year amortizing variable-rate loan.

Fixed-Rate Mortgages

Fixed-rate debt sets the interest rate for the life of the loan at the outset. As long as the loan is outstanding, the agreed-upon interest rate is the interest rate that the borrower pays. For commercial loans the interest rate is typically set as a spread over treasury bills. A lender's quote might be 100 basis points over the 10-year Treasury bill rate. If the Treasury bill rate for 10-year money is 4.50 percent, then the interest rate will be fixed at 5.50 percent for the entire 10-year loan term.

If the interest rate is set a few days prior to closing, commercial lenders will usually allow the borrower to "lock rate" (fix the interest rate) without posting additional money. However, if the borrower wishes to lock the rate 30 or more days prior to the anticipated loan closing date, then the lender usually requires that a rate-lock agreement be signed and that the borrower post an additional deposit, typically 2 percent, to cover any loss the lender might incur purchasing securities in the event the borrower fails to close the loan.

When the borrower locks rate, the lender goes out into the market and buys an equivalent amount of securities, that is, an amount equal to the loan amount, to hedge the interest rate risk. If interest rates move down, the lender loses on the securities it just purchased, but wins on the loan that closes at a rate that is higher than the market. A problem arises when for some reason the loan does not close. The lender loses on the hedge and cannot offset that loss with the gain on the loan origination. There is a real loss. The deposit is intended to offset such a loss in whole or in part. Also, if rates fall after a loan is locked, the deposit is designed to keep the borrower honest, discouraging him from taking a lower-rate mortgage since he will lose these deposit funds.

Given the uncertainty that surrounds closing any loan, if a borrower seeks to lock rate early in the process, it might be prudent to lock rate for an amount less than the full loan that has been requested. For example, if a $5 million loan has been applied for, the rate lock might possibly be for $4.8 million. Therefore, if the loan is approved for less than the full amount requested, the hedge does not have to be broken and potential resulting costs are avoided.

The big advantage of fixed-rate debt is certainty: The debtor knows exactly what his costs will be for the life of the loan. The negative trade-off is that fixed-rate commercial loans contain a prepayment penalty, as is more fully discussed later in this chapter.

Variable- or Adjustable-Rate Loans

In a variable- or adjustable-rate loan, the interest rate fluctuates as the index to which the loan is tied changes. Construction loans are usually a variable-rate mortgage. A typical construction loan might be set at prime plus 1 percent. Hence, if the bank prime rate moves up or down, the interest rate changes accordingly.

This type of a loan is perceived to be riskier than a fixed-rate loan because the interest rate could accelerate rapidly. In the early 1980s, for example, bank prime sometimes increased over 1 percent per month, reaching a high of about 18 percent. If the financing is intended to be long-term in nature, an annual and lifetime interest rate cap might possibly be negotiated. Alternatively, the interest rate risk could be hedged for a period of time to ameliorate a potential rate increase. The big advantage that a variable-rate loan has over a fixed-rate mortgage is its flexibility, especially in connection with the fact that this type of loan usually does not contain a prepayment penalty (or, if it does have a prepayment penalty, the charge is significantly smaller than a defeasance penalty found in a fixed-rate mortgage).

Hybrid Loans

Basically, I characterize all other loan types as hybrid loans. Common in single-family loans, but not as readily available in commercial mortgages, are the 5/1, 7/1, or 10/1 types of loans. This abbreviation stands for a fixed-rate for 5, 7, or 10 years, respectively, and then a variable-rate set monthly as a spread over the one-year Treasury bill rate or some other index.

Participating loans are, in a sense, another type of hybrid loan. This structure gives the lender a fixed rate of return, plus a kicker based upon the project's performance. Historically, participating loans are used when a lender funds more than 90 percent of a project's going-in value or in some way funds a loan with features that are not standard terms and conditions, such as issuing favorable release prices with a commitment to make loans to buyers. In essence, part of the loan (usually 60 to 75 percent LTV) is conventional debt and part (over 75 percent LTV) is equity, whether funded by the borrower or the lender.

What Is the Right Answer to Debt Structuring?

There is no right answer when it comes to structuring debt for a project. The key is to meet your borrowing needs wish list as closely as possible. Some owners are dollar-sensitive, and wish to maximize the loan amount. Other players seek the lowest interest rate, the lowest cost. Alternatively, some borrowers believe that flexibility, in terms of being able to repay the debt with a reasonable prepayment penalty, is the most important element in the loan terms.

Negotiating loan terms requires trade-offs. For example, in general, the lower the loan-to-value ratio, the lower the lender will decrease the spread, and, therefore, the lower the interest rate. The reverse, of course, is also true. The higher the loan-to-value, the higher will be the spread, and the higher the interest rate.

The nature of the lender's source of capital can also impact a borrower's ability to negotiate loan terms. Usually if a lender is originating a portfolio loan, that is, a loan that they intend to keep on the books, then they can be more flexible in structuring the financing. The portfolio loan is different from a conduit loan, in which the intent of the lender is to package the loan into a pool of mortgages, securitize the pool, and sell the security. This process is referred to as collateralized mortgage-backed assets (CMBA). When a lender documents a CMBA loan, its goal is for that loan to fit into the same box as its other loans so they can all be bundled together. Often, when attempting to negotiate a CMBA loan, the lender's response is "I cannot do that because the buyers will not accept that change or modification." Since the lender is really a conduit, originating and then packaging the loans for sale to a buyer, it often is the buyer's requirements that govern the loan terms and conditions. This issue becomes particularly sensitive with regard to loan documentation, since the buyers demand "standard loan documents." Additionally, once the loan is sold, the servicing entity is charged with complying and adhering to the loan terms. No flexibility is built into the process. Unfortunately, almost all commercial loans are either sold or the loan servicing function is outsourced. So in practice, regardless of the nature of the lender's source of capital, you end up facing the same market realities.

The lender's pricing is typically quoted in terms of a spread. The spread is a function of the general marketplace, competition among lenders, and the mortgage-backed security buyer's perceived risk. If the buyers adjust their pricing, that is often reflected in the spread that the lenders quote. Like the index that may move up or down, the spread may widen or constrict. At a loan-to-value ratio of 50 to 60 percent, the pricing might be 85 basis points over 10-year Treasury bills. If the loan to value is 75 percent, the pricing might be in the 110 to 120 range; if the loan to value is in the 80 to 90 percent quadrant, assuming the lender will consider funding this higher risk loan, the cost will increase possibly to 150 to 170 over the Treasury bill rate.

Building flexibility into a real estate loan can have tremendous advantages. The key ingredient in flexibility usually is the ability to pay off the trust deed for a relatively nominal cost. If your mortgage is at a 10 percent interest rate and the market rate plummets to 5 percent, your ability to pay off the existing loan and replace it with a loan at an interest rate 50 percent lower than the existing note's interest rate results in a tremendous economic advantage. As with the interest rate and loan to value, flexibility has its trade-offs. Typically, only if the interest rate is variable can you repay the debt for a nominal fee. The theory is that if the lender has the ability to adjust the amount it charges as interest rates increase, then the debtor should be able to keep the lender honest by being able to opt out and replace the loan with other debt without incurring a large prepayment fee. In the real world, in order to sell variable-rate programs to potential borrowers, protective provisions such as annual and lifetime rate caps are often built into the program. Also, in the real world, variable-rate programs will often have a prepayment penalty, although that penalty will typically be much less harsh than a fixed-rate defeasance or loss-of-yield formula. Very often, the variable-rate prepayment penalty will be a declining percentage, such as 3 percent in the first year, 2 percent in the second year, 1 percent in the third year, and open to repayment without a penalty after the end of the third year.

Commercial lenders who originate fixed-rate debt have figured out the risk elements in the game. They do not give the borrower the best of both worlds, that is, they do not offer a fixed-rate loan *and* the flexibility to replace the debt with a lower rate if interest rates drop, while agreeing to bear the negative consequences of living with an agreed-upon yield as rates rise. In order to counteract this possibility, a defeasance or loss of yield formula is usually built into the loan documents, so if interest rates fall, a steep penalty must be paid to the lender if a borrower elects to refinance at a lower interest rate. This penalty allows the lender to maintain its yield. The penalty offsets the lender's cost associated with replacing the asset. Similarly, with a defeasance obligation, the borrower must replace the mortgage with securities that result in a yield identical to that which the lender would receive if the mortgage were still in effect.

Seven Key Factors to Consider in a Real Estate Loan

Seven threshold factors must be considered when you are structuring a real estate financing. The seven factors are listed below with a more detailed explanation to follow.

1. **Nonrecourse versus Recourse Liability:** In the case of recourse, what, if any, are the limitations on the debtor's liability?
2. **Fixed versus Variable versus Hybrid Loan:** If fixed, what is the spread and what is the index over which the rate will be fixed? If variable, what are the program parameters in terms of index, spread, and rate caps? If hybrid, what are the details of the loan program?
3. **Loan term:** 3 years, 5 years, 10 years, or longer?
4. **Loan Amount and the Loan-to-Value Ratio.**
5. **Amortization:** What is the amortization time frame—for example, is there an interest-only feature for first two years or longer; what happens thereafter?
6. **Prepayment Penalty:** Is there a defeasance, a loss of yield, a declining percentage? When is the loan open for repayment and when is it open for repayment without a penalty?
7. **Assumption Provisions:** Is the loan assumable and, if so, under what conditions?

Liability

What is the difference between nonrecourse and recourse debt? With nonrecourse financing, if the borrower defaults, only the real property security for the loan may be used to satisfy the obligation. The lender may not go after the other assets of the obligor. In contrast, if the debt is of the recourse sort, the borrower is personally liable for the monies borrowed. Any and all of the debtor's assets, unless protected by statute, are subject to seizure in order to satisfy the obligation.

Given this extreme contrast—where under a recourse debt scenario the debtor is essentially "risking the farm," while with nonrecourse debt the risk is limited to the asset in question only—why would anyone ever sign up for recourse debt? When you reflect on this question, the answer becomes obvious: only when recourse debt is the single available option, or when other mitigating factors come into play. For example, lenders typically require recourse when the cash flow from the project does not fully support the debt. The classic example is a construction project. A "to be built" project has no income until the building is constructed and the tenants are in place paying rent.

There are other times when a borrower may choose recourse debt. I have structured loans where the borrower agreed to recourse debt in return for favorable pricing, significantly better than that of the standard nonrecourse loan. Also, if the loan-to-value ratio exceeds the standard 75 percent, the lender may ask for recourse for the dollars in excess of the "standard" loan amount. The lender views this kind of loan essentially as two loans: one up to the usual and customary ratio, and the balance as a personal loan to the borrower.

If the loan does have a recourse feature, the question becomes, Is it possible to negotiate a limitation on the debtor's exposure? If circumstances warrant, the lender may cap the personal exposure to the top 10 to 20 percent of the loan amount, or limit the personal liability to a specific dollar amount.

Fixed-Rate versus Variable-Rate versus Hybrid Program

As a borrower, should you select a fixed-rate program or a variable interest rate mortgage? First, of course, you must understand the differences in the programs. A fixed-rate mortgage gives the borrower certainty in terms of what the lender will charge during the life of the loan. However, what is missed by most borrowers is that there is uncertainty in terms of what the prepayment cost will be in the event the borrower elects to pay off the mortgage prior to maturity, since the defeasance penalty is based upon the Treasury bill yield at the time of repayment. Under a variable-rate program the cost, the interest rate, is tied to an index. The interest rate will be quoted as a spread over the selected index. For example, the interest rate might be stated as 120 basis points over the 10-year Treasury bill rate, or 200 basis points over the 11th district cost of funds, or 250 basis points over the London Interbank Offered Rate (LIBOR).

When deciding whether to go variable or fixed rate, your analysis should start with where interest rates are currently in relation to historical interest rates. If, for example, the overall interest rates are at a historic low, then that would lead to locking in a long-term low rate now. On the other hand, if the rates appear to be high historically, then a variable-rate structure may be warranted. There are other factors that should be considered, such as the variance between the fixed-rate charge and the variable-rate cost. If there is a large gap between the fixed rate of, let us assume, 7.5 percent and a variable rate of, say, 3 percent, possibly it is worth the risk going with a variable rate, especially if your perception is that interest rates will remain low for a protracted period or if you intend to sell the project as soon as possible. Often your motivation and vision of where you want to go with the project, as well as your desire for flexibility in terms of the prepayment penalty, may dictate the type of loan you select.

Loan Term

A critical matter in structuring a real estate financing is the term of the loan. The most common term today is a 10-year loan with an interest-only feature for the first couple of years, and then a 30-year amortization. If, however, the subject property is 50 percent vacant and your game plan is to create tremendous value by leasing up the vacant space, then it might be a wiser financial debt structure to time the loan term to coincide with the value creation time-frame. In other words, if you buy a 50 percent vacant property for 10 million dollars and lease the vacant space, too, let us assume, the property is now worth $20 million and you have $10 million of "trapped equity" in the project. Having tremendous equity in a project is not a bad thing. Your cash flow may be huge. On the other hand, you might want to refinance and pull out all or a portion of the "trapped equity," if you can. Loans, especially fixed-rate loans, usually contain a lockout feature for the first couple of years, as well as a steep prepayment penalty thereafter. Therefore, when financing "value-added properties," it may be crucial to tie the value creating efforts to the loan term. A three-year gap loan may be the right loan term. Alternatively, a variable-rate loan that allows the borrower to prepay the financing without a penalty after six months may be a better solution than long-term fixed-rate debt.

Implicit in the earlier discussion relating to the term of the loan is that we are referring to an immediate funding. The alternative to an immediate funding is a future funding, also known as a forward commitment. Under a future funding, the lender agrees to disburse the loan funds at a future point in time. Usually the future funding is conditional on certain events having taken place, such as the project being fully constructed with tenants in place producing a minimum gross and net income.

Obtaining a forward commitment might be a condition imposed by the construction lender. The construction lender wants to ensure that there is a source of funds available sufficient to repay the monies disbursed pursuant to the construction loan. Even if it is not a requirement to have in place a forward commitment, the borrower might feel that obtaining such a commitment makes sense from a conservative position. The forward commitment ensures that funds are available. Also, in a rising rate environment, the borrower is able to lock in an interest rate now, although usually at a premium over the immediate funding loan.

Loan Amount

The amount you want to borrow is always a consideration when weighing financing options. There is a direct relationship between the loan amount as measured by the loan-to-value ratio and the cost of the loan. In other words, as previously mentioned, as the loan amount increases, the loan-to-value also increases, and the loan's pricing should also go up. The increased cost is usually reflected in an increase in the spread. If a borrower wants the best pricing, he should reduce his loan request. If a borrower pushes dollars, that is, seeks the most money he can obtain out of a property, he should expect that the pricing will be at the upper level for the type of property and the type of lender in question.

Amortization

Amortization relates to the speed with which the borrower repays the principal portion of the loan. If during the entire loan term or during a portion of the loan term the borrower pays none of the loan's principal, but pays only the interest charges, then the loan is referred to as an interest-only (I/O) loan or as having an I/O feature. If the loan's principal is repaid in even monthly installments over a specific term—for example, 15 years—then the loan might be referred to as a fully amortizing 15-year debt. A shorthand abbreviation for this is 15/15; meaning a 15-year term fully amortizing over the 15-year period. If, in contrast, the loan is said to be a 30/10, the reference is to a 30-year amortizing mortgage with the outstanding principal balance due in 10 years.

Amortization translates into cash flow. For example, the illustration in Chapter 3 assumed the following:

Gross Income		**$1,440,000**
Expense Reimbursement		
Recapture over Base Year	18,000	
Utility Recapture	76,800	
Triple Net Charges	121,836	
Total Expense Reimbursement		216,636
Total Gross Income		$1,656,636
Vacancy and Collection Loss		(82,832)
Adjusted Gross Income		$1,573,804
Operating Expenses		
Elevator Contract	(11,197)	
HVAC Maintenance Contract and Repair	(5,413)	
Insurance	(5,000)	
Janitorial Contracts	(52,600)	
Landscaping	(6,410)	
Property Taxes	(97,067)	
Property Management Fee	(49,699)	
Repairs and Maintenance	(13,470)	
Security and Fire	(27,931)	
Taxes and Licenses	(420)	
Trash Disposal	(6,336)	
Utilities	(180,956)	
Total Operating Expenses		(456,499)
Net Operating Income		1,117,305
First Trust Deed of $7,650,000 @ 7.5% 30-Year Amortization		(637,892)
Cap X Reserves		(18,000)
Tenant Improvements and Leasing Commissions		(60,000)
Net Cash Flow		**$401,413**

If the first trust deed of $7,650,000 was priced at 7.5 percent interest-only, the yearly mortgage charge would be $573,750 instead of $637,892, resulting in a net cash flow of $465,555 instead of $401,413, a 16 percent increase. On an annual basis, the cash flow is enhanced by $64,142. Of course, your choice of amortization should be guided by your goals. If your goal is to build equity in the property and/or reduce the risk associated with debt, it would be consistent to build in a reduction of the principal using a 30-year amortization or an amortization with an even more accelerated basis. Of course, an alternative, if it is possible, might be to build in an interest-only feature with the right to pay down a portion of the loan principal without a penalty. This structure gives you the lowest monthly mortgage payment contractually, yet allows you the flexibility to reduce the loan balance as much as you can afford to, up to the agreed percentage, without a prepayment penalty.

Constant

In the preceding example, the interest rate is 7.5 percent with a 30-year amortization. The mortgage payment is set at the outset at a level amount of \$637,892 per year, or \$53,158 per month. This means that each monthly payment will be composed of interest on the outstanding principal balance at 7.5 percent as well as some repayment of principal. Please refer to Exhibit 5.1 for a graphic illustration of how principal and interest portions of the mortgage payment relate to each other over time. Please note as time goes forward, more and more monies are paid toward the principal and less and less goes to interest. This is because interest is charged on the principal outstanding, and as time goes forward, the principal is constantly repaid so that there is less and less money owed.

The constant is determined by the following formula:

$$\text{Constant} = \frac{\text{Total Principal and Interest Payment}}{\text{Outstanding Principal Amount}}$$

Since by definition with a fixed-rate loan the principal and interest payment is the same each month for the life of the loan, while the outstanding principal amount decreases each month by the amount of principal that is paid back, the result is that the constant increases over time. For example, initially the constant is 637,892/\$7,650,000 or 8.34 percent. However, in the beginning of the tenth year, assuming all regular monthly payments are paid on time, the outstanding loan balance will be \$6,639,817, yet the monthly payment amount remains unchanged. The constant is therefore 9.61 percent (\$637,892/\$6,639,817).

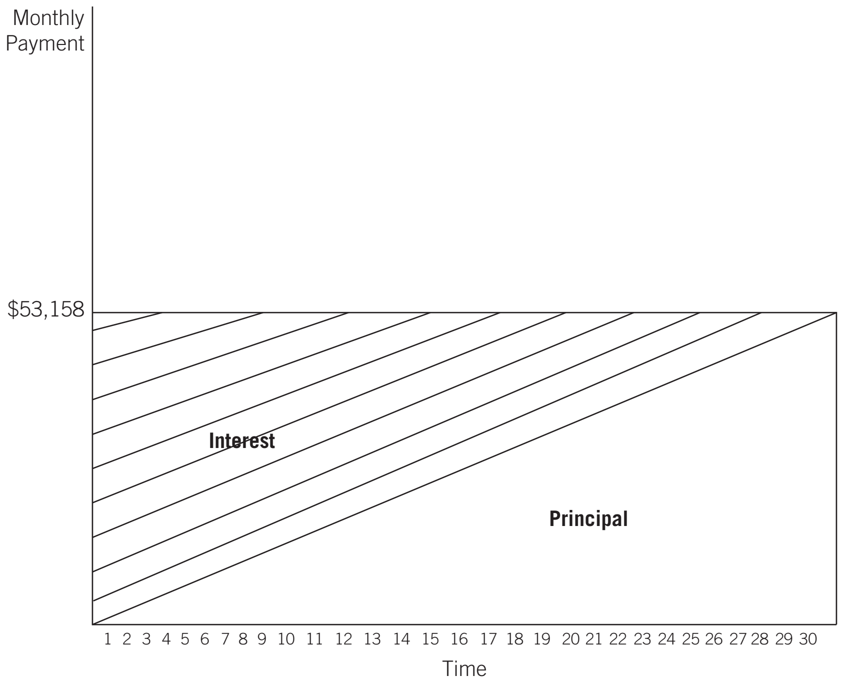


Exhibit 5.1 Graphic Illustration of How Principal and Interest Portions of the Mortgage Payments Relate to Each Other over Time

Why is the concept of constant important? As indicated next, it is often used to underwrite a loan request. Additionally, as the constant increases, it is often a good indicator of when a refinance is appropriate.

Loan Underwriting

The amount of the loan is usually a key element in structuring the debt, but you must understand that determining the loan amount, “sizing the debt,” is a negotiated process. Lenders “underwrite” a loan request to come up with the quoted dollar amount. I do not mean to suggest that the quoted dollar amount is a given, not subject to discussion, but rather that it usually is the starting point in the negotiation.

Financial institutions will usually underwrite off the Cash-Flow-before-Debt-Service figure. In other words, after deducting the operating expenses from the project's income, they will also deduct reserves, that is, their estimate of annually recurring capital expenditures, tenant improvement costs, leasing commissions, and the like. The figures used to make up the income and expense schedule are called "trailing 12-month figures." They are historical numbers for the past 12 months. If the owner has had significant success in leasing up the property in the recent past, possibly the lender will allow the current rent roll to be annualized, but in most cases the trailing 12-months' income will be utilized. Similarly, the past 12 months reimbursed expenses and the past 12 months operating expenses will be used in the analysis. Please refer to Exhibit 5.2 for a month-by-month detailed breakdown of the income and expenses for our hypothetical project.

In our hypothetical example in the beginning of Chapter 2, we assumed a debt level of $7,650,000 based upon 75 percent of the $10,200,000 purchase price. The purchase price was determined using a 9 percent cap rate on a $918,000 NOI. Comparing the Chapter 2 numbers to the trailing 12-months' figures results in several noteworthy points of comparison. First, the trailing 12 months' figures reflect a leasing ramp-up. The gross income increases over the year. The gross income shown in the trailing-12 is $1,286,000 versus the Chapter 2 hypothetical of $1,440,000. Additionally, as we developed the hypothetical, we added expense reimbursements totaling, on the trailing 12-month schedule, $191,195. The result was that the adjusted gross income for the trailing-12 is about $20,000 higher than the Chapter 2 figures. However, the NOI in the trailing 12 is lower than in Chapter 2, given that the trailing-12's increased expenses more than offset the income gain. The significant increases in operating expenses can be found in line items designated "HVAC Maintenance Contract and Repair" and "Repairs and Maintenance."

Exhibit 5.2 reflects a detailed breakdown for each of the expense categories by month over the entire year. The issue becomes, should all of these items, although actually incurred, be reflected as "operating expenses"? It is crucial to scrutinize the expenses to make sure they should be counted when submitting an income and expense analysis to a lender. Full disclosure is always required, but there is nothing wrong with being your own advocate. Usually a lender will want to view actual historical figures and make its own adjustments. As an advocate, I suggest that the presentation

Income and Expense Analysis (Calendar Year 2007)

Gross Income	January	February	March	April	May	June	July	August	September	October	November	December	Totals
Rent	100,000	100,000	102,000	102,000	105,000	105,000	106,000	108,000	108,000	110,000	120,000	120,000	1,286,000
Expense Reimbursement													
Recapture Over Base Year				18,000									
Utility Recapture	5,000	5,120	4,500	4,800	5,000	6,000	6,500	6,000	6,100	6,400	6,400	6,400	
Triple Net Charges	8,000	8,100	8,150	8,175	8,200	8,250	8,250	9,100	9,250	9,500	10,000	10,000	
Total Expense Reimbursement	13,000	13,220	12,650	12,975	13,200	14,250	14,750	15,100	15,350	15,900	16,400	16,400	191,195
Total Gross Income	113,000	113,220	114,650	114,975	118,200	119,250	120,750	123,100	123,350	125,900	136,400	136,400	1,477,195
Vacancy and Collection Loss	5,650	5,661	5,733	5,749	5,910	5,963	6,038	6,155	6,168	6,295	6,820	6,820	72,960
Adjusted Gross Income	107,350	107,559	108,918	109,226	112,290	113,288	114,713	116,945	117,183	119,605	129,580	129,580	1,388,235
Operating Expenses													
Elevator Contract	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	
HVAC Maintanance Contract & Repair	1,560	2,100	1,670	500	500	6,200	5,014	7,500	1,087	450	490	600	
Insurance	417	417	417	417	417	417	417	417	417	417	417	417	
Janitorial Contract	3,500	3,500	3,570	3,570	3,675	3,675	3,710	3,780	3,780	3,850	4,200	4,200	
Landscaping	500	450	1,670	2,100	450	450	450	600	450	450	450	500	
Property Taxes				24,277									
Property Management Fee	3,221	3,227	3,268	3,277	3,369	3,399	3,441	3,508	3,515	3,588	3,887	3,887	
Repairs & Maintanance	1,600	1,750	450	350	456	4,500	1,200	12,000	1,500	550	10,000	2,000	
Security & Fire	2,300	2,300	2,300	2,300	2,300	2,300	2,300	2,300	2,300	2,300	2,300	2,300	
Taxes & Licenses	35	35	35	35	35	35	35	35	35	35	35	35	
Trash Disposal	528	528	528	528	528	528	528	528	528	528	528	528	
Utilities	11,606	12,502	13,210	14,500	16,000	23,100	24,500	19,000	17,560	14,939	15,040	15,000	504,059.20
Total Operating Expenses	26,266	27,808	28,117	52,853	28,729	45,603	42,595	50,668	32,172	28,107	38,347	30,487	
Net Operating Income	81,064	79,751	80,800	56,373	83,561	67,684	72,117	66,277	85,010	91,498	91,233	99,113	882,176
Cap X Revises	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	27,000
Tenant Improvement & Leasing Commisson	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	60,000
Net Cash Flow before Debt Service	74,584	73,251	74,300	49,873	77,061	61,184	65,617	59,777	78,510	84,998	84,733	92,613	795,176

Exhibit 5.2 Trailing 12-Months' Income and Expenses

to the lender is critical. For example, if the lender does not require earthquake insurance, why should the borrower be penalized when compared to a similarly situated project next door that does not carry earthquake insurance? Are professional expenses such as legal and accounting fees an operating expense, or are they attributable to running the owner's business rather than a property, per se? Possibly there should be an allocation between the business and the real property. Additionally, if you have had out-of-the-ordinary expenses during the year, whether they relate to maintenance and repairs as in the trailing-12 or to legal expenses or some other category, possibly this category should be adjusted downward to reflect ordinary and reasonable expenses. Similarly, if an owner elects to hire a day porter to enhance management, or an experienced, high-level building engineer, or an HVAC specialist, are these expenses ordinary and reasonable when, in fact, the property could be well run during the year in the absence of such services?

Categories that should be scrutinized include all professional fees such as accounting costs and, as mentioned previously, legal expenses. In order to derive net cash flow before debt service accurately, a close look at the income and expense analysis must be made.

Financial institutions historically employ the lower of three tests to determine the dollars they will lend against a certain property, namely:

1. A loan-to-value (LTV) test. The property to be used as the security for the loan is appraised. The lender, based upon policy and pricing, will then set the percentage of the property's value that it is willing to fund. In other words, using the above cash flow numbers, if the NOI is $882,176 at a 7 percent cap rate, the property would be worth $12,602,514 ($882,176 divided by .07). If the lender is agreeable to lending on a 75 percent LTV basis, then the loan amount would be approximately $9,451,886. The simple calculation is the value of $12,602,514 multiplied by the LTV percentage of 75 percent. Given the tight lending policies that commenced in calendar year 2008, the LTV would probably be 65 percent with a cap rate of 10 percent. The result would be the significantly reduced loan amount of $5,734,144 ($882,176/.10 × .65).

2. A debt coverage ratio (DCR) test. This test takes the cash flow before debt service and divides by a factor, the DCR. It should be noted that in the not-so-distant past, lenders would utilize NOI and apply the applicable DCR to determine the funds available to service the debt. Today, the tendency is to first reduce the NOI by reserves before applying the debt coverage ratio. The DCR varies depending on the property type and the underlying credit of the tenants, but in general, lenders on commercial property use a 1.20 to a 1.30 ratio. In other words, using the example above, if the $795,176 Cash Flow before Debt Service is divided by a 1.20 DCR, then the funds available to service the debt would be $662,647. Mathematically, using whole numbers, this calculation is $795,176/120/100 or $795,176 × 100/120. The point is that 100/120 equals .8333, so when you multiply $795,176 by .8333 you get a number that is a little over 83 percent of your Cash Flow. The lender uses this lower number as a safety cushion before applying an interest rate constant to determine the loan amount to lend. The interest rate constant reflects, as a percentage, what the lender intends to charge for the loan. It is a function of current interest rates and amortization as discussed in the previous section. For example, if the lender is charging 6 percent interest-only, the constant is 6 percent. On a loan of $1,000,000, $60,000 would be collected during the year, hence $60,000/$1,000,000 equals a 6 percent constant. If the lender is using a 30-year amortization, then the monthly charge on a $1,000,000 loan at 6 percent would be $5,996, or $71,952 annually. The constant would be $71,996/$1,000,000, or 7.20 percent. An easy way to figure out the constant using an hp12c calculator is to plug into the amortization function the number of months in the loan (e.g., 360 for a 30-year loan), the monthly interest rate factor for "interest," 1,200 for "PV," clear the "PMT" and "FV" cells, then solve for payment, "PMT." Going back to our example, if a constant of 8.34 percent is used on the $662,647 available to service the debt, the result is a $7,945,408 loan amount ($662,647/.0834).
3. The stress test. Lenders today in an attempt to err on the conservative side, and especially if they intend to place the loan into a pool, securitize the loan and sell it as soon as possible, use a somewhat artificial test, called a "stress test," to limit the

amount of dollars they will fund. A typical stress test might use a .9 to 1.10 debt coverage ratio at an 11 to 12 percent constant to determine the loan amount. On a \$795,176 Cash Flow before Debt Service, if the DCR is 1.00, the dollars available to service the debt would be \$795,176 (\$795,176/1.00). Dividing \$795,176 by an 11 or 12 percent constant results in a loan amount of \$7,228,873 or \$6,626,467, respectively. Please note that, mathematically, dividing NOI by 11 or 12 percent is the same as multiplying NOI by 9.09 or 8.33, respectively, as shown below:

$$\text{NOI}/11\% = \text{NOI}/11/100 = 100 \times \text{NOI}/11 = 9.09 \times \text{NOI} = \text{Loan Amount}$$

After these three tests are run, the lender then, per the formula, would select the lowest resulting loan amount. In the above tests, if the LTV utilized is 65 percent, at a 10 percent cap rate, the result is a loan amount significantly lower than the existing debt, that is, \$5,734,144 versus \$7,650,000. If the borrower's loan has matured, he is confronted with difficult options: (1) refinance at \$5,734,144 and pay the existing lender an additional \$1,915,856 (\$7,650,000 – \$5,734,144) from other sources, (2) extend the existing loan's maturity date, or (3) modify the existing loan with a combination of an extension and a pay-down less than the \$1,915,856 amount. If the loan is a performing debt (not delinquent), most lenders today, understanding the changed underwriting criteria, will extend the maturity date of the loan.

It should be noted that if the underwriting test is a 10 percent cap rate at a 65 percent LTV, it is the same as saying the loan amount is 6½ times the NOI. This statement is a simplification of the mathematical calculation. In other words, the loan amount is determined as follows:

$$\text{NOI}/10\% \times 65\% = \text{NOI} \times .65/.10 = \text{NOI} \times 6.5 = \text{Loan Amount}$$

If the underwriting test uses an 8 percent cap rate at a 50 percent LTV then, to determine the loan amount, multiply NOI by 6.25. The same mathematical calculation applies, that is, 50 percent divided by 8 percent equals 6.25.

It is important to recognize that even with all of these mathematical calculations, underwriting is an art and not a science. We started the underwriting discussion with an assumption: namely, what the amount of the Cash Flow before Debt Service would be. However, as shown in this section, the calculation of the NOI is not clear and certain, but rather subject to adjustment depending upon underwriting guidelines and policies, as well as one's view of the various expense-line items. For example, what vacancy factor is the lender willing to use? Will the lender include month-to-month leases as part of the gross rent? If a lease rate is above market, will the lender mark to market and, for underwriting purposes, reduce the gross rent? What reserves will the lender use for capital expenditures, leasing commissions, and tenant improvements? Also, after the Cash Flow before Debt Service is determined, there are assumptions built into the various tests. What cap rate should the lender use to determine value? What is the DCR factor to be used to underwrite the loan? What shall be the constant for underwriting purposes? Underwriting is a negotiated process. The rules can be rewritten if the origination merits adjustment. Lenders, like all individuals, are subject to the art of persuasion.

When credit becomes tight, lenders rewrite the underwriting rules. When the DCR increases, they may make a rule that they will lend only against stabilized projects; when every loan is full recourse, they may impose an interest rate floor, and so on.

It is somewhat self-evident to say that when money becomes scarce and when credit is tight, the best real-estate purchases are available. When money is dear it commands a higher price, which is reflected in yield. To state thus principle in relation to value: The purchase price for the real-estate project decreases to generate the required yield.

Rule Number 13

It is usually when credit becomes tight and lenders are averse to funding loans that you can make the best real-estate purchases.

Cash-on-Cash Return

Investors, especially those investors looking for how much cash they are putting into their pocket, focus on their Cash-on-Cash return. This return is calculated by taking the Net Cash Flow, that is, the monies resulting from not only backing-out operating expenses but also reserves, and debt service as a percentage of the equity invested into the project.

$$\text{Cash - on - Cash Return} = \frac{\text{Net Cash Flow}}{\text{Equity}}$$

In our hypothetical example, the Net Cash Flow equals $401,413. The equity equals $8,311,500: that is, the project value of $15,961,500 (7 percent Cap Rate) less the existing loan balance of $7,650,000. Applying the applicable formula results in a Cash-on-Cash return of 4.83 percent ($401,413/$8,311,500).

The Mortgage Loan Application

When applying for a mortgage loan, it is the application stage that is most crucial. It is at this stage that the transaction is usually cemented. Most major lenders' applications, when countersigned at loan approval, become the loan commitment. This is not to say that a lender cannot change the loan terms concurrent with approval, but the lender's and borrower's objective is to obtain loan approval "as applied for." The point is that it is at the loan application stage that the underwriting is performed, and if the financial analysis is supported by the property operations then, theoretically, assuming the loan officer understands his company's underwriting guidelines, the loan should be approved as submitted. It is therefore important to obtain a copy of the loan officer's underwriting analysis, if possible, so you can verify that his assumptions correspond with the property's actual performance. If, when you review the trailing 12-month performance, the underwriting analysis matches the actual property's performance, the lender will be hard-pressed to modify the terms of the loan at a later stage.

The Pitfalls of Mortgage Lending

Applying for and processing a commercial loan is somewhat analogous to playing chess. Your success ratio will be enhanced to the extent you anticipate issues and address them prior to them becoming problematical. I refer to this process as a proactive approach to mortgage lending, or avoiding the pitfalls of mortgage lending.

Start from the Conclusion and Work Backward

If your desire is to obtain the largest loan possible you might look at the lending process as a chess game or a puzzle in which you know your goal and now work backward to accomplish it. A central factor in establishing the loan amount is the appraised value as well as the appraiser's underlying income and expense model, which must be constructed to reach the conclusion of fair market value. If you fail at the outset to understand where the appraiser will come in with value, you may be unpleasantly surprised with the end results.

Make an attempt to build a relationship with several competent and knowledgeable appraisers. Discuss the real estate project with these allies. Understand how they would come to a value conclusion. Would they count month-to-month tenancies? How would they value excess vacant land? If the rent roll reflects large variations in rent per square foot, how would they approach this factor? What do they perceive to be the vacancy factor in the subject area? What do they believe to be the current market rent per square foot? What is their experience as to what this type of building is selling for on a per-square-foot basis? What is their estimation of value? If you have established a working relationship with a few appraisers, you can get an approximation of how they would value the project. Value might vary widely among professionals, depending on how they look at the various pivotal factors, so it is important to understand the issues and the various "accepted" approaches.

If an appraiser comes in with a value you feel is unduly conservative, the worst thing you can do is argue that the value is too low without any supporting data. A more reasoned approach is to first review the appraiser's analysis. Where does his report differ from the other "accepted" approaches? Assemble documentation to support your approach and then, in a nonthreatening manner, present the argument for your position. Most appraisers will partake in a discussion concerning FMV if approached in this manner.

If dollars are a salient factor in structuring the loan, and if you have received a positive response from an appraiser, it becomes crucial to ask the potential lenders with whom you are discussing the loan whether or not they would allow XYZ appraisal firm to be selected to generate the appraisal. Under FIRREA (Federal Institutions Reform, Recovery, and Enforcement Act of 1989), the lender is required to select the appraiser who determines value.

Most major lenders have strict controls over the appraisal selection process. Is it a violation of FIRREA to ask if the lender will use XYZ appraisal firm? If you have originated several loans with the same lender, is it improper to ask the appraiser you have worked with on the last five loan transactions questions regarding his approach to determining value? Would it be improper to "prescreen" the value? The guidelines for proper conduct are very gray in these areas.

Prepayment Penalty

The *prepayment penalty clause* is a key element on which to focus. Many potential traps await the unwary with regard to this provision. The clause says, in essence, that if the loan is paid off early, the borrower is contractually required to pay the lender a certain amount of money in addition to the outstanding principal and interest.

Historically, the theory behind the charge is that when a lender originates a fixed-rate loan the lender concurrently locked in the cost of the monies to be lent by purchasing a "GIC," a guaranteed income contract. An insurance company commits to lend $10 million at 8.5 percent fixed for 10 years, interest-only years one and two, with repayment then based on a 30-year amortization. The lender prices its debt as a 2 percent spread over the 10-year T-bill rate. The life insurance company then goes to its capital source, a pension fund, and borrows money from the fund at 7 percent for 10 years, locking in a profit of 1.5 percent per year for a 10-year period. The life insurance company has matched its income and its expenses. The company is still taking risks: the risk that the borrower will not pay on time, that the borrower will default on the loan, and, ultimately, that they have not properly underwritten the transaction so that if the lender acquires the property through foreclosure or a deed in lieu of foreclosure that the value of the property will be less than the loan amount. These risks are conscious business decisions. They do not wish to also add on the risk of interest rate fluctuations.

Assume interest rates fell below 5 percent, so the life company's investment return on new originations was not 8.5 percent, but rather below the guaranteed return to the pension fund. If the borrower could pay off its loan with impunity, for any reason and without a penalty, the result could be disastrous to the lender. The insurance company gets its $10 million back; it no longer earns the

8.5 percent return, yet it still must pay the guaranteed income contract at 7 percent. Away goes the 1.5 percent profit per year. Enter a potential loss!

In order to counter this scenario, the life company builds into its loan documents a provision that says, in essence, that if you pay the loan off early, you have to pay the insurance company its 1.5 percent profit for the balance of the loan term. Arguably, the life insurance company would obtain the benefit of its bargain by taking the then–Treasury bill rate plus the agreed spread and comparing it to the contract rate. So, if the Treasury bill rate for the remaining term was 4.75 percent and the spread when the loan was originated was 2 percent, then the penalty would be 8.5 percent less 6.75 percent (T-bill rate plus spread), or 1.75 percent times the outstanding loan balance times the number of years to maturity. However, this is not how the calculation works. The lenders argue that at the time of repayment, the spread for this type of investment might not be 2 percent. The only guaranteed investment return is the Treasury bill rate itself. Hence, the prepayment penalty calculation is made by comparing the Treasury bill rate closest to the remaining term, 4.75 percent in our example, with the contract rate, 8.5 percent, a spread of 3.75 percent, times the outstanding loan balance times the number of years to maturity.

The loss of yield formula has evolved into a defeasance penalty. Today's lenders, in their loan documents, instead of merely requiring the debtor to pay the difference between the contract rate and the T-bill rate for the remaining term times the outstanding balance, require the obligor to go out into the marketplace and purchase securities that will give the lender a return equal to the T-bill yield (negotiation may allow other collateral). Then, in addition, the debtor pays a defeasance premium, which is essentially equal to the amount calculated under the loss of yield formula.

If you intend to pay off a loan and there is a defeasance penalty, it is crucial to negotiate as broad a definition for replacement securities as possible so as to, at a minimum, include agency paper, that is, Freddy Mac and Fanny Mae obligations. If there is a flight to safety, government paper may be priced well below agency securities so that when the time comes to purchase the securities, the defeasance premium would be much higher if you are required to purchase T-bills. What complicates this discussion is that usually there is only a short window to purchase the securities, for example, two to three days prior to loan closing, The point is that there may be a large gap in yield between Treasury bills, obligations of the United States Government and agency securities, versus obligations of a private entity that is considered a quasi-governmental entity, supported economically by the United States Government, but not an obligation of the Federal Government.

Technical Rule Number 1

Make sure in advance that acceptable securities for the defeasance are broadly defined to, at a minimum, include agency securities.

May You Prepay the Existing Debt?

If your objective is to refinance the property or to sell the property to a buyer who will obtain new financing, a threshold question should be: Can the existing loan be prepaid? Review your loan documents. Often, loans have an initial lock-out period during which time prepaying the debt is prohibited. If the borrower is unsophisticated and fails to review this issue, a problem might arise. I have witnessed seemingly sophisticated borrowers go into the application stage to refinance their loan and put up nonrefundable monies only to later discover that their existing loan cannot be prepaid for several years.

Technical Rule Number 2

Review the loan documents to verify that the debt may be prepaid.

What Dollar Amount Is the Prepayment Penalty?

If it is permissible and if you desire to replace the existing encumbrance, the issue of the cost of prepayment arises. You must calculate the prepayment penalty in advance so that you can make a judgment as to whether or not a refinance is economically practicable and feasible. Loan prepayment analysis programs can be found on the Internet. An Internet site that assists in calculating the prepayment penalty is Defease with Ease's program, found at defeasewithease.com. Of course, as the saying goes, "garbage in, garbage out." Take care to verify that you are imputing accurate loan assumptions, that is, interest rate, term, amortization, principal balance, and so forth.

You must scrutinize the loan documents since there may be unexpected provisions, such as a minimum 1 percent fee, that are not readily obvious based upon the current loan terms. You might contact the existing lender's loan service department in order to obtain a payoff figure. This request is commonly called a *demand statement*. It is important to properly determine the prepayment penalty, since the charge may vary from zero to a loss of yield formula to a defeasance penalty to a fixed percentage cost to a formula with a minimum 1 percent charge.

If the prepayment penalty is based upon a defeasance penalty, the defeasance premium will not be known until the securities are purchased. Possibly this risk can be hedged and/or possibly you, as borrower, might focus on shortening the time frame between committing to accept the loan terms and funding the new loan. If a sale is being undertaken, you might possibly pass on a portion of the risk associated with the unknown defeasance premium to your buyer.

Technical Rule Number 3

Take care to properly determine the amount of the prepayment penalty. If the amount is uncertain, take steps to ameliorate the risk of the amount becoming unacceptable.

May You Assume the Existing Debt?

An assumption of debt occurs when one party takes over the responsibilities under the loan documents from the existing obligor. The transfer of responsibility usually takes place in connection with a transfer of the property's ownership, in whole or in part. If you are contemplating a transfer, and this could include a transfer of an interest in the borrowing entity, the assumption clause should be scrutinized.

Transfers occur when either the ownership sells all or part of its interest or when the property is sold through a conveyance, that is, a grant deed. In both cases the issue arises as to whether the "due on sale" clause has been triggered or whether the new borrowing entity can, if desired, assume the existing loan. The due on sale clause indicates that if a certain percentage of the borrowing entity is changed or if the ownership sells the property, then the loan is due and payable. With regard to the assumption clause, the reference is to the new owner's ability to take over the existing loan, hopefully without modification. The assumption clause ties directly into the prepayment penalty provision, for if the loan documents block the borrower's ability to obtain a new loan, then a transfer can occur only if the loan is assumable by a new borrower. Typically, a 1 percent fee is charged for the privilege of transferring the loan to a new entity; however, often the charge can be negotiated for transfers within the past 12 months of the loan term. A charge of one half of 1 percent is usually acceptable to the lender if the assumption occurs in the first 12 months of the loan term.

Pitfalls revolving around transfers include carefully examining the existing loan to ensure that a transfer does not trigger the due on sale clause. Interfamily transfers for estate planning purposes are usually excluded from the effects of the due on sale clause, but the trust deed language should be examined. If a specific interfamily transfer is contemplated, language addressing that transfer should be inserted into the deed of trust rather than relying on general interfamily transfer verbiage. Often lenders insert a provision conditioning the ability of a prospective buyer to assume a loan, provided that the assignee has a "net worth equal to or greater than the borrower's net worth." A problem might occur if a borrower's net worth has increased significantly, and by allowing this type of language he may be inadvertently blocking a large portion of the transferee population from being able to assume the loan.

Technical Rule Number 4

Examine the assumption clause carefully. Make sure interfamily and estate planning transfers do not trigger the due on sale clause. Also avoid the net worth trap.

What, If Any, Notice Must Be Given to the Existing Lender?

If you are intending to repay an existing loan, you must examine the loan documents to determine what, if any, notice must be given to the existing lender. For example, assume it is October 1 and you are under contract to acquire a 120,000-square-foot shopping center for $10 million. The purchase contract requires you to close on October 25, and the new lender's loan commitment expires October 31. You have completed and approved all of your due diligence and, hence, your $100,000 good faith deposit is nonrefundable. Also, the lender has fully approved a new $7,500,000 first mortgage and you have reviewed and executed all of the loan documents. You ask escrow to obtain a payoff figure for the existing loan. The existing lender responds, supplying the balance due with the comment that, pursuant to the note, the earliest date it will accept a payoff is December 1, since a prior 60-day written notice is required before full repayment! Oops! Has your mortgage broker committed malpractice? What do you do? Learn how to beg? If you do not close in October, you will be in breach of your purchase contract and the new lender may be unwilling to fund or fund for additional consideration, especially if the interest rate has moved upward from when the rate was locked several months ago. One possible solution, if acceptable to the lender, would be to work with the title company wherein the lender funds, the title company holds in escrow sufficient monies to pay off the existing loan, and issues a clean title policy to the new lender. But why go through all of these machinations and risks when the simple solution is to review the existing debt loan documents and give the proper notice of intent to pay off the existing loan?

Technical Rule Number 5

Make sure you give the existing lender timely notice of your intent to pay off the mortgage.

What Are the Estoppel and SNDA Requirements?

When you obtain a new loan, it is standard practice for your lender to require that you produce *estoppels* and *subordination, nondisturbance, and attornment agreements* (SNDA) from the existing tenants. Essentially, an estoppel confirms the lease terms and verifies that the tenant has no claim against the landlord. An SNDA subordinates the lease in terms of lien priority to the new loan so that the lease is subject to the loan terms, yet with a nondisturbance provision that indicates that as long as the tenant honors its lease obligations in a timely manner, it will not be "disturbed" in its possession and use of the leasehold estate. The "attornment" feature obligates the tenant to recognize the new lender as the landlord in the event the lender obtains the landlord's position through foreclosure or through a deed in lieu of foreclosure.

When purchasing property with third-party debt, it is prudent to tie the lender's estoppel and SNDA requirements into the purchase contract. If the seller is not obligated to deliver on the key lender funding requirements, the seller could demand that the buyer close, yet the buyer would be unable to secure the necessary funding.

A problem may arise if the buyer does not know precisely what the lender is going to require in the estoppels or SNDA, or what percentage of the tenants must execute estoppels and SNDA. Of course, if you have identified who the lender will be, this issue can be discussed with the lender and you can obtain their requirements for the estoppel and SNDA. If you have not identified the lender, or it is too early to pin down their estoppel and SNDA requirements, recognize that some lenders require 100 percent of the tenants to comply, while other lenders will gear their requirements to a square footage test plus all of the major tenants, while still different lenders will allow the seller's certification to suffice for any gap. The drafting solution boils down to the buyer/seller negotiations. Often, the buyer will attempt to build into the purchase contract 100 percent compliance by the seller or will insert sufficient generic language that will satisfy all institutional lenders. For example, if acceptable to the seller, the contract language might say that the seller must provide such estoppels and SNDAs as are required in the institutional lender's loan application. Of course, the seller may respond, "Tell me who the lender is and their estoppel and SNDA requirements and I will tell you if they are acceptable—and let's build acceptable standards into the purchase contract." The usual solution is to draft the purchase and sale agreement (PSA) in generic terms, for example, "Seller to deliver acceptable estoppels and SNDAs equivalent to 90 percent of the project's square footage." The point is that this issue must be anticipated and addressed up front, ensuring that you cover the lender's requirements.

Technical Rule Number 6

Make sure you address the lender's estoppel and SNDA requirements.

Anticipate Problems: How Will the Lender's Underwriting Model Address These Issues?

When processing a loan, the trick is to anticipate problems. As mentioned in the beginning of this chapter, loan origination is like playing chess: You must look ahead and anticipate what issues or problems a lender may raise. Try to resolve these issues at the initial underwriting stage. It is at this point in time that you have the most bargaining power. The lender wants to originate the loan. In fact, several lenders may desire to make the loan. You must pose the difficult issues. See how the various lenders react. The objective is to reach a comfort level regarding how your selected lender will deal with the various problems. Your task is to find the lender with acceptable solutions.

Rule Number 12

Bring potential problems up at the outset of loan origination rather than allowing them to be raised when the lender discovers the issues.

The following are examples of some potential stumbling blocks that, if applicable, you might want to raise with your lender at the outset:

- **Month-to-Month Tenancies**

  If the project contains several month-to-month tenants, will the lender include their rent in its underwriting model? Does it help the borrower's case if the month-to-month tenants have been in place for a protracted period of time?

  It is crucial to view the lender's underwriter's loan model at the outset to verify that the underlying assumptions are accurate and that the underwriter has taken into account all of the key cash flow issues.
- **How Will the Lender Treat Under- or Over-Market Leases?**

  What if the rent per square foot for the suite rents varies greatly within the project, ranging, for example, from $1 per square foot to $2.75 per square foot? How will the lender underwrite the net income? It is not uncommon for a lender to attempt to determine "market rents" and "mark to market." The lender will adjust all rents above market to the marker rent per square foot number, yet will keep in place for underwriting purposes the contractual rents that are below market. This recalculated net operating income will be used to determine the loan amount. Determine at the outset what the lender's underwriting guidelines will be on this issue if the project tenants' rental charges vary greatly.

- **How Will the Lender Treat a Major Releasing Risk?**

  Assume we are seeking a loan to be secured for a shopping center that is 150,000 square feet with a grocery store containing 65,000 square feet. The grocery store's lease matures in six years. The lease contains an option to extend provision for an additional 10 years. The option must be exercised at least 6 months prior to the end of the lease term. The borrower is seeking a 10-year loan term. How will a lender address this releasing risk? Will the loan amount be drastically reduced? Will the lender insist that a reserve be created toward the end of the grocery store lease in order to prepare for the risk that the grocery store may not renew, or renew with landlord concessions, so that funds might possibly have to be spent on leasing commissions and tenant improvements? Will the lender, at some point in time, require a "cash flow sweep"? A *cash-flow sweep* or a *hard lock box* results in the lender receiving on a monthly basis the entire project rents. The lender then pays itself plus retains any agreed-upon reserves and only then remits any balance to the owner. Although the result is often ultimately the same when the borrower is obligated to pay principal, interest, and reserves, due to the lender's control of the project's cash flow, especially the delays occasioned in remitting funds to the borrower, this process can severely, negatively impact the project's viability. How will the lender factor in the leasing downtime and the anticipated loss of rent the downtime occasions? What will be the total amount of the reserve?

- **How Are Specific Environmental Issues to Be Dealt With?**

  If the subject property has an environmental issue, it is important to determine how the lender will deal with this problem. If the hazard emanates from the subject property, there is a greater liability exposure including damage claims from adjacent property owners. Will the lender accept an environmental indemnity insurance policy? Can an environmental indemnity insurance policy be obtained for this kind of potential problem and, if so, from what insurance company and at what price?

- **How Is the Lender Going to Deal with Repair Issues?**

  If the project has a physical problem such as a structural issue, noncompliance with ADA issues, or a termite infestation, how is the lender going to address the issue? Will the lender require immediate repairs and set aside 125 percent of the anticipated monies needed to accomplish the task, or allow the property owner a longer period of time to remedy the issues?

Rule Number 14

"Screen" or prequalify the lender by asking the difficult questions. Identify key underwriting problem areas and determine at the outset what the lender's underwriting guidelines will be on those issues, for example, under- or over-market lease rates, major releasing risks, specific environmental issues, and repair concerns.

Does It Make Sense to Prepay an Existing Loan?

In Chapter 1 we talked about creating a solution to breaking the cycle through buying value-added properties, leasing them up, refinancing, pulling your equity out of the property, and buying property number 2, and so forth. A problem can arise if the property you seek to purchase has a long-term loan encumbering the asset. After you create value, pulling your "trapped" equity out of the property might then result in paying a huge prepayment penalty.

It is never a good thing to incur a penalty to get out of a loan. Nonetheless, when weighing the alternatives, it might be a smart business move to pay a steep prepayment penalty to achieve the flexibility of restructuring the debt. If secondary financing is prohibited, what are the advantages of paying off a loan that might justify incurring a large prepayment penalty?

First and foremost, if you have worked the property and created a huge amount of equity, the money pulled out of the property might completely overshadow the lender's charge. For example, assume your dream came true and you purchased a 50 percent leased property for $4,000,000, putting $1,000,000 down at a then market cap rate of 12 percent. The first trust deed of $3,000,000 is at 8.5 percent, interest-only, with six years to go. Assume further that you created value by leasing-up the property and also built-to-suit an additional 7,000-square-feet building on the project site. During your lease-up period you also doubled the parking income, in part due to the lease-up and also in part due to the fact that overall market parking charges increased. Interest rates, as well as the cap rate, have fallen to the 5 to 6 percent range. The property is now worth $12,000,000 and a $9,000,000 loan has been quoted at 5.5 percent for a 10-year term with an interest-only feature for the first three years. By arranging a new first mortgage you can pull $6,000,000 out of the property, less loan costs and the prepayment penalty.

Is it economically sensible to replace the loan and incur the prepayment penalty? What is the amount of the prepayment penalty? In general, both under a loss of yield formula or defeasance language the prepayment penalty is calculated by comparing the Treasury bill rate to the existing contract rate times the then-existing loan balance times the number of years to maturity. In this case, let's assume the Treasury rate is 4.5 percent; therefore the prepayment penalty would be the contract rate of 8.5 percent less the Treasury bill rate of 4.5 percent times the outstanding loan amount of $3,000,000 times the six remaining years to maturity. The computation would therefore be:

$$4\% \times \$3{,}000{,}000 \times 6 = \$720{,}000$$

In addition, there are significant other costs associated with the loan pay-off, including legal fees to the borrower's counsel, legal fees to the loan servicer's attorney, the loan servicer's accountant's fee, a custodial fee, defeasance consultant fees, and the like. Let us assume that these additional charges amount to $80,000. The costs of obtaining the new loan must also be factored in. Assuming new loan costs of approximately $120,000, which represents a 1 percent loan fee plus miscellaneous closing costs, the net loan proceeds going to the borrower would be $5,080,000.

The prepayment charge is $720,000, but is it the "real" cost of the early payoff? Not really, because for the next six years the borrower's mortgage will be at the 5.5 percent rate, not at the old note interest of 8.5 percent. In other words, the borrower will annually save the cost of the three points, since the old loan has been replaced with a lower coupon mortgage. The "real" cost is the difference between the Treasury bill rate and the interest rate on the new loan times the outstanding loan balance times the years to maturity. In the preceding example the "real" cost would be:

$$1\% \times \$3{,}000{,}000 \times 6 = \$180{,}000$$

Again, while it is not a good thing, per se, to incur an additional cost, consider that the end result of the refinance is pulling $5,080,000 out of the property. What is more, the prepayment fee and other transactional costs are fully deductible in the year incurred. The borrower receives over $800,000 in immediate write-offs!

In addition, the net loan proceed can now be reinvested into other real estate transactions. The goal is to achieve a rate of return on the new investment that exceeds the 5.5 percent cost of the borrowed funds.

In our example, the existing loan has six years to maturity. By originating a new 10-year loan today at a very favorable interest rate, you also achieve an additional four years of interest rate protection.

Often, when you originate a loan, the lender creates reserve buckets for tenant improvements and leasing commissions. Reserves put away on a monthly basis may accumulate to a significant amount. When you fund a new loan, the built-up reserve balances are disbursed back to the borrower. It is the borrower's money. The reserve monies going back to the borrower increases the net loan proceeds.

Sometimes, after you have secured financing, project conditions change or your goals and objectives for the property may be revised. Features that were included or not included at the time the original loan was originated may be altered in connection with the refinance. For example, if you elect to sell apartment units as condominiums, a partial release clause may be built into the new financing. If you have excess land and are considering building an additional structure, the excess land might be excluded from the security in connection with placing a new loan against the property. In a sense, you get another bite at the apple in relation to structuring the financing.

Timing is always a factor when rates vary and the remaining life of a loan plays a role in the calculation. In the recent past we have witnessed a flat yield curve moving to an inverted yield curve. In a "normal" yield curve, the short-term interest rates are lower than the long-term interest rates. In a normal yield curve, the further you go out in time the less uncertain you are and, therefore, the interest rates should be higher. When the yield curve is flat, the short-term interest rates and the long-term interest rates are, within a small tolerance, the same. A reverse yield curve results when the short-term interest rates actually exceed the long-term rates. Ideally, when paying off a loan with a loss of yield or defeasance language in the prepayment penalty, the pay-off should occur when the yield curve is flat or reverse. If you have one year to go on the existing loan, if the yield curve is reverse, to calculate the prepayment penalty you would use the higher rate to figure out the penalty, which would therefore minimize the penalty, while you secure lower long-term interest rates.

To balance out this discussion, I must point out that there could be negative consequences resulting from the refinance, including tax consequences if the mortgage exceeds the properties basis, as is more fully discussed in the next chapter. Also, although it is good to receive cash, there may be a reinvestment yield issue. The borrower must look at reinvestment opportunities to evaluate if receiving a large sum of money is beneficial in the anticipated time frame.

Lines of Credit

Lines of credit are sought for various reasons, such as consolidating debt, paying for an expensive purchase—for example, a car or a boat—or making an investment. The most common method for securing a line of credit is to place a second mortgage against your primary residence. The line allows access to the equity in your home. The borrower, without needing to explain the usage, may draw on the line, repay all or part of the monies owed, and then draw on the line again and again. Potentially, a line of credit is a great way to pull equity out of your single-family home and get the funds working for you by investing in income-producing property.

Although it is somewhat atypical, lenders might insert a provision in second-mortgage loan documents that allows them to reappraise your property and lower the amount of your credit line. When might this occur? Obviously, the lender's call comes in a downward spiraling economy when home prices are tanking and credit is tight. Unfortunately, it also comes at the very time you desire the extra cushion of the line to invest in commercial real property opportunities. This scenario is bad, but what might be worse is when the lender says, "Your line amount is $200,000 with an outstanding balance of $120,000. Your new line limit is $100,000. Please pay down the line by $20,000!"

If the line of credit loan documents contain a reappraisal right, ask that it be eliminated, negotiate limits to the lender's right to restructure the line or, if the lender is not amiable to modifications, find a new lender.

Technical Rule Number 7

Scrutinize the line of credit loan documents to ensure that the loan amount may not be reduced based upon a reappraisal.

Negotiable Points of a Loan

With regard to what can and cannot be negotiated, it is important to note the distinction between deal points and loan documentation. The deal points, the spread (and hence, the interest rate), the loan amount, amortization, and the assumption provisions are all negotiable. The items I previously identified as key factors to consider in a real estate loan are all subject to negotiation. When you are discussing the loan transaction with a financial institution, you are working with one or two individuals, and these individuals are subject to the art of persuasion. In contrast, today when you are discussing the documentation of large commercial loans, although some wording may be modified, lenders tend to be hesitant to alter the basic gist of the overall language. The usual rationalization they offer is that the loans are targeted for securitization and sale. The end buyers demand uniformity, so loans that contain specialized language are not saleable. It may be permissible to change the interest from 6.25 to 6.15 percent—an easy deal point change—but radically redrafting the defeasance language probably would not be permitted.

I suggest that you can save money by selecting a lender you can work with and attempting to originate multiple transactions with this same lender. In connection with this philosophy, it would be prudent to work through a set of loan documents with borrower's counsel and counsel for the lender and then, for subsequent loans, use the same set of loan documents with changes that are particular for the subject transaction, that is, property location, loan amount, interest rate, and so on. This process will significantly reduce the cost of legal fees—a good thing since when applying for a major commercial loan, not only do you have to pay for your attorneys charges, but also for the lender's legal expenses!

The negotiation process starts at the loan application stage. If you are then locking the interest rate, how long a period is the rate lock good for: 45 days, 60 days, 90 days? What opinion letters does the borrower have to deliver? If, for example, you need not deliver an agency downgrading opinion or a REMIC (real estate mortgage investment conduits) compliance opinion, you can avoid significant legal fees. What percentage SNDAs and estoppels does the lender require? The application usually calls for delivery of 100 percent, yet usually the lender will accept SNDAs and estoppels from the major tenants plus some level of borrower certification as to the balance of the tenants.

In attempting to identify which provisions may be modified to obtain a better borrower-oriented loan product, I would first focus on those items that vary from loan to loan or that are unique for the loan in question. For example, the monthly reserve buckets for capital expenditures (Cap X), leasing commissions, and tenant improvements are dependent upon the condition of the subject property and, hence, vary from transaction to transaction and should be watched carefully. The lender should be willing to cap these reserves at some level. Lenders' documents exercise some degree of control over subsequent leasing of the security. This provision can be tailored to the nature of the tenancies. The lender does not want to micromanage the property, and so will usually agree upon a threshold lease size before its consent is required. As an example, all leases in excess of 5,000 square feet might require the lender's prior written consent. Alternatively, the provision might set forth acceptable lease parameters, and if those or better terms are met, then the lender's consent would not be required. In any event, there should be a time frame within which the lender's consent must be given or else the lease proposal would be deemed approved. This response time, or deemed approved language, is crucial, since once the loan has been securitized, the servicing agent may not be responsive. It would be quite aggravating to lose a lease transaction due to the servicing agent's nonresponsiveness.

After the variable factors are exhausted, the general standard loan terms should be examined.

Tackling the tough issues at the outset will pave the way for an expedited agreement that satisfies the needs of both borrower and lender.

Wealth Opportunities in Commercial Real Estate: Management, Financing, and Marketing of Investment Properties
By Gary Grabel

CHAPTER 6

Real Estate Taxation

A basic understanding of how taxation works and, more specifically, how real estate taxation works is essential to achieving the long-term goal of wealth creation through real estate. The taxman is your silent partner. It is great to make a profit in real estate, but the old adage remains true: "Nothing is certain but death and taxes." If you desire to maximize your profits as well as achieve your long-term goals, it is crucial to understand how best to work within the tax code.

Income Taxation

While you own and operate real property, taxes must be paid on the income that you earn in doing so. Let us take another look at our hypothetical model, the Diamond Medical Center. Again, let us assume Diamond Jack purchased the medical office building for $10,200,000 with $2,550,000 down (25 percent) and a $7,650,000 first trust deed (75 percent) at 7.5 percent interest-only for the first three years, then a 30-year amortization. The first year's operating results were as follows:

Gross Income		**$1,440,000**
Expense Reimbursement		
Recapture over Base Year	18,000	
Utility Recapture	76,800	
Triple Net Charges	121,836	

Total Expense Reimbursement		216,636
Total Gross Income		$1,656,636
Vacancy and Collection Loss		(82,832)
Adjusted Gross Income		$1,573,804
Operating Expenses		
Elevator Contract	(11,197)	
HVAC Maintenance Contract and Repair	(5,413)	
Insurance	(5,000)	
Janitorial Contracts	(52,600)	
Landscaping	(6,410)	
Property Taxes	(97,067)	
Property Management Fee	(49,699)	
Repairs and Maintenance	(13,470)	
Security and Fire	(27,931)	
Taxes and Licenses	(420)	
Trash Disposal	(6,336)	
Utilities	(180,956)	
Total Operating Expenses		(456,499)
Net Operating Income		1,117,305
First Trust Deed of $7,650,000 @ 7.5% 30-year Amortization		(637,892)
Cap X Reserves		(18,000)
Tenant Improvements and Leasing Commissions		(60,000)
Net Cash Flow		**$401,413**

Is the income tax a percentage of the Net Operating Income, of the Cash Flow Before Debt Service but after Reserves, or of the Net Cash Flow figure? The answer is that it is not a percentage of any of these figures. The income tax is a tax imposed on the net profits or losses from the annual operations of the property. Adjustments must be made to the above categories to derive Net Taxable Income.

Net Operating Income does not equal Net Taxable Income because NOI must still be reduced by depreciation and interest expense as well as by a percentage of capital expenditures, tenant improvements, and leasing commissions. Depreciation is a noncash deduction; it is not an operating expense. However, for tax purposes, depreciation is a reduction to gross income.

Cash Flow Before Debt Service but after Reserves does not equal Net Taxable Income for several reasons. First, interest expense is an ordinary and usual business expense, which, for tax purposes, reduces income to derive Net Taxable Income. Also, it is not permissible, for tax purposes, to use an estimated Cap X reserve; rather, the actual expenditure must be spread over the estimated useful life of the improvement. Similarly, tenant improvement and leasing costs must be spread out over a reasonable period (usually 100 percent of those costs cannot be counted as expenses in the year incurred). It is unclear in the above income and expense analysis whether or not these expenses are being properly allocated.

Net Cash Flow does not equal Net Taxable Income because, as stated above, you cannot reduce income by all of the Cap X and tenant improvement and leasing costs in the year incurred, but instead must spread these costs over a Tax Code–permitted time period. Furthermore, only the interest portion of the mortgage expense is a tax deduction. To the extent principal is repaid, it represents a reduction in debt rather than an operating expense.

For income tax purposes, the cash flow model might look as follows:

Gross Income			**$1,390,000**
Expense Reimbursement			
Recapture over Base Year		15,000	
Utility Recapture		95,000	
Triple Net Charges		145,500	
Total Expense Reimbursement			255,500
Total Gross Income			$1,645,500
Operating Expenses			
Depreciation (includes depreciation of capital) Improvements		(196,154)	
Elevator Contracts		(11,197)	
HVAC Maintenance Contract Insurance		(5,413)	
Property and Casualty	1,000		
Boiler	378		
Umbrella	492		
Earthquake	3,130		
		(5,000)	

Interest Expense	(375,000)	
Janitorial Contracts	(52,600)	
Landscaping	(6,410)	
Leasing Commissions	(20,000)	
Property Taxes	(104,267)	
Property Management Fee	(36,000)	
Repairs and Maintenance	(13,470)	
Security and Fire	(27,931)	
Taxes and Licenses	(420)	
Tenant Improvements	(40,000)	
Trash Disposal	(6,336)	
Utilities	(180,956)	
Total Operating Expenses		**1,081,154**
Net Taxable Income		**$564,346**

Assuming a cash-basis taxpayer, taxes are paid on what the taxpayer actually receives. Taxes are not based on a hypothetical figure. Please note that in the above example the gross income figure represents what the taxpayer actually collected, not estimated or scheduled rent. The same holds true for expense reimbursements. Expense reimbursements are monies actually collected by the landlord, not an estimated figure.

The first income and expense analysis presented in this chapter contained an estimated vacancy and collection loss factor of minus $82,832. Again, for tax purposes, the gross income equals the monies actually received. It implicitly takes into account monies not collected due to vacant space or tenant delinquencies. The actual income received must be reported, not reduced by an imaginary allowance.

In the first set of income and expense figures in this chapter, the gross income line is greater than the gross income numbers, using the amount actually collected, because vacant space is factored in as scheduled income. The hypothetical figures, however, indicate that actual reimbursement collections were greater than the estimated reimbursement amounts. Ultimately, the total income is greater for the actual figures since the assumed vacancy and collection loss amount of $82,832 significantly reduces the estimated figure.

In general, expenses are also based on actual numbers; however, there are exceptions to this rule. Depreciation is an exception. It is based upon assumptions. It is a fiction, a noncash expense. In order to calculate the annual depreciation expense, you start with the value of the project improvements. Land does not depreciate. The concept underlying depreciation is that of expensing the cost of an item over its useful life, matching cost with revenue. A value is determined for the project that usually equals the purchase price. An allocation is then made between land and building. The Internal Revenue Code (IRC) dictates the appropriate useful life that may be used for commercial structures, which is 39 years. If Jack's purchase price was $10,200,000, a dollar amount must be attributed to the value of the structures, which is depreciable, versus the land, which is not depreciable. Typically, a ratio is assumed between the building value and the land value. A 75/25 ratio is commonly utilized. Using this ratio for the building/land allocation results in the sticks and stones being worth $7,650,000. If a 39-year useful life assumption is employed, the annual depreciation deduction is $196,154 ($7,650,000/39).

The method of depreciation used in our example is called straight-line depreciation. It means that the amount depreciated each year is an even amount. You take the allocated value and divide by the estimated useful life. The resulting figure spreads the value of the building evenly over its estimated useful life. Other methods of depreciation, such as accelerated depreciation, place an emphasis on the initial years of the asset's life so that the deduction is heavier in the beginning years and lower in the later years. This is obviously beneficial, given that a dollar saved today is worth more than a dollar saved tomorrow. The IRC does not permit accelerated depreciation methods for real estate assets. However, some real estate professionals use a technique called *component depreciation* to increase the current deduction.

Component depreciation allows you to separate out the various types of property in a real estate project, such as air conditioning units, and characterize them as personal property with a shorter useful life. There are two major problems associated with component depreciation. First, the accounting cost associated with segregating the assets can be extensive. Second, it becomes difficult to trade the property since the "like kind" criterion, as will be discussed later in this chapter, is impaired.

There are certain expenses that may not be fully expensed in the year incurred, but rather must be spread over their anticipated useful lives. These expenses include capital expenditures that enhance the overall project, tenant improvements associated with improving a specific suite, leasing commissions, and costs associated with a loan origination such as points.

The main issue with expenses that must be depreciated or amortized is: Over what length of time must the costs be spread? You depreciate tangible assets such as buildings and you amortize intangibles such as good will. However, for purposes of this discussion, the terms "depreciation" and "amortization" shall be used interchangeably. It would seem logical that if the cost is associated with a specific event, then the amortization should have a logical connection to that event. For example, if you build-out tenant improvements for a suite or incur leasing commissions while placing a tenant into specific premises, then it would seem to follow that you should write-off these expenses over the lease term.

Notwithstanding this logical analysis, that is not how the rules work. The general rule of thumb is that the cost must be spread over 39 years, unless there is an exception. Therefore, one 39th of the tenant improvements and leasing commissions would be expensed each year. However, if the lease terminates and a lease is entered into with a new tenant and the premises are remodeled for this new tenant, then any unamortized expense could be written off that year. In contrast, if the new tenant takes the space in its "as-is, where-is" condition, then the write-off continues based on the 39-year schedule since, from an accounting viewpoint, no change has occurred.

Due to the fact that the general rule does not correlate with practical realities, some owners use component depreciation to enhance their write-off, especially if the project contains a significant amount of personal property. Under this method of depreciation, as mentioned above, the property is broken out and identified as real property and personal property, and shorter useful lives are attributed to specific items of movables. Component depreciation works well with properties that have a large amount of fixtures, furnishings, and equipment (FF&E), such as hotels. The main problem with component depreciation, as mentioned previously, is that since you cannot trade personal property, a 1031 exchange can be compromised. A 1031 exchange refers to the IRC

Section 1031 under which, if the requirements are met, it is permissible to defer a gain, in whole or in part, associated with the sale of real property.

Section 1031 exchanges are more fully explained later in this chapter. One way to get around the major component depreciation problem is to place the ownership of the property structure in one entity, which is depreciated on a 39-year basis, and to place the ownership of the personal property into another entity that can then depreciate the FF&E on a much-enhanced schedule.

The amount of taxes paid depends on a taxpayer's tax bracket as well as how ownership is held. If ownership is held as an individual or a partnership or in a limited liability company the owner's share of the net income is passed through directly to the individual taxpayer. In contrast, if title is held in a corporation (excluding a sub-S corporation, which is treated as a partnership for tax purposes) then the tax is paid at the corporate level and any individual involved with the company pays income taxes to the extent distributions are made to them, whether the distributions are in the form of salary or dividends.

Real Property Taxation

The federal government at the present time does not impose a tax based upon the ownership of real property. However, almost all state governments have a tax that is a percentage of the real estate's value. In California, the tax is assessed by the tax assessor in the county in which the real property resides. The tax rate is approximately 1.125 percent of the fair market value of the real estate. In California, once the property is assessed under Proposition 13, it may only increase in value for tax valuation purposes by 3 percent per year, and therefore the tax liability may increase by no more than 3 percent per year, unless there is a triggering event such as an improvement to the property or a sale or transfer. Since the real estate tax is a percentage of the assessed value, and given that the assessed value is kept artificially low, the result is that the real property tax is kept artificially low, unless there is an improvement, a sale, or a transfer.

In California, real property taxes are paid semiannually. The first installment for the applicable calendar year is due November 1 of that year and considered delinquent December 10 of that year.

The second installment is due February 1 of the next year and considered delinquent April 10 of the next year.

In California, the real property tax expense often comes up as an issue in connection with a sale. When the property is analyzed for an acquisition, if the seller has owned the property for an extended period of time, the property tax will probably be artificially low as compared to the tax that will be imposed after the sale. When determining the price the buyer is willing to pay, if the seller has not already adjusted the real property tax based on the sale price, the buyer will increase the real property tax operating expense, thereby reducing NOI and value. The seller may counter, if such is the case, that most if not all of the increase will be passed on to the tenants through CAM expenses, so the FMV should not be adjusted.

Taxation in the Event of a Refinance

As a general rule, a refinance is a nontaxable event. However, there are exceptions.

One exception that arises frequently is when a mortgage is originated in excess of the property's basis. In our hypothetical scenario, Diamond Jack acquired the medical office building in 2005 for $12,500,000 and sold the property to Steven Stable in 2007 for $14,500,000. Let us assume that instead of selling the center, Jack obtains a new loan of $10,875,000. He refinances the center. Let us also assume that at the time of the refinance, the property's basis is $9,807,692, that is, the $10,200,000 purchase price less two years of depreciation. The result is a mortgage in excess of basis of $1,067,308 ($10,875,000 less $9,807,692). Even if the new mortgage exceeds the property's basis there is no tax incidence if there is no distribution, but if proceeds are distributed, a taxable event occurs.

If the property ownership is held in the name of an entity—for example, a limited liability company (LLC)—one potential way to defer the $1,067,308 tax hit is to characterize the distribution as a loan from the LLC rather than distributed net loan proceeds. Of course, the members must repay the loan. and to the extent the LLC increases distributions during the year, since it has extra cash from the members' loan payments, the extra payments are taxable. The advantage of characterizing the distribution this way is that the tax obligation is spread out over the life of the loan, rather than having 100 percent of the liability concentrated in the year of the refinance.

In the event you seek to defer the tax liability revolving around mortgage proceeds in excess of basis, it is crucial that you act in a manner consistent with the debt created. Otherwise you run the risk that the IRS will treat the loan as a distribution. In order to support your claim that a legitimate debt was entered into, a Board of Directors meeting should be held, and its approved minutes should reflect the loan to the members. Also, of course, a note should be drawn and signed and the provisions therein complied with, that is, the member(s)/borrower(s) must pay the designed interest when due.

Taxation in the Event of a Sale

The basic rule is that when real property is sold, the profit or loss must be reported in the year of sale and the applicable tax paid, unless an exemption applies or the profit or loss is excluded from reporting. When the owner cashes out, when he sells his property, a gain or loss occurs.

Gain or loss on the sale of real estate is measured by taking the sale price less the property's basis.

Profit or Loss = Sales Price Less Basis

The concept of *Sales Price* should be clarified. The Sales Price should be refined to derive the Adjusted Sales Price or Net Sales Price. In other words, the Sales Price should be reduced by the cost of selling the property. These costs include real estate commissions, legal expenses, title charges, and the like.

Additionally, *Basis* must be defined. Basis equals the original purchase price plus any acquisition costs less depreciation taken plus any capital improvements.

Following our hypothetical scenario, two years after his acquisition, Diamond Jack sold the center to Steven Stable for $14,500,000. When Diamond Jack acquired the MOB, his closing costs were $100,000. Closing costs are added to the property's basis. Let us assume that during the two-year holding period, Jack spent $200,000 improving the property and based on the 75/25 building-to-land allocation took $196,154 in depreciation each year.

The following chart illustrates how the taxable gain or loss would be calculated:

1. Selling Price		$14,500,000
2. Subtract Selling Costs (3%):	435,000	
3. Adjusted Selling Price		$14,065,000
4. Original Cost Basis Including Acquisition Costs	$10,300,000	
5. Add Improvements	200,000	
6. Subtract Depreciation Authorized or Taken	392,308	
7. Adjusted Cost Basis:		10,107,692
8. Taxable Gain or Loss		$3,957,308
9. Tax Basis:		.15%
10. Income Tax Liability		$593,596
11. Recapture of Section 1250 Depreciation (Line 6 times 25%):		$ 98,077
Total Federal Tax (Line 10 plus Line 11):		$691,673

Installment Sale

When a seller receives only part of the sales price during the year of sale, the seller may elect to report the gain on an installment sale basis. The potential for an installment sale occurs when the seller carries paper, that is, as part of the purchase price the seller agrees to hold a mortgage.

If the seller does not receive all of the sale proceeds in the year of sale, then the gain may be spread, on a pro rata basis, over the term of the installment sale.

Let us assume that when Jack sells to Stable, the financing market is so tight that he is able to secure only a first trust deed of 65 percent LTV, or $$9,425,000. Stable puts down 25 percent, or $3,625,000, but based on the size of the first mortgage, there is still a gap of $1,450,000. In order to close this gap, Diamond Jack agrees to take back the remaining balance in the form of a note payable $290,000 per year for the next five years. The amount that must be reported annually is determined by a ratio between the gross profit and the contract price. This ratio is called the “Taxable Gain Ratio.”

The gross profit was calculated above as $3,957,308. The *contract price* equals the selling price less the balance of any mortgage payable by the buyer to a third party. The contract price equals $5,075,000, as shown below.

Contract Price = Selling Price Less Any Third Party Mortgage Taken Out or Assumed
Contract Price = $14,500,000 – $9,425,000
Contract Price = $5,075,000
Taxable Gain Ratio = Gross Profit/Contract Price
Taxable Gain Ratio = $3,957,308/$5,075,000
Taxable Gain Ratio = 78%

The result is that 78 percent of the sales proceeds equals the taxable gain. Hence, every time the seller receives the annual payment of $290,000, 78 percent of that payment, or $226,200, is taxable; the balance, $63,800, is a return of the original investment.

Realized versus Recognized Gain or Loss

A distinction is made between a *realized gain or loss* and a *recognized gain or loss*. When a potential taxable event occurs—such as the sale of a property—a realized gain or loss occurs. If the gain or loss is also recognized, tax consequences apply in the year of the event. If the gain or loss is deferred, then the tax consequences are carried forward and recognized in a future year, or years. (An example of a realized gain or loss that is not fully recognized in the year of sale would be an installment sale and a 1031 exchange where all or part of the gain or loss is deferred.) In essence, a realized transaction means that the gain or loss has occurred, while a recognized transaction means that the taxpayer's tax return is then affected by the event.

Short-Term versus Long-Term Capital Gain

The tax code makes a distinction between a short-term capital gain and a long-term capital gain. A short-term capital gain is treated as ordinary income and taxed in accordance with the taxpayer's tax bracket, while a long-term capital gain is taxed currently at a 15 percent rate. Which tax rate is less expensive depends on your tax bracket, but in general the long-term capital gain rate is usually less costly.

What differentiates a short-term capital gain from a long-term capital gain? The distinction is based upon the assets holding period. If you own the real estate for less than one year prior to sale, the gain is characterized as short term. In contrast, if the real estate is owned for more than one year, the sale is treated as a long-term capital event. This is why, when asked how long you intend to hold the asset, the response is often “one year and one day.”

Recognition of Expenses at Sale

In the Income Taxation section of this chapter, I discussed the concept of amortizing certain expenses over their estimated useful lives. In the year of a sale, since you no longer own the property, all of the unamortized costs may be expensed. It could happen that even though you have a huge profit on the sale of a property, you owe no taxes as a result of the sale, since you traded the asset under Section 1031 as discussed further on. In addition, you might even have a huge tax loss to offset other income. Even though the project operations were positive, given that all of the unamortized costs may be expensed in the year of sale, the property could actually generate an operating loss—and it might be a very large loss if, in the past, the seller made extensive tenant improvements and/or paid a large defeasance penalty.

Money in the Bank

At the end of the year, if you have a significant amount of money in the ownership entity’s bank account, do those funds result in a tax? In general, the answer is no. The test for the income tax liability is income less expenses, and with a capital gain tax, there must be a sale event. Money in the bank, in and of itself, does not result in a taxable event.

Section 1031 Exchange

As discussed earlier, if you sell real property, the gain on sale is taxable; it is similar to selling any other type of property, such as stocks, bonds, or widgets. Notwithstanding this statement, if you fall within an exemption, the gain on sale may be deferred. Compliance with

Section 1031 of the IRC allows a taxpayer to shift profit or loss to a future date.

The IRC provides that if you go from one commercial real estate investment to another commercial real estate investment, there is no taxable event at that time since, in essence, you have not cashed out but have merely traded one real property asset for another real property asset. This is referred to as a Section 1031 exchange. Section 1031 refers to the section of the IRC that outlines the steps that must be taken to qualify for the tax deferment.

When an exchange is a fully qualified Section 1031 reinvestment, all of the profit in the property sold or exchanged is tax deferred. The profit on the sale of the property is transferred, untaxed, to the replacement property. The result is that the cost basis in the property exchanged is carried forward to the replacement property acquired in the exchange.

Rule Number 15

It is always better to defer taxes rather than to pay them now, provided the exchange transaction makes economic sense.

An exchange can occur simultaneously wherein one property is traded for another property, but usually there is a delay between the settlement date of the property being relinquished and the settlement date of the replacement property.

The steps in complying with Section 1031 are very technical and care must be taken to ensure that each and every element is met. Usually in legal matters substance trumps form. However, when discussing a 1031 exchange, often form takes precedence over substance. For this reason it is important to be very clear about 1031 terms and requirements.

Definitions in a 1031 Exchange

The property that the taxpayer is selling is usually referred to as the *relinquished property* or the *down-leg*. The property that is being acquired is called the *replacement property* or the *up-leg*.

The party that is seeking to defer his taxes upon the sale of his property is usually referred to as the *taxpayer*, the *investor*, the *owner*, or the *seller*, in the appropriate context.

The *accommodator*, also referred to as the *1031 trustee* or *qualified intermediary*, is the individual or entity that holds the proceeds from the sale of the relinquished property, while the taxpayer is attempting to acquire the replacement property.

Boot is taxable cash, property, or mortgage relief received by the taxpayer.

Requirements for a Qualified 1031 Exchange

The following six items must be met in order to qualify for a 1031 exchange:

1. The relinquished property must have been held by the taxpayer for investment, business, and/or production of income. It is irrelevant how the buyer plans to use the relinquished property.
2. The taxpayer must hold the replacement property for investment, business, and/or production of income. It is irrelevant how the seller of the replacement property is using the property. Both the property sold and the real estate purchased must be "like-kind" property with regard to the taxpayer seeking the 1031 tax deferment. Rental real property qualifies as like-kind property, as does land held for investment. So does a leasehold interest if the remaining term of the lease exceeds 30 years. An individual's principal residence does not qualify as like-kind property. Also, "dealer property" and fractional co-ownership interests do not qualify as like-kind property. *Dealer property* is real estate held for resale such as subdivided lots or fix and flip property. A *fractional co-ownership interest* is, for example, a percentage ownership in a limited partnership (LP) or in a limited liability company (LLC). The individual who holds a 10 percent interest in an LLC cannot trade his 10 percent interest for rental real estate; rather, the entire LLC must trade its ownership to qualify as a like-kind transaction. You must trade investment real estate for investment real estate, but it is okay to trade an apartment building for an office building or a shopping center. The type of investment real estate does not matter. If you own a mobile home park, for example, you are not required to buy another mobile home park to qualify for a 1031 exchange. You may

trade the mobile home park for another type of investment real estate, such as an industrial property or an apartment complex. Please note that size and value are irrelevant when discussing the "like-kind" requirement.

3. The taxpayer must not have actual or constructive receipt of the net sale proceeds. In order for the taxpayer to avoid actual or constructive receipt of the net sale proceeds, the funds are transferred directly from the sale escrow to an accommodator. If the taxpayer receives the net sale proceeds and then transfers them to the 1031 trustee, the exchange will be disqualified. This *constructive receipt rule* applies to interest earned on the 1031 monies. The funds deposited with the accommodator from the sale of the down-leg may earn interest, which inures to the benefit of the taxpayer; however, the taxpayer's right to receive and his actual receipt of interest must occur only on or after acquisition of all of the replacement properties. If the taxpayer receives interest on the 1031 property, the result is not just the interest received being characterized as boot, but rather that the entire transaction loses the 1031 exemption. An exception to this rule occurs when the interest earned is disbursed by the accommodator as part of the proceeds used to purchase the up-leg. In such a case, the interest is boot, but the exchange is not disqualified since there is no constructive receipt of the interest earnings.
4. The replacement property must be identified within 45 days from close of escrow of the relinquished property. If you identify three or fewer replacement properties then there is no restriction as to their value. However, if you identify more than three properties, then you are subject to the *200 percent rule*. The 200 percent rule states that if you designate more than three properties, then your exchange will be disqualified if the value of the properties identified exceeds 200 percent of the sale price of the relinquished property, even if you do not actually purchase all of the identified properties.
5. The replacement property must be purchased within 180 days from close of escrow of the relinquished property or the tax due date, including extensions, if earlier. Both the 45-day identification period and the 180-day reinvestment time

frame count calendar days, which include Saturdays, Sundays, and legal holidays.
6. All properties must be in the United States.

Total or Partial Exchange?

If the six requirements outlined above are met, the transaction qualifies for a tax-deferred exchange. However, the following three additional items must be satisfied if the transaction is to be totally tax-deferred:

1. All of the cash coming out of the property must be reinvested into the replacement property or properties. The cash from the escrow account must be applied toward the acquisition cost of the up-leg. In other words, if you take any money out, it is considered cash boot and is taxable.
2. The replacement property or properties must have debt equal to or greater than the debt paid off or assumed on the relinquished property. New money may be added to the purchase price to acquire the up-leg to offset the mortgage relief, however, new debt cannot offset any cash boot.
3. The taxpayer may not receive any non-like-kind property. The value of any non-like-kind property received by the taxpayer, including the value of any notes held by the taxpayer, is taxable.

Most publications discussing the requirements to fully defer the tax in a 1031 exchange suggest a fourth requirement: that the acquisition cost of the replacement property or properties must be equal to or greater than the adjusted sales price (contract price less selling cost) of the relinquished property. In other words, you must trade up in value. This statement is an accurate statement, but by definition if you meet the first and second tests, you meet the trade-up-in-value test. Value is made up of equity and debt. The first test satisfies the equity component. The cash coming out of the property, by definition, is the taxpayer's equity. Equity equals sales price less existing debt, which is the cash being generated from the sale. Additionally, test number two requires that you trade up in debt. Putting tests one and two together ensures that you must trade up in value.

The following chart graphically illustrates how to determine if a trade is partially or fully tax deferred:

Example 1	Relinquished Property	Replacement Property	Difference
Sales Price	$8,000,000	$10,000,000	+$2,000,000
Debt	$6,000,000	$7,000,000	+$1,000,000
Equity	$2,000,000	$3,000,000	+$1,000,000
Cost Basis	$3,000,000	$3,000,000	

The profit from this sale is $5,000,000 (sales price of $8,000,000 less cost basis of $3,000,000). One hundred percent of the profit from the sale will be deferred. The debt has increased, either through an assumption of a mortgage or a new loan origination, and also all of the net proceeds have been reinvested—plus $1,000,000, which could be additional cash and/or a note carried by the seller. The taxpayer is going from one property to another, never cashing out, never having debt relief or cash boot. The basis in the relinquished property is carried over to the replacement property. When you acquire real estate, the cost basis equals the adjusted purchase price, here approximately $10 million. Since the taxpayer starts with a $3,000,000 basis, the theory is that the profit from the sale of the relinquished property is not being forgiven, but deferred to when the replacement property is sold.

Example 2	Relinquished Property	Replacement Property	Difference
Sales Price	$8,000,000	$10,000,000	+$2,000,000
Debt	$6,000,000	$5,500,000	–$500,000
Equity	$2,000,000	$4,500,000	+$2,500,000
Cost Basis	$3,000,000	$3,000,000	

Again, the gain on sale is $5,000,000 (sales price of $8,000,000 less cost basis of $3,000,000). Again, one hundred percent of the gain on sale is deferred. Although you have $500,000 of debt relief, the debt relief is offset by the additional infusion of equity in the form of cash.

Technical Rule Number 8

Mortgage relief must be reported as recognized profit, unless it is offset by the taxpayer's execution of a new loan, assumption of debt, or contribution of cash.

Example 3	Relinquished Property	Replacement Property	Difference
Sales Price	$8,000,000	$6,000,000	–$2,000,000
Debt	$5,000,000	$6,000,000	+$1,000,000
Equity	$3,000,000	0	–$3,000,000
Cost Basis	$3,000,000	$3,000,000	

The taxpayer has decided to downsize. He is going from an $8 million property to a property worth $6 million. The buyer is 100 percent financing the new acquisition. The debt is increasing by $1 million; however, the taxpayer is putting $3,000,000 into his pocket. Can the taxpayer offset the cash boot with the increased mortgage? No.

Technical Rule Number 9

Cash boot received by the taxpayer cannot be offset by an increased mortgage or in any other way.

What if the cost basis for the relinquished property was $6,000,000 instead of $3,000,000? Does the gain recognition change? Yes, the reportable gain can never exceed the actual profit realized on the sale. The actual profit on the sale would be $2,000,000 (sales price of $8,000,000 less cost basis of $6,000,000). Therefore, even though the mortgage boot is $3,000,000, only $2,000,000 of the gain is reported, with the other $1,000,000 treated as a return of capital.

Calculation of Gain or Loss in a 1031 Exchange

Using the above examples as a basis for analysis, a more formal procedure to determine recognized gain might be as follows:

	Example 1	Example 2	Example 3
Boot Calculation			
Debt on down-leg (relinquished debt)	$6,000,000	$6,000,000	$5,000,000
Subtract debt on the up-leg (replacement debt)	($7,000,000)	($5,500,000)	($6,000,000)
Net debt relief (may not be less than 0)	0	$500,000	0
Subtract any cash paid	($3,000,000)	($4,500,000)	0

	Example 1	Example 2	Example 3
Subtract any boot given	0	0	0
Add any boot received	0	0	$3,000,000
Total boot received	0	0	$3,000,000
Calculation of realized gain			
Value of up-leg	$10,000,000	$10,000,000	$6,000,000
Add debt on down-leg (relinquished debt)	$6,000,000	$6,000,000	$5,000,000
Add any deferred installments	0	0	0
Add value of any boot received	0	0	0
Add any cash received	0	0	$3,000,000
Total consideration received	$16,000,000	$16,000,000	$14,000,000
Subtract adjusted basis in down-leg	($8,000,000	($8,000,000)	($8,000,000)
Subtract debt on up-leg (replacement debt)	($7,000,000)	($5,500,000)	($6,000,000)
Subtract any cash paid	($3,000,000)	($4,500,000)	0
Realized gain or loss	$2,000,000	$2,000,000	0
Gain Recognized (lesser of total boot or realized gain)	0	0	$3,000,000

A 1031 Exchange Coupled with an Installment Sale

In example 3 earlier, the investor received $3,000,000 in cash when the down-leg was sold. What if to facilitate a sale, the investor gets $2,000,000 in cash and carries a note for $1,000,000? How is the carried back-paper treated? The seller-financed portion is treated the same as if the taxpayer received cash because the taxpayer could, for example, sell the note and realize cash.

Since paper carried back by the taxpayer is treated like cash boot, Technical Rule Number 9 applies and the cash boot cannot be offset, not by an increased mortgage or in any other way.

Creation of Tenants-in-Common (TIC) Interests

As mentioned, like-kind property does not include a fractional interest. Therefore, if the ownership of the property is in an LLC or an LP, and if the members or partners, as applicable, agree to sell the property in order to effect a 1031 exchange, you must trade on the LLC or LP level. In other words, although some of the parties may cash out and pay taxes, any remaining partner must trade into the same property.

What is commonly done in order to create flexibility is to split the entity into multiple entities prior to the trade. For example, assume John and Bill each owns a 50 percent interest in LLC number 1, which is the owner of Whiteacre. They both desire to sell Whiteacre. Both partners want to trade their interest, but they want to go their separate ways, with each to invest his net proceeds into a different property. Prior to the sale of Whiteacre, John relinquishes his interest in LLC number 1. His interest is deeded to LLC number 2. From a drafting perspective, John and Bill might document this ownership change in a "Withdrawal and Transfer Agreement." Whiteacre is now owned 50 percent by LLC number 1 and 50 percent by LLC number 2, as tenants in common (TIC). John and Bill, through their respective LLCs, enter into a Tenants-in-Common Agreement (TIC Agreement) to set forth the covenants, terms, and conditions that will govern their mutual ownership of Whiteacre. A properly drawn TIC Agreement should cover, among other things: (1) the management of Whiteacre, (2) the parties, rights and obligations with respect to the various costs and expenses relating to Whiteacre, (3) the rights and obligations of the parties with respect to cash distributions from the properties operations, and (4) the decision-making process relating to extraordinary events such as a sale or a refinance. If the above steps are taken and a sale occurs, John and Bill are not tied together. Each can trade separately or either may elect to cash-out and pay the applicable tax.

The taxpayers should be sensitive to three issues relative to the creation of these separate TIC entities:

1. The IRS can argue that the creation of the separate TICs was merely a device to avoid taxes, and that the entities should be collapsed and the trade disallowed. The greater the separation in time between the formation of the two TICs and the sale, the more substance the form will have. If two or more tax years can be straddled, for example, the two TICs are formed in year 2009 and the sale occurs in 2010, the TICs will arguably have more legitimacy. Also, if more activity in relationship to the property, for example, a refinance, occurs during the time the two TICs hold ownership, the taxpayer can argue a stronger business purpose and therefore give more credibility to the TIC entities.

2. The loan documents should be scrutinized to ensure that the transfer out of a 50 percent interest does not trigger an assumption fee issue or a due on sale argument.
3. Bill might want to admit additional members to LLC number 1 in order to avoid a technical dissolution for tax purposes.

This chapter covers many of the technical rules that are important to understand so that the tax consequences of your actions are as clear as possible. Once the tax consequences of your actions are digested, you should attempt to plan and act proactively to avoid a huge unexpected tax bill.

CHAPTER 7

Acquisitions and Dispositions

So . . . you want to buy real property? You want to get into the game?

> **Rule Number 16**
>
> When buying real estate, don't be all over the board. Concentrate on a subset within a subset, that is, concentrate on a specific property type in a specific geographic location.

Focus on Specific Property Types in Specific Geographic Locations

Why narrow your concentration? There are several advantages.

First, by focusing on a specific property type, you learn the language and nuances that are unique to that property type. You learn to focus on issues that are associated with that type of real estate. For example, if you are involved with shopping centers, percentage rent clauses may have to be negotiated. What is a percentage rent clause and what are the usual and customary points of negotiation associated with this type of provision? If a supermarket is doing annual sales of $200 per square foot, does that mean they are doing well or does it take $400 per square foot to have a successful store? If you are working with industrial property, what does it mean when someone says the "clearance is twenty feet" or that the rear of the building is "dock high"? Mobile home parks have "doublewides" and "triplewides" and remetered utilities; apartments may have rent-control laws and problems associated with a high turnover rate as well as issues surrounding furnished versus nonfurnished units; hotels track daily occupancy rates. What does a "star report" contain and what are the differences between three-, four-, or five-star ratings? When you are involved with medical office buildings, you know from experience that the tenant improvement costs are significantly higher than those for generic office space. You also learn how to create a tenant mix that generates synergy between the various users.

Secondly, by narrowing your focus, you can establish a relationship with other individuals or entities that provide services or are otherwise involved in that area. By focusing on a specific product type, the likelihood of repeated contact with the same individuals is enhanced, and consequently your ability to get to know helpful parties in your designated field is significantly increased. You can cement relationships with real estate brokers, commercial lenders, potential tenants, venders, and so on. To illustrate, if you have vacant space in your neighborhood shopping center and you own two other neighborhood shopping centers in the general market area, would it not be a logical leasing tactic to approach your existing tenant base to see if any of those tenants might consider opening another store at your other location? Becoming active and participating in applicable trade organizations is an effective way to foster additional relationships and contacts. For example, in the shopping center sector, the International Conference of Shopping Centers (ICSC) holds regional meetings with networking sessions as well as timely lectures.

Thirdly, by focusing on a specific property type, you gain experience and learn over time what works and what does not work. A standard lease for one product type may vary significantly from that needed for another product type. A death and disability clause may be important in a medical office lease, where the doctor's personal services are important in relationship to his ability to pay the rent, while a pet clause or an age restriction may be more apropos in a residential lease. The concerns centered around managing a high-rise office project, for example issues regarding heating and air conditioning as well as elevator service, are quite different than concerns related to a mobile home park, where most problems revolve around the common areas such as the pool and the club house.

Establish Buying Criteria

Once you narrow down a product type and area, you should establish buying criteria. You must decide upon, among other things, project size, in terms of acquisition price and square footage, for example, over $3,000,000 and in excess of 50,000 square feet, as well as the number of required tenants and lease expiration concentration. What are the ideal specifications? There is no right answer to this question. This is what makes a horse race. What works for some parties may not work for others. Some buyers are risk-averse as well as management-averse and, hence, desire stable single credit tenant properties on long-term leases; other players seek multitenant projects with staggered leases. Do you seek to acquire properties with an upside, which usually translates into a modest to large vacancy factor and/or below market rate leases, or are you seeking more stabilized assets that may be 100 percent leased and therefore contain less risk? Understanding your company's niche or perceived niche in the marketplace is crucial. Are you set up to tackle problem properties that might need an extensive facelift or have toxic issues or are on unfavorable ground leases, or is your organization more geared to purchasing quality, 100-percent-leased "trophy" properties? These types of questions must be addressed, because the more definitive your objectives are when interfacing with real estate brokers or sellers, the more efficient you will be in culling out those projects that are not of interest and the less time you will waste on reviewing projects you will never ultimately purchase. By clearly knowing what you will or will not buy, you will greatly enhance your credibility.

To a large extent, what one has done in the past, one will do in the future. Therefore, if your buying criteria are in need of clarification, the first place to look is where you have been successful in the past. Where and what did you buy in the past and what were the elements that made those investments work?

Acquisition Philosophy

Your buying criterion defines what you tell the outside world. It sets forth general parameters as to property type and location, and various property, leasing, and tenant requirements. It allows you to screen all types of submissions within broad guidelines. However, it is necessary to go beyond the general to a specific economic framework outlining what works for you. You must establish a understanding of what you are attempting to accomplish from a yield perspective. It is important to be clear about what your economic goals are. To some extent, your economic goals might be dictated by your capital source, meaning your investor or investors. If your investor base requires a 10 percent return, how can you buy at a 6 percent cap rate? Even with leverage, your yield will most likely not reach 10 percent. Another important factor to take into account with a target yield might be maintaining a spread between the cost of capital and the capitalization rate, that is, the degree of positive leverage. The upside potential might also factor into the equation. Depending upon your horizon, if the potential exists to turn the project into a home run, a lower initial yield could possibly be acceptable. The point is that, in addition to general categories, a specific desired return on investment should be established, at least internally, so you can quickly evaluate projects and seize opportunities if the right fit arises.

Governmental Impact

Local, state, and possibly national rules and policies can have a dramatic effect on your real estate game plan. Examples of the critical need to understand governmental rules abound.

If you are acquiring apartments in rent-controlled areas, it is important to understand not only the rules controlling when rent can be raised, but also legal ways to "decontrol" the rent.

If you are seeking to undertake historical renovations, it is important to understand the criteria that must be met for work to qualify as a historical renovation, as well as the resulting tax advantages.

If you elect to build low-income housing, it is important to understand the criteria that must be met to qualify for this category of construction and the potential tax benefits associated with the various governmental programs.

If you are operating in a heavily regulated sector, for example if you have a property that contains a surgical center, it is paramount to have a handle on the applicable rules and regulations and equally important to have a feel for when a consultant is needed to clarify the applicable codes. Often, recognizing when an expert is needed can mean the difference between success or failure.

Initial Screening

So far in this chapter, we have discussed focusing on a specific real estate product in a specific geographic area. We have also mentioned the need to establish buying criteria that delineate a range for project size and any other feature that is deemed a required element. Furthermore, we have seen that an acquisition philosophy that focuses on yield should be established. Clearly defining what type of real estate you seek to buy in terms of product type, geographic location, size, tenant mix, and number of tenants, aids the elimination process. It is additionally important to have a methodology to cull out from submitted projects those that are likely to work on an economic level. Accordingly, it is necessary to set economic guidelines for what kind of potential returns you will need in order for you to move forward with a project.

It is important to spend time on your initial screening because, to a large degree, up to this point you have had a free ride. You have spent time attempting to learn about the project, but you have not spent any serious money. In the event buyer and seller agree on the price and the other terms of sale, the process starts to get expensive. A purchase and sale agreement must be drafted, which usually means attorney fees. The buyer then enters the due diligence phase, which translates into spending money on an appraisal as well as on a Phase I and possibly a Phase II environmental report, a property condition report, a seismic study, lender good faith deposits, a survey, and so on. If after due diligence you close the sale, the monies spent become part of the cost of purchase. In the event, for whatever reason, you elect not to go forward, the due diligence costs become part of doing business—a sunk cost usually not recoverable. In most cases these costs are borne by the promoter and not charged back to investors. The moral is that care should be taken to check out a potential project as thoroughly as is reasonably possible before you more forward to the next steps, that is, a contract to purchase and the associated due diligence.

Rule Number 17

Spend time on the initial screening of a project to verify whether you desire to move forward, because the next steps are expensive.

Let us assume the elements of the offering pass your basic buying criteria. Now, in order to make a quick initial determination of whether or not you are interested in pursuing this investment, it is necessary to assemble certain minimum documentation for a "down and dirty" analysis. It is helpful to have a checklist of needed items to provide to potential sellers and/or seller's brokers. The checklist might look as follows:

- A brief description of the property, including location, size (gross, rentable, and usable square footage), floor plans, a site plan, and number of parking spaces.
- A rent roll showing the tenants' names, suite numbers, rentable square footage, lease start and expiration dates, rent escalations (how much and when), and whether or not there are any options to extend (and, if so, on what terms).
- Historical income and expense figures: at a minimum last year's figures plus year-to-date numbers. (The expenses should be broken down by line items, similar to the analysis in Chapter 6.)
- A disclosure of the terms and conditions relative to any pending leases or renewals (which is helpful as a guide to understand market rent).
- Existing debt information, including the name of the lender, the outstanding balance and the original balance, the remaining term, the current interest rate, amortization, whether or not the loan is assumable (and, if so, the assumption fee), whether or not the loan may be prepaid (and, if so, the prepayment penalty or defeasance fee).
- In the event the real estate is a leasehold estate, a copy of the ground lease and ground lease summary, if available. It is important to understand who the landlord is, the remaining term under the ground lease, options to extend, the ground rent, when escalations in ground rent occurs and how they are calculated.

You have made the cursory determination that a specific real estate deal merits further study. You are going to review further information or you have asked the seller to provide further information. It is now time to play 20 Questions. The classic game begins with the query "animal, mineral, or vegetable?" In the real estate game, your focus must be on problem identification. Every project has its weaknesses. The successful real estate entrepreneur identifies the problem areas and figures out ways to eliminate or mitigate those issues. Your 20 Questions might be as follows:

1. What is the seller's motivation for selling the project?
2. Should you go see the project? There is no substitute for "kicking the dirt." Real estate is a hard asset. It is essential that it be seen before the buyer makes a firm commitment. But when? The answer to this question really depends on where the property is in relation to your operational base. If the property is around the corner, of course, go view it. On the other hand, if the property is 3,000 miles away, do more analysis before getting on a plane. I have seen beginners who run to see a project before they really understand the issues and before they have a strong sense that this project will work for them. A lot can be accomplished much more efficiently at your desk rather than by running off to view the dirt.
3. Should the area surrounding the project be viewed? The same timing concerns about viewing the surrounding area applies. At some point, it is essential that you view the neighborhood surrounding the project. If there is a toxic dump next to the project, or boarded-up buildings, or a run-down nursing home that emits an unpleasant odor, these factors must be considered.
4. What is the purchase price per square foot in comparison to reproduction cost per square foot?
5. Are the existing tenant rents at market rate? What is the market rental rate? Determining this factor might involve discussions with leasing brokers, appraisers, or other knowledgeable sources. Are any concessions, such as free rent or tenant improvement allowances, being given to lease space? If so, what is the typical concession?
6. When do the existing leases expire? Is there a concentration of expiring leases in one year? Is there any large lease that will expire in the near future?
7. What is the vacancy factor in the project? What is your perception as to how easily the vacancy can be filled, at what rent, and at what cost?

8. How are the tenants doing? This is particularly important for any anchor tenants. What are their sales per square foot? What is the creditworthiness of the tenants? Based upon the tenants' payment record, the accounts receivable report, what, if any, tenants are likely to default?
9. What is the internal rate of return (IRR) and the net present value (NPV)? Does the IRR and the NPV meet your threshold requirements?
10. What is the net cash flow? What is the cash-on-cash return? Is the net cash flow sufficient to induce your investors to support this project?
11. What, if any, fix-up expenses does the project need? Does the project need only cosmetic repairs, such as paint and landscaping, or is a more extensive facelift required? Are there any major structural issues or other major expenditures needed?
12. What are the realistic reserves for capital costs, tenant improvements, and leasing commissions?
13. Are there any environmental issues? If the site contains or contained a gas station or a dry cleaner with a plant, this matter becomes highlighted.
14. What is the status of the financing? Must the borrower obtain new financing or can an existing loan be assumed at favorable rates? If new financing must be obtained, can the existing loan be repaid and at what cost?
15. What is the gross amount of cash that must be raised/ invested in the project?
16. What is your investor's reaction to the project?
17. If the project involves a ground lease, is the ground lease "mortgageable"? Are there other issues surrounding the terms of the ground lease?
18. Are there any natural hazards that you must be concerned about, for example, earthquakes in California, hurricanes in Texas, or floods in Minnesota?
19. Are there physical problems associated with the project, for example, a lack of adequate parking or shop space with depths that are not workable for the majority of potential tenants?
20. Where is the upside in the project?

The Purchase and Sale Agreement

It is beyond the scope of this book to analyze a *Purchase and Sale Agreement* (PSA) on a clause-by-clause basis; however, the following material discusses crucial contract terms with a focus on practical business suggestions. Also, ideally, the buyer or his attorney should compose, concurrent with drafting the PSA, a succinct summary of critical dates and a separate list of all documents that must be produced during escrow. By doing this prior to execution of the PSA, the buyer can clearly understand his obligations and therefore, hopefully, not omit an important date or document.

Identify What You Are Purchasing

In a real estate transaction, usually the main items being bought are real estate, land, and the improvements that are situated on the land. However, care must be taken, because if you are purchasing a hotel, for example, there might be extensive personal property that should be transferred with the acquisition. Hotels typically will contain extensive fixtures, furniture, and equipment (FF&E) integral to the hotel's operations that are usually transferred upon sale. Likewise, the hotel's liquor license might be an important personal property right that might be involved in the sale. If you are acquiring a medical building with an existing surgical center lease that will be taken over, it might become crucial to make sure that the surgical center license is preserved so that the accreditation process does not have to begin from ground zero, which could take years to accomplish. More mundane items such as security deposits and reserves must also be covered.

When conveying real property, the seller executes a deed. When transferring personal property, a bill of sale is signed. If the conveyance of real property is a leasehold interest rather than a fee simple estate, then the documentation of the transfer is usually done by having the seller execute an assignment of the lease rather than a deed.

What if you are attempting to buy a property with assumable existing financing at 5.25 percent, with 10 years to run, while the market interest rate is 6.25 percent? Would you pay the same price if the property had no debt on it? The answer logically should be no, since the submarket rate loan should be worth something to the buyer. The buyer's cash flow will be better if he assumes the existing loan rather than if he must go to the market and obtain new financing. The premium that the buyer is willing to pay is often referred to as a *financing premium.* Essentially, due to the favorable financing, a buyer should be willing to pay more for the seller's *equity interest.* The equity interest is the difference between the property value and any debt financing. The enhanced payment for the financing premium should be reflected in the purchase price and the PSA must reflect that the buyer is to assume the existing financing.

Time Factors

It is crucial to clearly specify a time frame for:

- The period within which the parties must execute the PSA.
- The number of days the parties have to open escrow.
- When the buyer must deposit into escrow the good faith deposit.
- The length of time the seller has to deliver the reports and other material within its possession for the buyer's review.
- The period within which the buyer has to perform its due diligence.
- The time frame within which the buyer has to obtain a loan or assume the existing loan.
- The date by which the buyer must close after the loan contingency has been satisfied.
- The period within which any buyer's extension that has been granted must be exercised. If the buyer has an extension, does the buyer have to pay additional money for the extension and, if so, when is the money due? Are there time constraints governing whether or not the additional money is applied to the purchase price? In other words, if you miss a due date are there negative consequences—such as the additional deposit not being applied to the purchase price, but rather increasing the purchase price?

Deposit Monies

Good faith deposit money will usually be required at the outset when escrow is opened, and additional deposits are required after the buyer's contingencies are satisfied. The contract might also require additional money if the buyer seeks to extend the closing time frame. From the buyer's perspective, it is important to provide that these deposits are applied against the purchase price, in the event the transaction closes, and are returned in the event a condition is not approved. In general, the buyer should not put up money to go forward to secure financing until after the due diligence period is over. The deposit monies given to a lender are typically nonrefundable and therefore it is unwise, unless other overriding factors dictate, to put up dollars with a lender when the other contingencies are still outstanding.

Of course, it is the seller's objective to have the deposit monies "go hard," that is, become nonrefundable as soon as possible. Typically, the deposit monies become nonrefundable at the end of the due diligence period. The buyer has finished his review of the project operations and his investigation relating to the property condition. The buyer approves the contingencies and moves toward closing. In practice, what often happens is that the buyer approves all of the contingencies, with the exception of one open issue. An amendment is drawn that allows the buyer to get out of the sale and to receive his earnest money back if, and only if, there is a failure to meet narrowly defined conditions. In short, the seller seeks to keep the buyer's feet to the fire by limiting the buyer's outs if the parties agree to continue.

Estoppels and Tenant Interviews

Estoppels are executed by a tenant wherein the tenant represents that the lease is in full force and effect and that there are no defaults by the landlord. In the estoppel, the tenant also repeats and acknowledges the lease terms. Rather than relying on the veracity of the seller, both the buyer and the lender will want to obtain an estoppel from each of the tenants.

What should the estoppel contain? A well-drafted estoppel should request the tenant to confirm or indicate the following 11 items:

1. The parties to the lease: the landlord and the tenant.
2. The address of the premises.
3. An identification of the lease and any amendments to the lease.
4. A disclosure of whether or not there are any guarantors.

5. An acknowledgement of the tenant's economic responsibilities, that is, rent and other tenant obligations, such as utilities or operating expenses over a base year.
6. An acknowledgement of the lease term, start date, and expiration date.
7. A representation that the tenant has had the opportunity to review all prior operating expense reconciliations and that no monies are owed to the tenant under the lease and specifically for operating expense charges.
8. A representation as to any outstanding tenant improvements or tenant improvement allowances.
9. A statement by the tenant as to whether or not there is any free rent still to be taken by the tenant and, if so, when.
10. An acknowledgment by the tenant that there are no lawsuits filed by the tenant against the landlord or any claims that may become a lawsuit.
11. A disclosure of any options to extend the lease or options to purchase.

Most of the above items are expected in an estoppel, but items 7, 8, and 9 are often overlooked by a purchaser. Since these categories represent potential overcharges or concessions to tenants, if the matters are significant, the result may be a price reduction or some other contract modification, such as the seller agreeing to place funds in escrow to cover potential disputed operating expenses or pay for outstanding tenant improvements and/or free rent.

When completing the estoppels, the landlord should have certain documentation readily available to facilitate completion of the form and to ensure accuracy. A rent roll and the most recent billing statements are helpful since this documentation confirms the rent and indicates any delinquencies.

What is the effect of an error in the estoppel that sets forth terms that differ from the Lease? Arguably, the answer depends on who executed the estoppel. Usually only the tenant signs the estoppel. The rule is that the tenant cannot unilaterally modify the lease terms. The Lease controls and the changed terms have no effect. I was involved in a case wherein an estoppel contained an option to extend that was not granted in the Lease. The landlord argued that the option was an error. The court agreed and ruled that the option was null and void. Would the result have been the same if the landlord had also signed the estoppel? Depending on how clear and definitive the language was, the tenant would have a stronger case that a lease modification has taken place. Given the lease modification argument, property owners should be careful not to sign the estoppel or if they must execute the form, they should be very careful that the terms and conditions contained in the estoppel parallel the terms and conditions in the Lease.

Let us assume that a tenant signs an estoppel, a buyer purchases the property relying on the language in the estoppel, and then six months after close of escrow the tenant calls the buyer, now the owner, and indicates that the prior owner made a miscalculation in the CAM analysis and you owe the tenant $100,000. The tenant argues that you, the new owner, when you purchased the property obtained all of the benefits of ownership, including the right to collect rent pursuant to the lease, but you also acquired all of the obligations under the lease, including the obligation to properly account for the prior CAM charges. In response you e-mail to the tenant a copy of the estoppel he signed six months ago that clearly states that no monies are owed to the tenant, that he acknowledged that he has exercised all rights he so desired in terms of verifying the accuracy of the prior CAM analysis, and that he was satisfied that no correction in the accounting was required. The point is that the estoppel prevents the tenant from coming back to the new owner and undercutting the statements made therein. This example brings out the need for a comprehensive, well-thought-out estoppel and the need to retain a copy of the estoppel for future use, if necessary. Very often after a purchase or a refinance the task is so momentous and the paper work so voluminous that the owner does not distinguish what is important to retain and what is of little value. One document that should be retained and placed in an important document binder as well as scanned in a computer backup file is a copy of the tenant estoppels.

A potential buyer will also desire to discuss the project and the tenancies of the various tenants with the applicable tenant. The timing of when the estoppels must be secured and when the buyer is able to conduct the interviews is important. The buyer typically wants to obtain the estoppels and conduct the interviews as soon as possible. On the other hand, the seller usually does not want his property disrupted with estoppels and tenant interviews unless he feels confident that the buyer is serious and will close the transaction.

The due diligence period is typically 45 to 60 days. A compromise I have utilized to satisfy both buyer and seller is to provide that the seller starts the estoppel process and allows tenant interviews at the midway point in the due diligence time frame. The theory is that enough time has passed to allow the buyer to have a real sense of whether or not he or she will move forward with the purchase, yet the due diligence period has not expired—so, hopefully, within the due diligence period or shortly thereafter the buyer will be able to approve the estoppel and interview contingency.

Delivering the estoppels to the tenants later in the process gains one other practical benefit: the ability to coordinate the buyer's and the lender's estoppel criteria. The goal is to obtain the estoppels from the tenants only once for this purchase and sale transaction rather than having to satisfy the buyer and then go back to the tenants with another estoppel to meet the lender's requirements.

Contingencies

In a PSA the contingencies are in favor of the buyer. The PSA says, in effect, that the parties have agreed to transfer the property at a given price, provided the buyer approves of certain items, including the condition of the property, title to the property, a survey, a soils report, a structural report, an earthquake study that sets forth the probable maximum loss (PML), and the proposed lender's terms and conditions. Usually, in addition to a general contingency about the property condition, the contingencies that are designated are the financing contingency and/or a feasibility contingency, but, depending on the nature of the acquisition, other contingencies such as specific regulatory approval may be added. If specific regulatory approval is needed, such as a zoning change or a conditional use permit, documentation appointing the buyer as the seller's agent to interface with the city may be needed. The point is that the buyer is in the driver's seat. At any time he decides he is not satisfied with one of the contingencies, he may cancel and get his deposit back. It is for this reason, in general, that a buyer cannot be forced to close, but a seller can be required to sell the property.

Rule Number 18

If the contract is properly drawn, you can always force a seller to sell, yet you can never force a buyer to buy.

Of course, once the contingencies are satisfied, the contract becomes enforceable by both the buyer and the seller, but usually this occurs, if at all, near close of escrow.

Another issue that should be kept in mind with relation to contingencies is what constitutes approval of a contingency. If the time frame passes for disapproval of the contingency, is the contingency deemed approved? In other words, is silence deemed approval? The contract controls. In general, the best policy is to require written notice for approval. This way there is no inadvertent approval.

Management during and after the Due Diligence Period

Often the PSA will set the approval by the buyer of its due diligence as the dividing line for key rights and liabilities. The principle is that during the due diligence period, the buyer may back out of the transaction with impunity. However, after the buyer approves its review of the property, the books and records and so on, it is then assumed that the buyer is committed to purchasing the property and that therefore there should be a shift in certain rights and liabilities. A good illustration of a shift in rights and responsibilities can be seen in the buyer's approval rights. Typically, during the due diligence period, the seller has the right, upon a disclosure to the buyer, to enter into new leases or to modify existing leases. However, once the buyer has removed the due diligence contingencies, then the PSA usually grants approval rights to the buyer so that the buyer may control any new contractual arrangements between the landlord and the tenants. Consistent with the approval rights are the costs associated therewith. In other words, the costs associated with entering into a new lease or modifying an existing lease include tenant improvement dollars, free rent, brokerage commissions, and the like. The issue becomes, Who shall bear this expense? Typically, the party that has approval rights must bear the expense. Therefore, during the due diligence period the burden is placed on the seller, yet the expense most likely shifts once the due diligence period expires.

The "As-Is" Clause

The seller desires a strong "as-is, where-is" clause passing all risks to the buyer, while the buyer wants as many representations and warranties as it can obtain.

A strong "as-is, where-is" provision will indicate that the seller has not made any representations, warranties, promises, covenants, agreements, or guaranties or any kind, whether express or implied, oral or written, past, present, or future concerning:

- The value of the real property.
- The dimensions or square footage of the land or the improvements or the accuracy of any survey.
- The income to be derived from the real property.
- The suitability of the real property for any and all activities and uses that the buyer may conduct or wish to conduct thereon or the availability of any entitlements from any governmental agencies.
- The habitability, merchantability, marketability, profitability, or fitness for a particular purpose of the real estate.
- The manner, quality, and state of repair or lack of repair of the real property.
- The nature, quality, adequacy, or condition of the real property, including without limitation, the water, soil, archeological status (including without limitation, soil expansiveness, corrosion, stability, or seismic, hydrological and topographical conditions and configurations).
- The compliance of or by the real property or its operation with any laws, rules, ordinances, or regulations of any applicable governmental agency (including without limitation requirements or the Americans with Disabilities Act of 1990, as amended).
- The manner, condition, or quality of the construction or materials, if any, incorporated into the real property.
- Compliance with any environmental laws.
- The presence or absence of hazardous materials that may now or in the future require investigation or remediation under environmental laws on, under, or about the real property (including without limitation, soils and groundwater conditions).
- The conformity of the real property to past, present, or future applicable land use, zoning, or other planning, building, or technical laws, regulations, orders, or requirements of any governmental agency.
- The adequacy or deficiency of any under shoring.

- The fact that all or a portion of the real property may be located on or near an earthquake fault line or located in a special study zone.

In general, sellers are able to negotiate the aforementioned disclaimers under the theory that the buyer should conduct his own due diligence, which includes examination and testing.

Representations and Warranties

As to the seller's representations and warranties, it is common for the seller to agree that it is duly formed, that it has the requisite authority to convey the subject real and personal property, that it is not in receivership or dissolution nor has it made an assignment for the benefit of creditors, that it is not a "foreign person," that the PSA constitutes a legal, valid, and binding obligation of the seller enforceable in accordance with its terms, and that performance of the PSA by seller will not result in a breach of, or constitute any default under, any agreement or instrument to which the seller is a party or by which the seller or the property is bound. Beyond these representations, what happens next boils down to negotiation strength. What usually happens is that the party who is most ambivalent as to whether or not the sale takes place—and who, therefore, is most willing to "walk away from the table"—typically gets its way.

Rule Number 19

"Winning" in a real estate negotiation usually boils down to which party is the more indifferent as to the whether or not the sale will be consummated.

Additional representations that a buyer may ask for, as well as other negotiated items, include the following:

1. There are no material claims, actions, suits, or proceedings, nor any order, decree or judgment, in law or equity, pending or in effect against or affecting the real property or threatened or contemplated against or affecting the real property.
2. The submitted rent roll is true, accurate, and complete.
3. The submitted income and expense statements for a requested period are true, accurate, and complete.

4. As to the tenant leases, that except as disclosed by seller in writing:
   a. The list of tenant leases contains a complete list.
   b. The tenant leases are in full force and effect, are binding obligations of the applicable tenants, are enforceable in accordance with lease terms, and are assignable by seller to buyer without the consent of any other party.
   c. None of the tenants has a right of first refusal, option right, or other right, to purchase all or any portion of the real property.
   d. None of the tenants is in default, beyond any grace period provided in the applicable tenant lease, in the payment of rent or additional rent under its tenant lease, or is otherwise in default of any material obligation under its tenant lease.
   e. The seller is not in default of any material obligation under any of the tenant leases.
   f. All tenant improvements required to be performed by the seller under the tenant leases have been completed and any amounts owed by the seller in connection therewith have been fully paid.
   g. There are no security deposits held by the seller under the tenant leases.
   h. There are no lease commissions due and owing or payable by seller regarding the tenant leases.
   i. The seller has furnished to each relevant tenant under the tenant leases reconciliation statements with respect to the additional rent paid by such tenant for all relevant periods under the tenant leases during the seller's ownership of the real property prior to the buyer, and has paid all sums due and owing to each such relevant tenant in respect of the reconciliation of such additional rent for all such relevant periods.
   j. There are no rights of possession of occupancy of the property or any portion thereof granted by the seller to any person or entity other than the tenants under the tenant leases.
   k. To the best of seller's knowledge, none of the tenants under the tenant leases:
      - Is in receivership or dissolution.
      - Has made any assignment for the benefit of creditors.

- Has admitted in writing its inability to pay its debts as they mature.
- Has been adjudicated a bankrupt.
- Has filed a petition or has had a petition filed against it for involuntary bankruptcy, or has filed a petition or answer seeking reorganization, or has requested an arrangement with creditors under the Federal Bankruptcy Law or any similar law or statute of the United States or any state.

5. With respect to service contracts:
  a. The list of service contracts supplied is a complete list of all service contracts currently in effect.
  b. The service contracts are in full force and effect, are binding obligations of the respective parties, are enforceable in accordance with their terms, and are assignable by seller to buyer without the consent of any other party.
  c. None of the parties, including seller, is in default, beyond any grace period provided in the applicable service contract, of any material obligation under the service contracts to which it is a party.

6. During the period of seller's ownership of the real property, no hazardous materials are or have been installed or stored in, discharged or released from, or otherwise exist at, on, or under the real property, except for the safe and lawful use and storage by seller of quantities of hazardous materials in accordance with environmental laws.

7. The seller is to provide a true, correct, and complete copy of the relevant third-party documents (list follows), without any warranty as to their accuracy, except as specifically set forth in the PSA, in any seller's estoppel, or as part of the documents required for closing upon which the buyer is entitled to rely.

For its part, the seller seeks to limit its representation and warranties. In my opinion, representations like item "3" above, regarding the precision of income and expense statements, are the most dangerous representation the seller can make. Given the potential for inadvertent errors and miscalculations, it is one thing to check and double check a rent roll against existing leases and quite another thing to guaranty the accuracy of income and expense numbers.

8. Who pays for the various costs?

Which party bears which cost is 100 percent negotiable; however, the parties will usually follow the customary and standard practice in the area where the contract is entered into.

The standard practice in the Southern California area is for the seller and buyer to share the escrow fees equally. The seller pays the transfer taxes and any sales brokerage commissions. The seller is responsible for paying for a CLTA owner's title policy, and the buyer must bear the cost of any enhancement, such as the added cost associated with an ALTA policy and any and all endorsements required by the buyer's lender. The seller will typically pick up any costs associated with paying off any existing loan such as any defeasance penalty, and the buyer will pay all costs incurred in connection with securing a new encumbrance. The important point to remember is that although the "standard" is outlined above, the various costs are still subject to negotiation, and modifications and exceptions are often made to the "standard." For example, it is not uncommon for the buyer to bear a portion of the sales brokerage commission. Similarly, it might not be unreasonable for the seller to place a cap on its exposure for the defeasance premium. The seller may be able to cancel escrow or require the buyer to pay for all or a portion of the penalty above a certain level.

9. Liquidated damages, mediation, and arbitration

Usually the deposit monies are liquidated damages, so if the buyer defaults, the seller keeps the monies posted. Very often the seller will attempt to limit his exposure to the same dollar amount. Today, in the world of 1031 exchanges, these limitations are usually inadequate. A buyer or a seller in the process of trading can have disastrous results if the other party breaches and does not perform as agreed, especially in light of the restrictive time constraints applicable to Section 1031. At a minimum it is helpful to significantly increase the liquidated damage amount after the due diligence period has expired.

In practice, I have found mediation very ineffective since it is not binding. Arbitration, if binding, resolves the controversy, but unfortunately I have found that the court system with a judge results in a fairer, more legally reasoned resolution. Arbitrators tend to "split the baby," while judges offer usually a stricter legal result. Given the above, my tendency is to avoid mediation and arbitration clauses and build in an attorney's fee clause with a waiver of a jury trial. Counsel should be consulted for drafting the applicable provisions and an opinion as to the appropriateness and/or language relating to mediation, arbitration, and waiver of a jury trial.

Building a Team

Acquiring real estate requires the employment of experts in several areas. The seasoned professional real-estate player assembles his team prior to an acquisition, so when the opportunity arises to acquire the "right" property, he is prepared to execute. For any given acquisition, all of the team players may not be needed, but having them as resources is key, so if and when they are required, you will be prepared to move forward and close the transaction.

The key players on the team consist of investors, lenders, a certified public accountant, and an attorney. These are the core players. The investors bring the equity to the table, the lenders bring the debt, and a CPA and an attorney bring the expertise to assist in structuring and documenting the transaction. On the team in a supportive role might also be a sales agent, a mortgage broker, an appraiser, a due diligence expert, a company that prepares environmental reports (such as a Phase I and Phase II environmental surveys), a structural engineering company that can calculate a seismic study reflecting the maximum probable loss, a title company, a surveyor, an escrow company, and a defeasance firm that can purchase securities as substitute collateral.

A firm that generates a property condition report or a licensed inspector may be helpful in identifying problem areas. Often, if areas of concern are identified, it is necessary to hire a general contractor and/or a specialized subcontractor to address the issue in terms of remedies and pricing. Subcontractors may include such areas as HVAC, electrical, plumbing, roofing, and so forth.

Working with the same firms and the same individuals within those firms builds knowledge of how they operate. Long-term relationships generally translate into fewer surprises, fairer pricing, and flexibility, when it is needed.

Due Diligence

Once a purchase and sale contract is entered into, a period will be specified during which the buyer may examine all aspects of the transaction to verify that he or she wishes to move forward with the purchase on the agreed terms. This period is referred to as the due diligence period. A prudent buyer should compose a checklist of items that the seller should be asked to produce for examination. A comprehensive due diligence checklist is shown in Appendix D on the companion website.

Buying property is analogous to a chess match. Psychological strategies are key in structuring a purchase and a sale agreement and in moving from contract to closing. As a buyer, you may not want to ask up-front for all of the items listed in the checklist. Such a request would be too overwhelming for a seller. As a strategy, it is usually better to request key items like the rent roll and historical income and expense numbers and then, as the due diligence progresses, request additional appropriate material.

The seller is under a duty to disclose matters adversely affecting the property that he knows about or should have known about. However, it is often difficult to prove that the seller knew or should have known about such a matter. Therefore, when purchasing real estate, the general rule is: "buyer purchase at your own risk—buyer beware." The burden is on the buyer to conduct, to his satisfaction, adequate tests, inspections, analysis, and research so that he is comfortable with the risk profile of the investment. When a buyer is conducting his due diligence he or she should continually ask himself, "What is wrong with this deal? Why have other buyers not jumped to purchase this investment? Where are the risk factors?" By identifying the problems, a buyer can then properly evaluate the risks and seek ways to ameliorate the risks, if possible. If the buyer feels he or she cannot sufficiently cushion the risk factors in light of the funds that are to be committed, then the proper course of conduct would be to pass on the investment. Seasoned real-estate investors often comment that some of their best deals are the ones they did not do.

Rule Number 20

Due diligence boils down to: What is wrong with this deal? Why have other buyers not jumped to purchase this investment? Where are the risk factors? In a real-estate purchase, the reality is "buyer beware."

What are some of the potential problems that might affect an investment?

- Maturing leases.
- Financially weak tenants.
- Tenants that show a poor payment record.
- Tenants that are losing money.
- Environmental issues.
- Structural problems.
- Inadequate parking.
- An ill-conceived project configuration, for example, structures blocking shop space visibility, or second-story retail space in a market that is flooded with more convenient ground floor retail.
- Tenants' leases maturing with rents above market.
- An inability to finance the project.
- Financing that is poorly conceived, for example, an amortization that impairs the cash flow.
- A ground rent that escalates based on land value and is out of proportion to the gross rents.
- A short ground lease term or problems with the mortgage ability of the ground lease.
- Significant deferred maintenance.
- A thin market in terms of potential tenants.
- A competitive project that is in the planning stages or that will shortly come to market.
- A major tenant planning to vacate because it is constructing its own building or it has made plans to relocate.
- Code violations.
- Leases that are restrictive in terms of what other uses may be conducted at the project.
- Unfavorable lease terms such as flat rent for a protracted period of time or cotenancy provisions that place future monetary burdens on the owner.

The due diligence checklist or a similar process should be approached methodically on a step-by-step basis. In addition, please note the following five items:

1. **Leases**

   It is crucial to read and analyze the leases. The buyer is purchasing a leased fee estate. He falls into the shoes of the seller and will be bound by the terms and conditions of the leases. I have been under contract to purchase properties wherein the seller supplied a copy of the leases, but failed to point out that significant concessions were made to tenants in terms of future free rent and tenant improvement allowances. When a schedule was composed showing the concessions, a price reduction was negotiated. The estoppels should always require the tenants disclose any outstanding free rent, tenant improvement allowances, or work to be completed by the landlord.

Care should be taken to verify that if a lease is guaranteed and a subsequent amendment was entered into, that the guaranty was reaffirmed concurrent with execution of the amendment. Usually this is done by having the guarantor sign the amendment with language that states that the guaranty remains in full force and effect. Leasing agents and owners often overlook this subtlety. If the amendment contains substantive lease changes, even an extension of the term, an attorney for the guarantor can make a strong argument that the guaranty is no longer in full force and effect.

A well-drafted guaranty should contain language such as "It is specifically agreed by Landlord and Guarantor that the terms of the foregoing Lease may be modified by an agreement between Landlord and Tenant or by a course of conduct without consent or notice to Guarantor and that this Guaranty shall guarantee the performance of said Lease as so modified." Even with this language an argument can be made that without the guarantor's specific consent, he is released from liability when a substantive amendment is entered into. Nonetheless, inserting this type of language in the guaranty gives counsel for the landlord an argument that the guaranty is still operative, even with a subsequent amendment. The key point is, yes, this type of language should be in the guaranty, but why create the argument when the controversy can be avoided by simply having the guarantor execute the amendment with appropriate reaffirmation language?

2. **Income, Expenses, and Project Viability**

Your return is based on the cash generated from the project. Therefore, take extra care to verify that you are getting what you think you are getting from the outset. Hitting a home run in terms of profitability usually involves capitalizing on the unknown, for example, by leasing-up vacant space. Such future opportunities are unpredictable, a function of hard work and your entrepreneurial skill, but for now you should at least be able to confirm the current status of your income and expenses.

It is also important to have an understanding of the competitive market for the subject property. Is there a new project already approved or in the planning stage that could undercut the subject property's viability? You can do everything "right," but suppose the competitive project across the street is in foreclosure, the lender takes it back, and then sells it at far below your acquisition cost, allowing the foreclosure buyer to significantly undercut your asking lease rate. Analyzing reproduction costs versus the purchase price per square foot will assist you, in part, in determining your competitive advantage or disadvantage, but it is still crucial to have a handle on market sales and lease rates.

3. Third Party Reports, Inspections, and Tenant Interviews

A prudent buyer should conduct tests and engage various experts to conduct studies and evaluate the working condition of physical aspects of the project. Areas of concern often include HVAC, roofing, elevators, environmental issues, and code compliance. Often the buyer's lender will require some or all of the important tests and/or reports and will want to order the reports directly or, as with estoppels, control what must be included therein. I have witnessed all-cash buyers who, by lacking the discipline of a lender that requires third-party reports, shortcut the closing process only to find out that there are serious physical problems with the improvements that would most likely have been uncovered in a property condition report. The property condition study should address deferred maintenance and mechanical system issues. Typical concerns include the condition of the surface parking, the air conditioning system, and the roof. Do any of these areas require repairs that have been put off?

Third-party reports include title reports. This is usually the purview of the lawyers. Attorneys review the preliminary title report in conjunction with the survey. The title report sets forth items of record that affect the property such as liens against the property, that is, recorded trust deeds and unpaid real property taxes and assessments, easements, and covenants, conditions, and restrictions (CC&Rs). The survey will show matters of record as well as matters that affect the property and that can be discovered by plotting boundary lines and by undertaking a visual inspection (e.g., encroachments). Locatable easements can be plotted on the survey, so if it is found that an easement runs through a structure an endorsement to the title policy may be secured. The endorsement might, for example, ensure against damage to the owner's property in the event a repair is needed. For example, let us assume the easement is for a utility line that runs under a structure that is in need of repair. Primary responsibility for any damage would lie with the utility company, but the endorsement might add additional protection through the title insurance company.

It is also important to keep track of the progress of the commissioned reports or documentation. Timing is crucial. The PSA sets a time frame within which due diligence must be conducted. The necessary reports must be generated within this time period with enough wiggle room to react to a problem should an issue arise. Keep a spreadsheet showing when the various items were let and the scheduled delivery date. Make calls or send e-mails periodically to obtain a status report and to keep the vendor on target. Delays can occur in any of the contracted areas, but I have found the most likely problem areas surround the appraisal, the survey, counsel's opinion letter relating to the enforceability of the loan documents, zoning letters, the loan funding in general, and the estoppels in particular.

I attempt to use tenant interviews as a way to learn more about the property, but also as a means to get to know my prospective tenants/clients. Questions usually revolve around the property itself and around the tenant's intentions. Prior to the interview, it is a good idea to review the lease file and the tenant's rent history. The lease file should reveal if there have been complaints by this tenant. The tenant's rent history will show if this tenant pays his obligations in a timely manner.

Questions about the property should focus on the overall project as well as on a tenant's particular suite. A direct question works best: "What complaints do you have, if any?" I find it particularly productive to ask how the tenant would improve the project. Obviously, questions concerning the tenant's intentions are especially important the closer the interview is to their lease expiration date.

4. **Environmental Issues**

Environmental issues are a hot button today. Problems can arise relating to asbestos, polychlorinated biphenyls (PCBs), lead paint, underground storage tanks, ground water contamination, and the like.

The first step is to check out the property to be acquired and its past and present usage. The investigation should not stop there. It is also necessary to be concerned with adjacent properties and their usage, past and present. A former gas station or a dry cleaning facility that contains a plant could be a source of contamination. If a gasoline plume spreads to your property and the original contaminator is no longer around, or is judgment-proof, the environmental agencies look for a "deep pocket" to clean up the mess. If you are an owner or in the chain of title, they could be knocking on your door, even though fairness would suggest you are also a victim. Environmental insurance is a possibility, but like all insurance it only covers potential future risks, not known problems. If an environmental problem is identified, the buyer should and usually does call for a Phase II study, which is drilling with soil sampling. Even if the buyer agrees to pay for the testing, the seller's response is often, "You cannot drill. You must purchase 'as is.'" Why would a seller prohibit the testing? Possibly because the seller does not want to know that there is a problem. If a problem is uncovered, the seller might then be forced to clean up the contamination or, at a minimum, disclose the issue to the next potential buyer if the sale does not go through.

One of the risks that is often overlooked in connection with environmental problems relates to financing. Even though the loan may be nonrecourse, the carve-out liabilities in the loan documents or in a separate environmental indemnity agreement might pass to the borrower the risk applicable to environmental hazards. The result is personal liability for environmental problems. Are you willing to risk your home for this investment when there is a known environmental issue?

5. **Code Compliance**

A buyer must be cognizant of the fact that there are myriad code issues that must be complied with in connection with property ownership. Americans with Disabilities Act laws, zoning regulations, parking requirements, and setback restrictions are just a few of the laws that must be satisfied. Although correcting problems can be costly and therefore should be focused upon, code compliance issues are usually not fatal to an acquisition.

Dispositions

One of the most crucial decisions in real estate is the decision to sell or hold. You must recognize that if you elect to do nothing, you are in essence electing to hold. If you sell when the market cap rate is 9 percent, and two years later the cap rate is 6 percent, then, unless you had other overwhelming motivations, you sold too early. Conversely, if the market cap rate is 6 percent and then a year later there is a severe recession resulting in numerous tenant defaults and a market cap rate of 12 percent, the investor who is cash-rich, the investor who liquidated his properties, might have had the best crystal ball.

The problem with this discussion is that it is easy to be a Monday morning quarterback; you can always call the right move after the play. The main task is to call where you are in the cycle. If the cap rate is 9 percent, it could go to 12 percent or fall to 6 percent.

In evaluating where value is going to go, part of your analysis should focus on interest rate/cap rate trends. If the yield curve is going up, it is probably going to go up longer than you anticipate. If the yield curve is going down, it probably will go down longer than you thought it would.

Another factor to focus on is the general economy. Are foreclosures up or down? Has unemployment increased or decreased? What is the outlook on bankruptcy filings? Has there been an increase or decrease in bankruptcy filings from last year? The gloomier the economic outlook, the worse things look, the greater the number of people who will be forced to sell. More sellers mean more inventory, more inventory means that for a seller to consummate a sale he must lower his price. Cap rates increase.

Understand, for every completed transaction, there is always a buyer and a seller. What increases or decreases price is when, at any point in time, there are more buyers than sellers or more sellers than buyers. If there are more buyers, then sellers have a bidding war. Multiple buyers push prices upwards. In contrast, if there is a glut of properties on the market then the oversupply will tend to dampen prices. Sellers, in order to compete, will lower their prices so that their property, rather than their competitor's real estate, is sought after.

Federal Reserve policy is another key indicator of where the market is going. Policy decisions made at the Open Market meetings are very informative in terms of where the Board views the economy trending and, of course, its policy decisions directly affect the trend. If the Fed increases interest rates, capitalization rates should eventually go up and values will decrease. Interest rates affect the cash-on-cash return an investor can derive from his ownership. Interest rates as reflected in T-bills, commercial paper, or bonds are viewed, essentially, as an alternative investment to real estate. An investor can acquire an ownership interest in a commercial real estate development or he could buy a bond, which is an agreement to pay interest at an agreed rate of return. Increases in bond yields should force real estate prices to fall. If bond yields are returning 5 percent, real estate yields might be 7 percent. Bonds are obligations by corporations or governmental entities or some other obligor to pay a stated return. The bondholder merely "clips the coupon." The bondholder does not have to actively run a real-estate investment to receive his return. He relies solely upon the good faith and credit of the debtor to pay its obligation. The risk is a function of the creditworthiness of the debtor. Bond yields could be lower or higher than receipts from a real estate investment. It depends on the creditworthiness of the obligor, meaning the likelihood that the obligor will meet its debt obligations. In general, however, when you compare municipal bonds or high-grade corporate bonds to a generic real-estate investment, the bond yield will be less risky and therefore priced to generate a lower return. Consequently, if bond yields go from 5 percent to 7 percent, real-estate yields, to maintain parity and competitiveness, might increase from 7 percent to 9 percent.

Real-estate lender's loan pricing is also a good barometer of what is on the horizon. If lenders are tightening credit, increasing spreads, lowering loan to value ratios, they are obviously saying difficult times are ahead.

In my opinion, an indicator that factors in all of the above and is probably the most important trendsetter is market psychology: *What do people think is going to happen?* For example, if everyone believes that rates are going up, people borrow now before the rates go up and this increased demand pushes rates up. Conversely, if everyone thinks interest rates are going to decrease, they hold off borrowing today, planning to catch the lower interest rates in the future. The decreased demand forces lenders to lower their interest rates to attract more borrowers and rates decrease.

Similarly, if everyone believes the economy is going downhill, they lower sales prices and cap rates rise. If the general public feels the economy is robust, that the economy is doing well and will do well forever, then sellers increase their prices and are reluctant to sell for less than their purchase price.

The problem with predicting interest rates, cap rates, and value is that there are a myriad number of factors that influence the final outcome. Some of these factors are dependent, some independent. The world has gotten smaller: What happens in Germany, China, and Japan affects us domestically and vice versa. Fed policy, domestic trends and statistics, and people's perceptions all taken together can result in a confusing picture.

Rule Number 21

The trend is your friend. Go with the trend.

The previous discussion still begs the pivotal question: Should I sell or hold?

There is a lot of built-in bias against selling. A sale results in a taxable event, unless you fall within an exemption such as a 1031 trade, which is an event in which you sold, but you also bought back into real estate. Also, there are transactional costs associated with a sale; that is, lawyer's fees, sale brokerage commissions, title charges, escrow fees, documentary transfer charges, and so on. As a seller, you also have the problem of what to do with the proceeds once received. This might seem like a good problem to have, but if you are making 10 percent plus on your equity investment and the banks are paying less than 1 percent on deposits, it is a concern. Last, depending on the existing financing, the seller may be saddled with a large prepayment penalty or defeasance premium.

Motivational factors that might push toward the sale decision include the following 12 items:

1. The owner has created tremendous value through lease-up, changes of use, or other value-added activities and would like to capture this value.
2. The owner wants the funds to invest in another business opportunity.
3. The owner's analysis shows that his cash-on-cash return on equity is small in comparison to what he might earn if he cashes out and invests in other ventures.
4. The owner perceives a major risk that he would like to avoid such as:
   a. A large maturing lease that the owner knows or is concerned will not be renewed.
   b. The potential passage of new legislation that could cripple a major tenant or tenants. State and federal laws can have tremendous impact on the operational profitability of certain businesses, especially those businesses that are heavily regulated. For example, several years ago California enacted a fee schedule applicable to outpatient surgical centers. The schedule drastically reduced the amount that could be charged for certain procedures and therefore overnight significantly affected the profitability of some centers.
   c. External events can adversely damage a real-estate project. For example, if a 125,000-square-foot neighborhood shopping center is anchored by an 80,000-square-foot supermarket and the supermarket shutters its doors, this development could have a severe negative impact on the side shops that might have depended upon the supermarket's traffic for a percentage of their customers. A similar effect might occur to a medical office building on the campus of a hospital if the hospital closes. Also, construction might have a negative impact. I have witnessed city sidewalk and road construction take such an extended period of time that it negatively impacts a hotel's volume as well as retail-store foot traffic.
5. Conflicting goals and possible discord within the ownership structure. If there are multiple owners, the owner's goals and/or financial picture may change over time, leading to differing opinions as to issues that arise. A sale could be a solution to these conflicts.

6. The owner perceives that the time is right, given the cyclical nature of real estate.
7. The owner is a real-estate fund or a publicly traded entity that has a specified disposition target date. The owner wants to show profitability to its investors.
8. The owner is pressured or forced to sell under duress by, for example, the loss of significant tenants coupled with a maturing loan.
9. The owner realizes that he made a bad investment and feel that now is the right time to cut losses.
10. The highest and best use entails specialized skill or capital that the present owner lacks. The owner envisions that he can capture some of the upside by selling to a party that is capable of capitalizing on the project's potential. For example, a major shopping center or a large high-rise office building can be constructed on the site, but the current owner does not have the know-how to build the project.
11. The current project is taking an inordinate amount of the owner's time and energy. A sale will free up the owner to concentrate on more lucrative endeavors.
12. Estate planning concerns that render a sale the most practical and cost-effective option.

The Refinance Alternative

When analyzing whether to sell or hold, the alternative of a refinance should be considered. Let us assume you purchased a property for $5 million and obtained a $4 million purchase-money mortgage. Let us assume further that five years later the property is worth $10 million. You could sell and receive $6 million to reinvest, but the problem is that your silent partners, the state and federal governments, will have their hands out for a large share of your profit. The gain on the sale is measured by subtracting the sales price from your basis. Basis is defined as initial purchase price plus capital improvements less depreciation. Hence, if you held the property for a long period of time, your basis might be fairly low, given the depreciation write-offs, and therefore the capital gain on a sale quite high. Alternatively, if you refinance at $7.5 million (75 percent loan to value) you pull out $3.5 million less any defeasance penalty and costs tax-free and still own the property!

Is not the refinance a partial sale for 75 percent of the property's value? Yes, but the tax code does not look at it that way. Since you have not sold there is no taxable event! Please note, however, there may be a mortgage in excess of basis issue, but there are ways to ameliorate this problem. In contrast, if you sell for $10 million and your basis is zero ($5 million cost less depreciation) your gain is $10 million—100 percent subject to taxation!

This analysis becomes somewhat more complicated, since most owners who elect to sell will then seek to defer the gain through a 1031 exchange.

As discussed in Chapter 6, Section 1031 is the Internal Revenue Code provision that permits you to defer the gain on the sale of real property if you meet its strict requirements, namely:

- Both the property sold and the real estate purchased must be "like-kind" property held by the taxpayer for investment, business, and/or production of income.
- The taxpayer may not have actual or constructive receipt of the net sale proceeds.
- Identification of the up-leg must occur within 45 days, closing within 180 days.
- Both the up-leg and the down-leg must be located in the United States.
- In addition, in order to be fully tax-deferred:
  - All of the cash coming out of the relinquished property must be reinvested into the replacement property.
  - The up-leg must have equal or greater debt then the down-leg.
  - The exchanger may not receive any non-like-kind property.

Given the strict requirements of 1031 exchanges, the search for the up-leg is not always successful. Accommodators report that a good portion of the funds placed into the accommodation accounts are returned to investors.

When pressured to identify an up-leg and save taxes, the taxpayer may be inclined to purchase a marginal property that has minimal upside. The investor should not make a bad deal simply in order to avoid taxes. Given the difficulty of identifying an up-leg, the sale versus refinance decision might tip toward a refinance.

Who Is More Vulnerable, the Seller or the Buyer?

The buyer spends money performing his due diligence and is assuming the seller is in good faith. If the buyer discovers problems sufficient to warrant canceling escrow he has wasted a lot of money, time, and energy.

On the other hand, the seller's property is tied up as due diligence goes forward. If the buyer does not perform, the seller has wasted time and energy assembling the due diligence material.

Either or both parties may be contemplating an exchange and need to effect the transaction to accomplish their goals. The buyer may have sold a property and has designated this property the up-leg. The seller may be in a long escrow with the intent to sell the subject property and then close on the escrowed property. Reverse exchanges, wherein the seller sells first and then trades into the exchange property, although possible, are not common. If a party is trying to accomplish an exchange, it is most likely to be the buyer.

It can be argued that, on balance, it is the seller who is more vulnerable than the buyer from the initial contract stage through the due diligence period. The reason is due to Rule Number 18. If a contract is properly drawn, you can always force a seller to sell, but you cannot force a buyer to buy. The contractual relationship between parties gives the buyer a way out in the form of a contingency period wherein the buyer must approve or disapprove the condition of the property, the financing, and so on.

Once the time line has passed and the buyer has approved the contingencies, arguably the balance of power shifts and the buyer has potentially more to lose. The buyer has committed and usually the contract now provides that the earnest money deposit is at risk. Indeed, it is often required that the earnest money deposit be increased at this juncture.

Notwithstanding the above, I believe that in general it is the buyer who is more vulnerable in a purchase/sale transaction, because the buyer starts from day one spending nonrecoverable monies whether he closes or not, and whether the seller has improperly disclosed or not. Additionally, more often than not, it is the buyer who is contemplating an exchange that, if not closed, can have severe tax consequences.

The Sale Decision Has Been Made

If you have decided to sell, your next question becomes, What should be done to prepare for a sale?

- ❑ **Step 1:** Review the existing financing and explore possible alternative financing. Can the existing financing be paid off? If it can be prepaid, what is the cost? Inquire if the existing lender would be interested in rewriting the loan and, if so, under what terms? What loan terms can be secured from other competitive lenders? Can the existing loan be assumed? If it can be assumed, what is the price? The seven key factors in a loan set forth in Chapter 5 should all be explored, that is, liability, type of loan, amount of the financing, the interest rate, the amortization, prepayment penalty, and the ability to assume the loan.
- ❑ **Step 2:** Walk the property and make a checklist of any deferred maintenance items. This is just an extensive cleanup list. Are the trash enclosures clean? Are the trash bins in good condition? (Usually a disposal company supplies the containers. At zero cost to the property owner, the trash vendor will usually switch out the old bins for new containers.) Is there trash that has accumulated on a perimeter fence? Is there garbage under exterior stairwells? (Paper and garbage often accumulate in areas that block its flight from wind or in areas that are not readily accessible.) If the project has a tenant storage area, that area can often be a dumping ground and might need attending to. Janitorial closets, electrical and mechanical rooms, elevator control rooms, HVAC areas, and the like should all be checked. The objective is neatness and cleanliness. A buyer is willing to consider a significantly higher price when viewing a well-run, immaculately clean property.
- ❑ **Step 3:** Reflect on ways to cosmetically improve the overall aesthetics of the project. Most properties can benefit greatly from a fresh application of lipstick: painting the exterior, slurry coating the parking area, and freshening up the landscaping. A project can be greatly enhanced by creative use

of paint. New contemporary colors or, for example, a contrasting reveal can, for a modest expenditure, completely change the look of the project. Lighting and signage are two other areas that might be in need of a updating or a cosmetic makeover.

- ❑ **Step 4:** Bring up to date preventative maintenance items so that the buyer's inspectors will give the project an A+ evaluation. For example, the HVAC units should be serviced if they have not recently been worked on. Minor repairs can be done if needed and the filters changed. If the project has rain gutters, are they in need of cleaning?
- ❑ **Step 5:** Given that you ultimately intend to sell the project and therefore will seek to maximize your net income, and hence your sales price, think in terms of obtaining the upper limit in the band of monthly rent. In other words, if you are negotiating with a tenant and the tenant is seeking to obtain a lower rent per square foot, rather than reducing the base rent you can offer other concessions, such as free rent or a larger tenant improvement allowance.
- ❑ **Step 6:** Reflect on a marketing program and commit it to writing. This should include a marketing brochure or flyer.
- ❑ **Step 7:** Get all of the necessary paperwork in order. This includes ordering a preliminary title report and all of the items that show. Then, of course, review the preliminary title report to verify that there are no issues—and if there is any issue, resolve it. You should also make sure that all of the documentation relating to the ownership entity is current and readily available. For example, if the owner is a limited liability company, have the "articles of organization" (as they are called in California) been recorded? This documentation is also referred to by the form reference "LLC-1." Do you have a copy of the fully executed operating agreement and documentation that the entity is qualified to do business in the state where the property is located?
- ❑ **Step 8:** In anticipation of a sale, a purchase and sale agreement might be prepared, which would include key items of importance to the seller such as specific disclosures, for example, the presence of asbestos and an acceptable "as is,

where is" provision. I highly recommend not using a "standard" AIR form, unless it is modified to delete, for example, mandatory mediation and binding arbitration.

Sell In-House or through a Broker?

Okay, you have gone through the eight steps set forth above and you still want to sell the property. The next question that must be addressed is, How you are going to market the project? Do you want to hire an outside broker, or should you attempt to market the property yourself? To some extent this question revolves around your ability, the available time you have, and your perception of the value of a sales broker. Most sales of commercial property are conducted through the broker network. In general, the perception is that the price that can be obtained will exceed the monies paid to a broker representative. Nonetheless, the ease with which a property can be marketed through loop net or other on-line services today arguably lessens the necessity for a commercial sales broker or leads to a compromised agreement with a reduced fee if the owner procures the buyer.

If you decide to hire a broker to market the property, at least two brokers should be interviewed prior to selecting the best candidate. At least this is so unless there are other motivating factors, such as a long-standing relationship with a particular broker or a particular brokerage company or the possibility that a qualified broker with the proper expertise is a partner in the project. In my real estate firm, we tend to go back to the broker that originally brought us the project, provided we have a continuing relationship with that individual and his firm. This is not a contractual requirement, but rather we view it as a "reward" for bringing us the project in the first place.

If you elect to hire a broker to market your property, a listing agreement should be entered into. Issues that must be addressed include:

- The type of listing, exclusive versus nonexclusive.
- What is the commission amount?
- When is the commission due?
- How are cobrokers to be treated?
- Are any potential buyers excluded or included at a lower commission level?

- Frequency of meetings and written reports. Several of these issues will be expanded upon in Chapter 10, which further addresses the leasing broker relationship.

Of course, if a third-party broker is hired to market the project, their assistance should be sought relative to step 6: your marketing program.

Actual Numbers versus Scheduled or Potential Numbers

When reviewing a real estate financial presentation, whether it is a “for sale” prospectus or a presentation seeking financing, it is crucial to understand the assumptions that underlie the package. Often, in order to push value, the model will use scheduled rents for vacant units and then build in a vacancy and collection loss factor that is less than the actual vacancy and collection loss numbers. In other words, if the actual project is 15 percent vacant, then the analysis might show gross rental numbers as if the project were 100 percent leased, with the vacant space rent equal to what the owner is currently marketing the space for or what the rent per square foot was for the last signed lease. The pro forma then reduces the rental stream by a vacancy and collection loss factor of 5 percent on the basis that this number represents “stabilized” occupancy. The logical misstep in this analysis is that if this truly represents “stabilized” occupancy, then why has the current owner not achieved this result? Additionally, often the analysis fails to properly account for the down-time necessary to achieve the assumed lease-up or its full costs in terms of tenant improvements, leasing commissions, free rent, and the like required to achieve the 100 percent leased goal.

The Long Run versus the Short Run

A very wise man once said to me that you measure productivity and success over your entire life, the long run, rather than over the immediate future, the short run. Real estate has its ups and downs. The trick is to be able to withstand the down cycles, because in the long run, almost all real estate projects come out winners. It might take years rather than days, weeks, or months, but if you can survive the vagrancies of the low points in the cycle, there usually is a positive upside that will allow for profitability.

A mantra that everyone learns in a beginning course in real estate is “location, location, location.” The basic concept is that where the property is located is the most important ingredient in evaluating the worth of a piece of property. You can change the physical structure of improvements, but you cannot, as a general rule, change the nature of the area in which the property is situated. Location is certainly a very important factor. Nonetheless, it certainly is not the only factor. Another real estate mantra is that "one person's loss is another person's gain." Most great buys in real estate are made when someone has miscalculated or failed to achieve a property's potential. The miscalculation may be due to a purchase during a high point in the cycle and an inability to carry the property when values fall. The inability to carry the property may be because a loan has come due and the property no longer underwrites for the existing loan balance and/or has a heavy vacancy factor. Similarly, the failure to achieve a property's potential may be due to a multitude of reasons, including mismanagement, failure to follow through and execute on a lease-up game plan, losing a major tenant, general economic conditions, and on and on. Often another key ingredient is timing. I have seen the same property be unsuccessful with one person, yet very successful with another group. The difference was timing. Therefore, possibly the classic real-estate mantra should be revised to say, "Location and timing, location and timing, location and timing." It is great if one is able to time an acquisition to buy at the low point in the cycle, but that often does not happen perfectly. No one can call the market perfectly. Truly sound planning and strategy should emphasize how to be able to weather the hard times. Having *staying power* ideally translates into:

- Conservative financing (not being overleveraged).
- Adequate reserves put into the project.
- An equity structure that is not heavily fee-driven and that ensures the owners will support the project.
- A deal structure that places the investor's interest on the same side of the table as the sponsor's goals.
- Owners with a conservative lifestyle, who can, themselves, withstand financial storms.

Rule Number 22

Staying power is the most important success principle in real estate.

Wealth Opportunities in Commercial Real Estate: Management, Financing, and Marketing of Investment Properties
By Gary Grabel

CHAPTER 8

Case Studies

The problems posed in this chapter are intended to respond to what has been covered so far or to introduce new material by setting forth a factual scenario that contains either errors in analysis or issues that should be discussed. As you go through the problems, I suggest attempting to spot and then jotting down errors or issues. You might get a sense of a potential problem even though you are not sure how it should be resolved. Your detective work can then be judged against the book's analysis of the problem. Good hunting.

Problem Number 1

Assume the following factual scenario:

1. Peter and John own Highpointe Center, a 100,000-net-rentable-square-foot shopping center located in Chino Hills, California. They purchased the center in December of 1998 through a limited liability company, Highpointe, LLC. Peter and John each have a 50 percent interest in Highpointe, LLC. They purchased the Center for $4,000,000. At the time of acquisition they put $1,000,000 down and financed the balance with a purchase money mortgage of $3,000,000.
2. Two months after they purchased Highpointe Center, John finds a buyer who is willing to pay the partners $5,000,000 for Highpointe: a one-million-dollar profit in two months! Peter and John get into an argument about the ability to defer the gain if they trade into a larger property. Peter argues that

the IRS will consider their company a "flipper," a party who holds a property for "resale," and would therefore disallow any trade. John avers that the key test is "intent" and he claims "his heart is pure." When he bought Highpointe Center, he intended to keep it long-term as investment real estate; just because a great opportunity came along, that should not taint his intention. Also, they will straddle two tax years. They bought in 1998 and will sell in 1999. John argues that the Code does not spell out any precise holding period to qualify for a Section 1031 exchange.

3. Peter and John decide to let their tax attorney friend, Alfred, decide the issue. Alfred agrees to act as mediator, but jokingly indicates that his fee will be the million-dollar profit. Alfred, as a conservative tax attorney, sides with Peter. He argues that it is safer to hold the property for at least a year and a day to qualify under the 1031 rules.
4. Based upon Alfred's advice, Peter and John put off selling Highpointe. Fast-forward eight years. The investors have made improvements to the property and have also taken depreciation over the past eight years. Their current basis in Highpointe Center is $3,000,000. In anticipation of selling Highpointe in August of 2007, Peter and John refinance the Center, obtaining a new loan for $6,000,000. Peter and John net $3,000,000 out of the refinance. Although the original loan has amortized slightly, there are offsetting closing costs.
5. Two months later, in October of 2007, Peter and John enter into escrow to sell Highpointe for $8,000,000 with a 45-day due diligence period and a 30-day closing thereafter. Peter realizes that he will have a $2,500,000 profit ($8,000,000 sales price less $3,000,000 basis divided by two). Peter desires to trade his interest pursuant to Section 1031 of the Internal Revenue Code. John, on the other hand, is tired of the hassles associated with managing real estate and decides to retire with his net proceeds to Puerto Vallarta, Mexico. Peter and John figure that when the dust clears and Highpointe is sold, the total proceeds will equal $5,000,000: $3,000,000 from the refinance and an additional $2,000,000, which is the amount of their remaining equity over the $6,000,000 debt.
6. In anticipation of selling Highpointe, Peter sets up an account with his brother, Paul, to act as a facilitator, also

known as a Section 1031 trustee. Peter uses his brother, even though Paul has spent some time in jail for tax fraud, to act as accommodator because he trusts his brother—and $2,500,000 is a lot of money! Peter has heard stories about accommodators running off with the monies they held in trust. The result is that not only does the taxpayer lose his money but, even worse, since he no longer has the funds from the sale he may lack the resources to close on the up-leg and therefore must pay taxes on the sale transaction and possibly, depending on the timing, may be in breach of contract on the up-leg. Peter has total confidence in his brother Paul. He knows that Paul would never cheat him—after all they have the same mother—but he is somewhat concerned given that Paul's financial position is not very strong. Paul has had a problem getting and holding a job since he got out of prison. In fact, Paul has mentioned to Peter that he is contemplating bankruptcy.

7. On November 15, 2007, the Highpointe buyer approves all of the due diligence contingencies. The Highpointe sale closes on December 15, 2007. A few days later on December 22, 2007, Peter gets a call from his in-house bookkeeper, Arthur, who indicates that he has $100,000 in the Highpointe bank account. He asks for instructions on what to do with the cash. Peter yells "Get the money immediately to the accommodator, there isn't a moment to be lost!" Arthur messengers the cash over to Paul with instructions to deposit it into the Highpointe trade account.
8. When the sale closed, Peter's share of the sale proceeds were transferred to the accommodator, Paul. To celebrate the closing on New Year's Eve, December 31, 2007, Paul takes his family and Peter's family out to an Italian buffet dinner. To pay for the party, Paul gives Peter all of the interest that has been earned so far on Peter's net sales proceeds from the Highpointe sale.
9. On New Year's Day, January 1, 2008, Peter receives a call from John in sunny Puerto Vallarta, Mexico. John has found Peter's up-leg, Hotel Beautiful, a 50-room luxury hotel in Puerto Vallarta in close proximity to the sand and ocean. The hotel is on a long-term 99-year ground lease with 29 years remaining. Peter is ecstatic since he has been busy completing

his 2007 tax returns and has not had time to hunt for the replacement property. Peter files his 2007 return January 15, 2008. He is very happy to get that chore out of the way. Peter tells Paul to register Hotel Beautiful as his up-leg. To make sure he is safe, Peter identifies five additional properties with a combined value of $25,000,000.

10. Peter enters escrow to purchase Hotel Beautiful on January 27, 2008, within the 45-day identification period. He looks at his calendar and figures that he closed the sale of Highpointe on December 15, 2007, so that gives him until February 15, 2008, to identify the up-leg(s) and go into escrow, which he did, and then 180 days from February 15, 2008, to close on Hotel Beautiful, that is, until the end of October 2008. Peter does his time table very accurately, consulting a calendar, since he understands that when determining the identification period and the reinvestment period for a 1031 exchange, one must be 100 percent accurate. Peter wants to make sure he counts only business days, Monday through Friday, and does not include the weekends or legal holidays such as the Fourth of July.

11. The agreed purchase price for Hotel Beautiful is $5,000,000. Peter's strategy is to purchase Hotel Beautiful with 100 percent of the net proceeds from the sale of Highpointe—$2,500,000 and the $100,000 that Arthur found after the sale closed—plus an old houseboat that the seller has agreed to take as part of the payment. Peter and the seller have agreed the houseboat is worth $100,000. Peter figures that he will never touch any money from the sale of Highpointe and therefore he will defer all of his taxes. In connection with the acquisition for Hotel Beautiful, Peter intends to secure a new $1,000,000 loan from his bank, with the seller taking back a second trust deed in the amount of $1,300,000, the balance of the purchase price.

12. Peter closes the purchase of Hotel Beautiful in May of 2008, well within the 180-day reinvestment period. Peter remembered the 200 percent rule and did not close any of the other identified properties. He did not want the IRS to be able to make any argument that his trade was invalid, so he avoided the criterion that the value of the replacement properties must not exceed 200 percent of the relinquished property.

13. Peter assumes that since all of the monies in the trade account from the Highpointe sale have been used to buy Hotel Beautiful, he is finished with the 1031 trade. Peter calls Paul and instructs him to close the accommodation account and to send him any remaining interest in the account.
14. Please refer to Exhibit 8.1 for a graphic depiction of the significant events set forth in Problem Number 1.

What issues arise, given the fact pattern depicted in Problem Number 1?

1. There is no specific designated holding period to qualify for a 1031 exchange. However, Alfred's advice is sound. To be on the safe side, it is prudent to wait a year and a day. This time frame assures that the taxpayer will straddle two tax years and is long enough so that the IRS would have a hard time arguing that the property was purchased for resale. Notwithstanding this general principle, John is correct that the test is intent and if the taxpayers can establish that their intent was to hold the property for investment when purchased, a trade of Highpointe would be eligible for 1031 treatment even if held for only a short period of time.
2. A refinance in anticipation of a Section 1031 trade results in a profit up to the refinance proceeds. To avoid taxation, there must be a legitimate reason for the refinance unrelated to the sale, such as paying off a maturing loan. Peter and John also have created the mortgage over basis scenario. Since title is held in a limited liability company, partnership tax rules apply and the mortgage over basis is not a taxable event, provided the debt is allocated to each partner. A negative capital account is permissible. Please note that a limited liability company can elect to be taxed as a partnership or as a corporation.
3. It is improper to trade a fractional interest. Peter is apparently attempting to trade his 50 percent ownership interest in Highpointe Center. His 50 percent interest does not qualify as a "like-kind" property. In order to effectuate an exchange, Peter would have to trade on the property ownership level. In other words, Peter must use Highpointe, LLC, to acquire the up-leg, not part of the ownership in Highpointe, LLC.

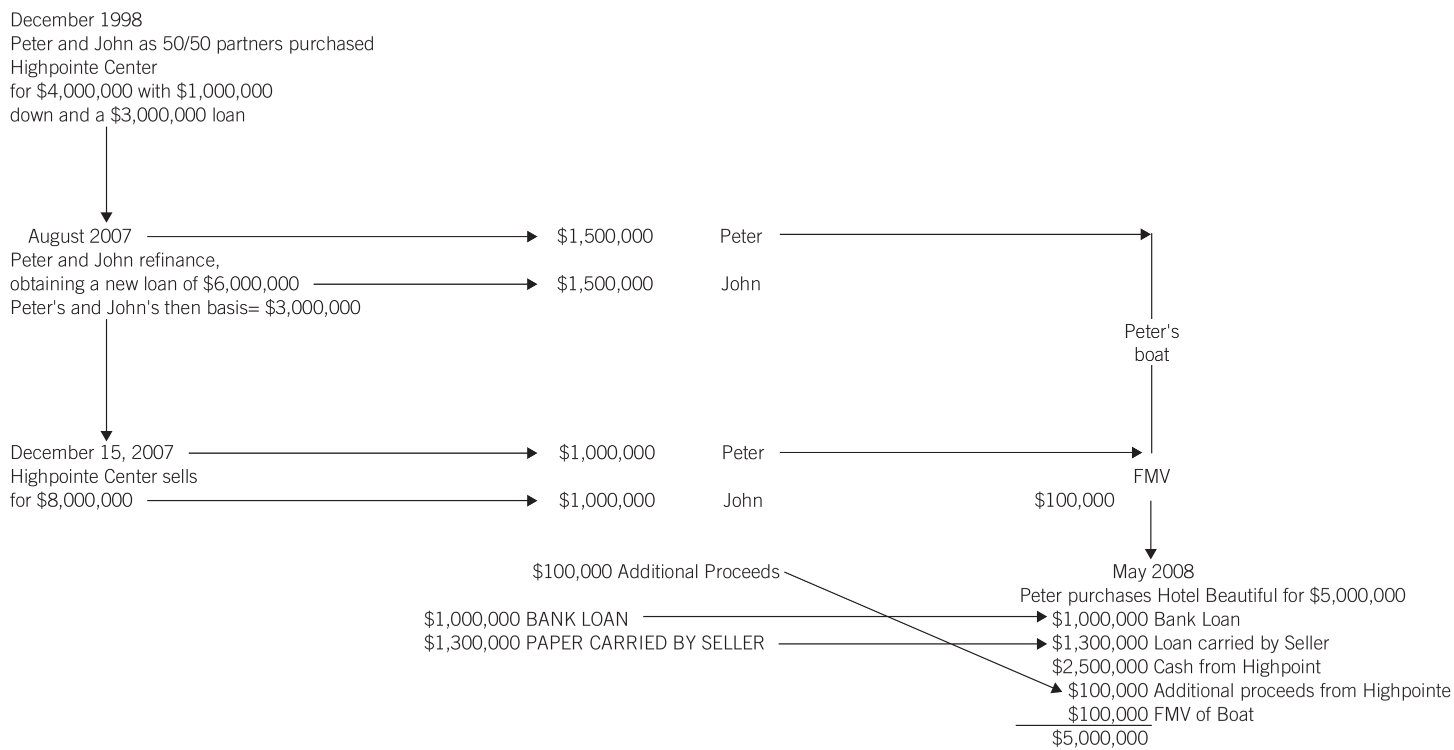


Exhibit 8.1 Problem Number 1

Peter could buy out John's interest in Highpointe, LLC, or Peter and John could each hold title in the Center through separate and distinct tenant in common interests. When separate entities hold tenant in common interests, each holds an undivided interest in the real estate, not a fractional interest. Therefore, it is permissible to trade a tenant in common (TIC) interest. To create two TIC interests, Peter could withdraw from Highpointe, LLC, and have his interest deeded to another entity, such as Highpointe II, LLC. Peter and John would enter into a TIC agreement to govern the management of the center. If Peter and John elect to go in this direction, they should review the applicable loan documents. Most likely, the trust deed will provide that a transfer of 50 percent of the borrowing entity requires the lender's consent and possibly the payment of a transfer fee even though there has been no substantive change in ownership.

It should be noted that the timing of when the TIC interests are formed can be crucial. It is important to avoid any inference that the property is held for sale rather than for investment purposes. It would therefore be preferable for the Peter, the party who seeks to trade, to retain his interest in Highpointe, LLC, which has been consistently been held as an investment property. If a new entity is created during a sale escrow, the IRS could argue that this entity intended to hold its interest in Highpointe Center for sale rather than as an investment and is therefore not like-kind property. Ultimately, the issue boils down to intent since most contracts for purchase do not close.

An alternative for Peter and John to consider would be for John, the nontrading partner, to keep his share of the sale proceeds with the accommodator and take distribution of his $1,000,000 after Peter's exchange period is complete. Disadvantages for structuring the transaction in this manner include (1) potentially tying up the nontrading partner's capital for an extended period of time and (2) accruing accounting fees that can be costly.

4. The individual or entity who receives the net proceeds from the investor's sale of a property may not be a "disqualified party." Paul is a disqualified 1031 trustee. Paul's criminal past does not disqualify him; a felon may be an accommodator.

However, family members may not act as facilitators. Family members include the investor's brother, sister, his spouse, his parents, and grandparents and lineal descendants. The rule is that the investor must avoid actual and constructive receipt of the net proceeds. If the monies are given to the investor's brother, for purposes of qualifying for a 1031 exchange, it is as if the funds went to the taxpayer. The Section 1031 trustee may be any person or entity, except a family member or any business entity controlled by the investor. Also, Paul's imminent bankruptcy should be a concern to Peter. In a court case known as the LandAmerica 1031 Exchange Services case, the court held that the money held by the bankrupt accommodator was to be included in the bankruptcy estate as funds available to its creditors. The court noted that the LandAmerica exchange agreement gave up the taxpayer's right, title, and interest in the exchange monies to the accommodator. Also, the court indicated that state law controls whether or not the exchange funds are part of the bankruptcy estate. California law, unlike the state law that controlled in the LandAmerica case, provides that exchange funds held by a qualified intermediary are not subject to attachment by the accommodator's creditors.

5. Interest disbursed to the investor prior to closing the up-leg disqualifies the exchange. It is permissible for the investor to earn interest on the monies deposited with the Section 1031 trustee. However, the investor may not receive any of the interest until all of the replacement properties have been acquired by the investor. If the investor receives any interest prematurely, the entire Section 1031 exemption will be denied. Consequently, it would not be a good tax-planning move for Peter to pay for the New Year's Eve celebration dinner with the interest earned on the monies held by the accommodator.
6. An individual or entity that functions as a professional accommodator would probably return the $100,000 delivered by Arthur the bookkeeper. These funds would probably not be reflected on the sale closing statement. Before Peter directed Arthur to "immediately transfer the monies to the accommodator," it would have been prudent for the taxpayer to have inquired about the source of these monies. If the money

is not accounted for in the sale escrow, the funds probably are the taxpayer's funds earned prior to the sale. Three main sources of these funds include: (1) cash in the down-leg account pre sale, which would be the seller's funds not associated with the sale; (2) funds paid to the taxpayer that were held in the lender's various buckets, such as tax and insurance impounds, the reserve for tenant improvement and leasing commissions, or the cap X reserve (again, these monies were earned and distributed to the taxpayer's pre-sale and are therefore the seller's funds and not part of the sale proceeds); and (3) depending on the agreed arrangement between buyer and taxpayer/seller, rents that flow in to the seller after the close. (For example, it is common for the parties to prorate as of the closing date with the buyer receiving credit for rents due, yet unpaid. The seller then collects and keeps all of the rents for the month of closing. In other words, let us assume the closing occurs on the tenth of the month. All of the rents are collected by the seller and kept by the seller. The portion of the rents attributable to the first 10 days is the seller's pre sale monies and the portion of the rents relating to the balance of the month is not sale proceeds but rather, in essence, reimbursement monies to the seller since the buyer was given a credit for these rents in escrow.)

7. Foreign real estate located outside the United States does not qualify as "like kind" for purposes of Section 1031. The hotel in Puerto Vallarta may not be used as the up-leg for domestic based real estate. No limitations are placed on the value, size, or location of the property involved in a Section 1031 reinvestment plan, as long as the properties are located in the United States. It is permissible for a California resident to trade property he owns in upstate New York for land in Alaska or Hawaii, but the replacement property may not be located outside of the United States.

8. A leasehold estate in real property will qualify for Section 1031 treatment as long as the remaining term under the ground lease exceeds 30 years. The 30-year period may include extension options. In the hypothetical, the remaining term is 29 years and hence a leasehold interest in Hotel Beautiful would not qualify for Section 1031 treatment.

9. The rule everyone remembers is that you must close the up-leg within 180 days of closing the down-leg sale. The rule requires the 180-day closing, but also requires the up-leg to be purchased before the taxpayer's tax return for the year of the sale is actually filed or before the due date for filing this tax return, including any extensions. In the hypothetical, Peter filed his return before acquiring the up-leg. He closed out his tax year and his Section 1031 reinvestment plan at that point in time and is therefore not able to take advantage of the full 180-day reinvestment period that would otherwise be available. The consequence is that the taxpayer must report the sale of Highpointe Center in his 2007 return, which was filed before he acquired Hotel Beautiful. Peter may not defer his gain and he may not transfer Highpointe Center's basis over to Hotel Beautiful.
10. Peter miscalculated the identification period and the reinvestment period. Both the 45-day identification period and the 180-day reinvestment time frame counts every calendar day including Saturday, Sunday, and legal holidays. Also, the 180-day exchange period runs from closing of the down-leg, not from the end of the identification period.
11. If you identify three or fewer properties, there is no limit placed on the value of the identified properties. However, if you identify more than three properties, the two hundred percent rule applies. This rule applies at the identification stage regardless of which properties the taxpayer actually purchases. The rule states that if more than three properties are identified, then the combined value of the identified properties may not exceed 200 percent of the relinquished property. Peter violated this rule.
12. Regarding the boat given to the seller of Hotel Beautiful as part of the down payment, since the boat does not qualify as Section 1031 property, this transfer would be treated as a separate taxable event. The gain or loss on the boat contribution would be determined based upon a comparison of the value of the boat to its basis. If, for example, the boat had a $50,000 basis, the taxpayer would have to report a $50,000 profit. The basis plus the profit, a total of $100,000, would be added to the basis of the replacement property.

13. Does a hotel qualify as "like-kind" property that may be traded for other "like-kind" property? Yes, hotels and motels are treated as property used in a trade or business and therefore qualify as "like-kind" property.

14. Peter never "touches the money." Ignoring the issue of a refinance in anticipation of a trade and the tax consequences surrounding a mortgage in excess of basis, based solely on the financial numbers from the sale of Highpointe and the purchase of Hotel Beautiful, must Peter report a gain on sale? The analysis would appear as follows:

	Relinquished Property	Replacement Property	Difference
Sales Price:	$4,000,000	$5,000,000	+1,000,000
Debt:	$3,000,000	$2,300,000	−700,000
Equity:	$1,000,000	$2,700,000	+1,700,000
Cost Basis:	$1,500,000	$1,500,000	0

Peter owns a 50 percent interest in Highpointe Center. Therefore, 50 percent of the sales price, debt, and equity are attributed to Peter. Peter's share of the existing debt is $3,000,000. It is being replaced with a new loan of $1,000,000, plus seller-carried paper of $1,300,000, for a total of $2,300,000 in debt. Peter is going down in debt and appears to have mortgage relief of $700,000. However, remember Technical Rule Number 1: Mortgage relief must be reported as recognized profit, unless it is offset by the taxpayer's execution of a new loan, assumption of debt, or contribution of cash. In the above fact pattern, Peter is contributing $1,700,000 in excess of his equity in the down-leg and therefore this cash infusion offsets the mortgage boot. Also, as just mentioned, there is no cash boot since Peter has injected all of the money from the sale of Highpointe plus additional cash. As part of the trade, Peter received $100,000 of value for his houseboat. The houseboat does not qualify as 1031 property and, depending on Peter's basis in the houseboat, a gain or loss must be recognized in connection with the transaction.

Logically if you meet the no-debt-relief test and the no-cash-out test, you should have also met the trade-up in value test, because if you add the mortgage assumption or new loan and the cash generated by the sale, that should, by definition, equal or exceed the sales price.

15. If you designate more than one potential up-leg, the trade is not completed until all of the designated properties are purchased or the 180-day closing period has expired. It is improper for Paul to distribute any of the interest until either of these events has occurred, even if the taxpayer has disbursed all of his trade money, even if he has no intention of purchasing any of the other designated properties, even if it is not practicable or feasible to purchase any of the other registered properties. Nonetheless, this rule can be circumvented if the interest earned is disbursed by the accommodator as part of the purchase of a replacement property, for then there is no constructive receipt of funds.

Problem Number 2

1. John, Bill, and Fred want to buy a 100,000-square-foot shopping center on Bell Road in Phoenix, Arizona, called the Bell Commerce Shopping Plaza (the "Bell Center" or the "Center"). The three have excellent credit and feel that their collective experience in real estate, in which each complements the other, should allow them to operate the property efficiently and deal with any problems that may arise.

   For the past five years, John has been working for a property management company. He started as an assistant manager and now is in charge of overseeing six shopping centers ranging in size from 50,000 square feet to 500,000 square feet. Bill has also been in the real estate business, employed as a broker leasing retail product that includes everything from small stand-alone storefronts to a large shopping mall. Fred has extensive experience in the finance field. He is currently working as a mortgage broker for a large commercial mortgage brokerage company. Fred has not specialized in one product type, but rather has arranged several loans for clients wherein the debt is secured by a shopping center.

   John, Bill, and Fred discuss the purchase of the Bell Center with the current owner and settle on a $10,000,000 purchase price. Fred, the mortgage broker, figures he can place acquisition financing against the Center at 75 percent LTV, or a $7,500,000 first trust deed. The loan quote was interest-only for the first three years, then a 30-year amortization. The lender requires impounds for taxes and insurance as well as reserves, on an annual basis paid monthly, of $.50 per square foot for capital improvements and $.30 per square foot for tenant improvements and leasing commissions. The partners would therefore need to put down approximately $2,500,000 plus closing costs and reserves totaling $300,000 (see Exhibit 8.2) to acquire the asset. Usually, the seller is obligated to pay 100 percent of the sales brokerage commission; however, it is a negotiated fee and, depending on the circumstances, it is not uncommon for the buyer to pick up a portion of the charge. The assumption in this hypothetical is that John, Bill, and Fred will pay a portion of the sales brokerage fee, that is, $50,000. The problem is that they do not have $2,800,000. The most they can scrape together between them is $280,000.

2. John, Bill, and Fred decide to syndicate the acquisition. In order to attract investors they put together an offering brochure that contains the following:
   - A short executive summary outlining the salient features of the investment.

Exhibit 8.2 Closing Costs

Title Insurance	$10,000
Escrow	2,500
Real Estate Commissions	50,000
Appraisal	5,000
Property Condition Report	2,500
Phase I Environmental Report	2,000
Legal Fees	2,000
Borrower's Counsel	8,000
Lender's Counsel	20,000
Lender's Loan Fee	75,000
Reserves	125,000
Total	$300,000

- An investment summary setting forth details concerning the project, which includes biographical sketches on the sponsors, a narrative on why the acquisition works—including the sponsor's strategy for creating value—and a disclosure of the proposed deal structure.
- Project location maps, including local and regional maps as well as an aerial photograph, site plan, and photographs of the project.
- A current rent roll.
- An Argus analysis, that is, an income and expense spread sheet reflecting projected figures over a 10-year period with a sale in the beginning of the eleventh year.
- A sources and uses of funds breakdown.

To raise money for the venture, the partners intend to approach family and friends as well as business contacts that the three have made over the past couple of years. In chatting with other real estate professionals, they have heard in general terms that a limited partnership offering may be considered a security, and they are concerned that they could be violating the Security and Exchange Commission rules and regulations as well as state security laws.

3. In February of 2000, John, Bill, and Fred have a meeting and discuss how they are going to hold title to the Bell Center. John suggests a limited partnership with the limited partners holding a 99 percent interest and the corporate general partner taking a nominal 1 percent interest. John asserts this is the best of both worlds, since the partners are protected from personal liability, given the partners are "limited" partners, and since it is a partnership, then partnership taxation applies. Bill favors a limited liability company because it also insulates the partners from personal liability, and is how everyone seems to be taking title. Fred indicates that he always wanted to be an officer of a corporation, so he suggests that the group form a corporation and avoid double taxation by filing an S election. The group finally decides to go with Fred's decision and form an S corporation, Bell Center, Inc., and acquire the Bell Center through this entity. The group asks Fred to spearhead the formation and the Chapter S election. After Fred forms the corporation, he calls a CPA friend, Edger, to assist with the paperwork. Edger tells Fred that the group is off to a great start; in fact, he would like to invest in

the venture and not to worry about the S election, since they have until the end of calendar year 2000, or up to the filing of the first tax return, for Bell Center, Inc., to make the election.

4. The entrepreneurial partners contributed 10 percent of the required initial funding into the venture, $280,000. The balance of the monies was raised from investors. The shareholder agreement for Bell Center, Inc., provides an even split between the entrepreneurial members and the capital side. Consequently, John, Bill, and Fred each hold stock equivalent to an 16.67 percent interest (50 percent divided by 3) from the entrepreneurial side. The money side also is allocated a 50 percent (50 percent) interest and since John, Bill, and Fred injected 10 percent ($280,000/$2,800,000) of the capital, their collective property ownership relating to the capital side is a 5 percent interest. Therefore, the sponsors each acquire an 18.34 percent interest in the property for a total interest of 55 percent and the other members collectively hold a 45 percent interest. By structuring the ownership in this manner John, Bill, and Fred obtain a 50 percent promotional interest in the Bell Center.

   The shareholder agreement also specifies that after the normal and usual operating expenses, including the first trust deed obligation and the agreed management fee, are covered that the money contributed to the corporation will receive a cumulative priority return of 7 percent paid monthly. Thereafter, assuming the reserves are adequate, if there is any money available for distribution, the distributions are made according to the profit percentage.

   John, Bill, and Fred form an entity named JBF Management, LLC, which enters into a separate management agreement with the Bell Center, Inc. The management fee is set at 5 percent of the gross income with the provision that no additional compensation is to be paid to John, Bill, or Fred in connection with leasing activity, construction management, financing or any other service. The Bell Center, Inc., shareholder agreement specifically authorizes the sponsors to manage the Center for a fee of 5 percent of gross income.

5. Over the next five years the "partners" renovated the Center. Capital expenses were allocated to putting a new facade on the Center, painting the entire exterior, and re-asphalting

the parking lot; tenant improvement monies were spent to fix up interior space for new tenants and in connection with renewals. The Bell Center was fixed up at a cost of $500,000 funded from operating cash flow. John applies to the lender's servicer to receive reimbursement for the monies spent from the reserve account. He receives $100,000 back. The servicer takes the position that a lot of the funds were placed in the wrong category, and in any event the request exceeds the reserve balance for that category. John figures he will resubmit, but the servicer advises he cannot because, in processing the prior draw request, the servicer did not designate which items were reimbursed—so now they have no way to determine if a specific item was paid.

6. Over this time frame, Bell Center, Inc., took $1,333,333 in depreciation deductions ($8,000,000 of value allocated to the improvements based upon a 30-year useful life). In February of 2005, the group refinanced the Center, securing a new 10-year loan of $10,000,000 from the Securitization Bank with an interest-only feature for the first five years. When applying for the new loan, Fred assisted his partner in completing financial statements. The Bell Center was valued at $13,333,333. Based on this value, he figured that each partner had, on paper, $1,061,667 in equity in the property. Not bad for an initial investment of $93,333 per partner ($280,000 divided by 3). A return of over 11 times the initial investment over a five-year period! Fred calculated the $1,061,667 equity per partner by taking the FMV of $13,333,333 less the existing lien amount of $7,500,000 and arriving at $5,833,333. Each partner's ownership percentage of 18.20 percent was then multiplied by the total project equity of $5,833,333.
7. Immediately after the loan closed, the Securitization Bank placed this loan into a pool of similar loans, securitized the pool, and sold the security to a pension fund with the servicing contracted to Mindless Service Corp.
8. In November of 2007, John, Bill, and Fred receive an offer for the sale of the Bell Center for $15,000,000. Between 2005 and 2008 an additional $800,000 in depreciation was taken and another $100,000 in capital improvements was made to the property. The adjusted basis as of February 2008 is calculated to be $8,641,667. John, Bill, and Fred decide they must

make some decisions. They feel it is a good time to either refinance the Bell Center again or sell the property. If the existing $10,000,000 loan is paid off, the defeasance penalty would be $500,000.

What issues arise given this fact pattern?

1. The partners heard general comments from other real estate professionals that a limited partnership offering may be considered a "security." They are concerned that they could be violating the Security and Exchange Commissions rules and regulations as well as state security laws if they do not make the proper disclosures. Is this concern valid? If it is valid, how should they address this concern? The main concerns should center on disclosures to investors and the requirement to file with the applicable governmental entity or entities. Should the offering binder contain a disclaimer? If it should have a disclaimer, what should it say? What, if any, documentation should the partners secure from prospective investors? As will be discussed further in Chapter 11, the offering memorandum might on its face indicate that this is not a registered offering. In the body of the offering, it might provide disclaimer language to indicate that the offering is illiquid, speculative, and involves a high degree of risk of loss. The offering might also indicate that the financial projections provided are estimates only, based on assumptions that may be incorrect, and there can be no assurance of their accuracy. Also, it might be mentioned that there are restrictions on a partner's right to transfer or pledge its interest. Several additional disclosures, as set forth in Chapter 11, might be included in the offering memorandum. To ensure that the project falls within the private offering exemption and/or the intrastate exemption John, Bill, and Fred might ask each investor to execute an accredited investor letter that might contain in addition to language concerning the investor's gross income and net worth, statements as to their relationship to the promoter, the limited manner in which the offering is being made, its local nature, and the fact that both the investors and the sponsors reside and do business in one state. Also, it might be prudent to obtain an acknowledgement of the applicable

exemption relied upon from the applicable state where the property is located. In California, Corporations Code Section 25102(f) outlines the needed qualifications for an exempt nonpublic offering. The Corporations Commissioner provides a form that the issuer may electronically file. Filing the form does not grant an exemption to the issuer, but rather only provides notice to the Corporations Commissioner that the exemption is being relied on.

2. Thought and analysis should go into deciding the legal form that the entity that is to acquire and hold title to the real property asset takes. Prior to acquiring the real property, the buyer should consult with his attorney and/or accountant. The consequences of selecting the wrong form of ownership can be devastating. Part of the discussion should take into account liability and state taxation law. All three entities discussed—a limited partnership, a limited liability company, and a corporation—afford protection from personal liability, but the accounting treatment for these three types of entities may differ dramatically. Both the limited partnership and the limited liability company are governed by partnership taxation rules, while the corporation, is controlled by C corp. or S corp. rules depending on your election. S corporations have specific, special rules designed in the Code. Therefore, for example, even though there is no double taxation with an S corporation, the refinance in 2005, as discussed more fully in item 5 further on, results in a mortgage over basis taxation problem and a tax on the distributed funds. If the property were held in a limited partnership or in a limited liability company, the refinance would not result in a taxable event.

   The S corporation status is a creation of the Internal Revenue Code and therefore the Code must be strictly followed in order to qualify for this treatment. The Code indicates that there can be no more than 75 shareholders, the shareholders must all be United States residents, the shareholders and the directors must be individuals rather than business entities, and the election must be made by filing form 2553 with the IRS within 70 days of formation. Edger's advice concerning when the election can be made is, therefore, incorrect. If a Sub S election is properly made, then Fred is correct: For tax purposes, the corporation is a pass-through entity and there is no taxation on the corporate level; all of the tax incidences pass through to the individual shareholders.

3. Care must be taken when applying for reimbursement of reserve monies. Ironically, these are the borrower's funds held by the lender, since the lender's underwriting concluded that these monies will be needed to improve the center. The problem is that once a loan is securitized, the servicer acts as a fiduciary and must literally enforce the terms of the loan agreement, sometimes with illogical, absurd results. If you apply for reimbursement and fail to confirm the amount in the bucket applied for, it is not uncommon for the servicer to take the position that, to the extent the request exceeds the amount in reserve for that category, you cannot reapply for those requested reimbursement items. The servicer argues that since they do not distinguish between which items were paid or not paid, they have no way to tell if a certain reimbursement request was honored. Consequently, they just deny all money requests in excess of the reserve amount and prohibit you from reapplying for any of the submitted reimbursements!
4. When calculating depreciation, a 30-year useful life was used for the building structures. The IRC requires that a 39-year period be used for the purpose of spreading the deduction.
5. Was there a tax consequence when John refinanced the property in February of 2005? If title to the property is held in the name of a partnership or a limited liability company, partnership taxation rules apply and the refinance has no tax consequences, even if the mortgage exceeds basis. However, if title, as here, is held in corporate form, then specific corporate taxation rules apply and, if a mortgage is originated in excess of basis, any distribution would result in a taxable event. There is also a potential for some of the interest on the new $10,000,000 loan to be nondeductible depending upon the taxpayer's use of the proceeds after considering the tracing rules. (Please see IRC Section 163(8)(t)). For example, if the partners, John, Bill, and Fred, decide they have made it financially and purchase a yacht for $500,000, then 20 percent ($500,000/$2,500,000) of the interest expense associated with the new loan would be personal, nondeductible interest. This makes logical sense, since if John, Bill, and

Fred, while purchasing a boat, financed the acquisition then the associated interest expense would be a personal, nondeductible interest expense. The disallowance of the deduction would follow the rule that you should not be able to do indirectly what you cannot do directly. In contrast, however, if all of the net refinance proceeds go back into the property as rehab funds, then all of the interest expense is deductible. Typically, it is up to the individual taxpayer to determine if his allocated share is investment interest or nondeductible, nonbusiness interest. The tracing rules are fairly complicated and therefore the taxpayer's accountant should be consulted for specific applications.

One way to defer the tax, even if title is held in corporate name, is to create a debt obligation. Hence, the monies distributed that exceed the property's basis, that is $337,658 ($10,000,000 – $9,662,342), are characterized as debt rather than as a profit distribution. The partners must pay the $337,658 back to Bell Center, Inc., in the form of principal and interest payments, but in essence they are paying themselves back, since they are the owners of Bell Center, Inc. In reality, the payments become a wash. In other words, the partners pay interest on the $337,658 distribution at a market rate of, let us assume, 8 percent, 30-year amortization, or $29,534 per year, which is a deductible expense on the individual tax level. Bell Center, Inc., must recognize the payment as income, but it also can distribute out all or part of the principal and interest payment during the year. The point is that rather than paying an immediate tax on the $337,658 distribution, the partners may pay the tax over time as they receive distributions. If this debt vehicle is adopted, it is crucial to properly document the transaction. Proper documentation includes drafting a note on the agreed terms and compliance with the note's provisions. The investors must make the note payments to Bell Center, Inc. Also, corporate minutes or a shareholder agreement should reflect authorization of the borrowing. Failure to take the proper steps to document the loan might allow the IRS to argue that the debt was really a disguised taxable distribution.

6. In connection with the refinance, Fred miscalculates John, Bill, and Fred's equity. Fred has disregarded the cash equity contribution of $2,800,000. These monies must be repaid to the investors before funds are paid to the entrepreneurs. If the property was sold for $13,333,333, first the debt of $7,500,000 must be repaid; then the investors including John, Bill, and Fred would receive back their cash investment of $2,800,000; finally, the balance of the funds would be distributed according the partners' ownership percentage. Consequently, the equity calculation would look as follows: FMV of $13,333,333, less existing debt of $7,500,000, less cash contributions of $2,800,000 equals equity of $3,033,333. John, Bill, and Fred have a 55 percent interest, so their collective equity allocation would be $1,668,333. This amount plus John, Bill, and Fred's portion of the cash equity, $280,000, equals $1,948,333. This is still a great return on a $280,000 investment over a five-year period, but short of the $3,185,001 equity that Fred calculates.

7. If the Bell Center is sold for $15,000,000, the profit on sale would be calculated as follows:

Sales Price		$15,000,000
Less Adjusted Basis		
Purchase Price	$10,000,000	
Plus Closing Costs	72,000	
Plus Capital Improvements from 2/2000 to 2/2008	419,231	
Plus Capital Improvements from 2/2005 to 2/2008	93,846	
Less Depreciation Taken ($8,000,000/39 × 8)	1,641,026	
	8,944,051	
Profit		$6,055,949

Of the $300,000 in "closing costs, $103,000 relates to loan costs, which must be amortized over the life of the loan, and $125,000 represents reserves that are not initially a project expense, but rather capital set aside by the taxpayer for future use and, when expended, would be an immediate expense or a depreciable capital expense. The balance of the monies is an unamortized cost that is essentially part of the purchase price and that therefore increases basis.

The hypothetical does not clearly indicate when the $500,000 fix-up monies were spent. It just says "over the next five years the partners renovated the Center.” The depreciation on the $500,000 fix-up capital expenditure was calculated based upon a 39-year life over an eight-year period based on an estimate of the monies outstanding over the five-year fix-up time frame. The same type of estimate was made for the additional $100,000 spent between 2005 and 2008. The analysis shown therefore reflects the unamortized capital improvements and increases the property’s basis.

The gain on sale is passed onto the individual owners so the tax effect would depend upon each partner’s individual situation; for example, an investor might have other write-offs that would offset the gain. Nonetheless, in general, the current tax laws would impose a tax of 25 percent for depreciation recapture plus the applicable state tax, and a 15 percent rate for long-term capital gains. The result, if there is an outright sale, is an immediate tax in the year of the sale of at least $1,072,495: depreciation recapture of $410,257 ($1,641,026 of depreciation taken [$8,000,000/39.5 × 8] at 25 percent) plus $662,238, which represents a tax on the gain of $4,414,923 (Profit less Depreciation Taken, since depreciation is already taxed as shown earlier) at the long-term capital gains rate at 15 percent. An option to defer the tax, of course, is a 1031 exchange, but then the trade must be accomplished at the Bell Center, LLC, level, since there are no separate ownership interests.

In addition to the tax on sale, the partners must also deal with the defeasance penalty. If the buyer assumes the existing loan, the assumption fee of usually one percent can typically be passed on to the buyer. The reasoning is that the assumption fee is analogous to the buyer obtaining new financing and in such a situation the fees paid to acquire a new loan, which are controlled by the buyer, are paid for by the buyer. There is no right answer as to who pays the defeasance penalty, but usually the seller pays it since it is the seller’s loan that is being paid off. The costs associated with acquiring the new financing, as previously mentioned, are the buyer’s expenses.

If the buyer assumes the existing loan, the seller should request, as part of the assumption process, to be relieved of liability relating to the loan and the carved-out “bad boy” exceptions, that is, the personal liability for such things as fraud, waste, distributing funds to partners after a default, and so forth.

Given that the defeasance penalty is usually a seller cost, the major problem a seller often overlooks with regard to the penalty is that you cannot quantify the amount at the outset since the ultimate calculation is done three days before closing. You could possibly hedge the expense, but certainly you would not want to enter into a hedge until after the buyer has approved all of the PSA contingencies. Since the approvals arrive toward the end of the process, a hedge does not seem merited. A compromise position, if agreeable to the buyer, would be to cap the seller's defeasance costs at a certain level with a sharing arrangement thereafter. Alternatively, the PSA might give the seller the right to cancel escrow if the costs exceed a certain amount.

From John, Bill, and Fred's perspective, can Bell Center, LLC, deduct the defeasance penalty? If a defeasance penalty is paid by the seller, then yes—the Bell Center, LLC, could deduct the charge. It would be an expense in the year incurred.

Should John, Bill, and Fred refinance and then sell or should the new loan be secured concurrent with the closing of the sale? If the refinance occurs first, the net loan proceeds could go to the accommodator directly so that it could not be argued that the taxpayer would have constructive receipt of the funds. When the sale occurs, it should be pre negotiated with the lender that there is no assumption fee and that John, Bill, and Fred are released from the carved-out liabilities. The problem is that the IRS has taken the position that any refinance proceeds received in preparation for a sale or exchange prior to acquiring the replacement property is cash boot, as per Revenue Regulations Section 1.1031(k)-1(f). The exception to this rule is if the purpose of the refinance was unrelated to the sale or to the 1031 exchange. For example, if the loan was maturing so that new financing had to be secured in any event, then it could be persuasively argued that the refinancing was not geared toward marketing the Property and was not part of the integrated events in the sale or 1031 reinvestment plan. If a refinance is going to occur prior to the sale, the key is to create a time gap that, ideally, straddles two tax years. It should be noted that although refinancing and then trading could arguably result in the refinance proceeds being labeled as boot, this structure is more foolproof in terms of guarantying the deductibility of the defeasance penalty.

From a 1031 perspective, it is safer if the refinance and sale occur concurrently. The net sale proceeds are forwarded directly to the accommodator and the loan is closed in the buyer's name. The IRS could argue that the defeasance penalty is a cost of the sale and should therefore lower the basis rather than being a deductible expense attributable to the financing being paid off, but given the amount of the defeasance penalty and the amount of the potential tax, the first priority from the seller's perspective is usually to preserve the 1031 trade.

Problem Number 3

What are the consequences if, in connection with the sale of the Bell Center, John, Bill, and all of the other investors except Fred elect to trade the Bell Commerce Center under Section 1031 of the IRC rather than contracting for an outright sale?

First of all, the trade must occur on the Bell Center, LLC, level. In other words, Bell Center, LLC, must be the party that enters into the exchange. It would not be permissible for individuals within the LLC to trade their interest separate and apart from the LLC and qualify for a Section 1031 exemption. You may not trade a fractional interest. It is the entity, Bell Center, LLC, that owns Bell Center and therefore you must trade on this entity level.

If one or more of the members of Bell Center, LLC, desires to cash out, does that disqualify the exchange? No, but care should be taken. An attorney that specializes in 1031 exchanges should be consulted so as to ensure that the cashed-out partner's distribution does not disqualify the exchange and does not result in undue gain to the remaining partners. Fred will recognize a gain. He is in essence selling his partnership interest.

The buyer, Let's Negotiate, and the managing members of the selling entity, John, Bill, and Fred, have a meeting to discuss structuring the sale of the Center. The parties agree that the sales price will remain at $15,000,000, but Let's Negotiate points out that it is very difficult to secure financing at this point in time, and that even if financing were secured, the LTV would be at most 65 percent. The result is that the parties could not replace the dollar amount of the existing loan; furthermore, the defeasance premium would increase the cost another $500,000. Let's Negotiate suggests that he, as the buyer, assume the existing $10,000,000 loan. He agrees to pay the 1 percent assumption fee. He also agrees to pay $1,000,000 as a down payment and asks the seller to carry back a note for the balance of the purchase price. Fred, the finance guru for the seller, confirms that it is a difficult market for arranging financing, but counters that the cash equity of $1,000,000 is only 6.67 percent of the purchase price—an abnormally low down payment. The parties agree on a down payment of $2,000,000 with the buyer to assume the existing debt, and the seller to carry back a note in the amount of $3,000,000 for five years at 7 percent interest.

The parties have come to a meeting of the minds on how to structure the sale of the Bell Commerce Center. However, this structure fails to secure a crucial party's consent, that is, the consent of the lender through its designated loan servicing agent, Mindless Service Corp. (MSC). Almost all commercial loans contain a due on encumbrance clause barring secondary financing. MSC's consent will be required not only for the assumption of the existing first trust deed, but also for the parties to place a secondary encumbrance against the Center.

The sale of the Bell Center closes in February 2008. Escrow disbursed $66,666 directly to Fred, and the balance of $1,933,334 is transferred to an accommodator for the Bell Center, LLC. The Bell Center, LLC, agreement would dictate how the net sales proceeds are distributed. It is assumed in the previous hypothetical scenario that net proceeds from the sale will first go to repay the outstanding debt, followed by a distribution to the members to pay any accrued and unpaid preferred return, then to repay any positive capital accounts, and finally distributed to the members according to their percentage interest. In this case, since the net cash proceeds are less than the members' capital account, an allocation must be made. Fred contributed $93,333 into the LLC (one-third of $280,000) out of a total of $2,800,000. Fred's capital contribution represents 3.33 percent of the total contributed capital ($93,333/$2,800,000). Therefore, Fred's share of the net proceeds would be calculated as follows: $2,000,000 × .033 = $66,666.

The $3,000,000 results in a taxable gain. The paper carried back by the seller is considered cash boot. However, the transaction qualifies for installment tax treatment under Section 453 of the IRC. Consequently, the income received by the taxpayers is ordinary income. The taxpayers benefit because their gain is spread out over five years rather than required to be recognized in the year of the sale.

In order for the members who have elected to trade to defer the balance of the gain, the up-leg must involve a purchase or purchases wherein the debt is greater than the allocated debt to the trading members and the allocated equity must be traded into one or more properties wherein the equity is equal to or greater after the trade. Fred's membership interest was 18.20 percent (one-third of the 54.59 percent). Therefore, the remaining member's interest is 81.80 percent. The existing debt is $10,000,000. Hence, the allocated debt to the members who have elected to trade is $8,180,000 ($10,000,000 × .8180). Also, the allocated remaining equity share is $1,933,334 ($2,000,000 distributed less Fred's allocated share of $66,666). To defer 100 percent of the remaining profit, the members must buy one or more properties with a debt greater than or equal to $8,180,000 and an equity greater than or equal to $1,933,334. If they buy a property worth $10,113,334 ($8,180,000 + $1,933,334) or more, these tests are satisfied provided the debt is equal to or greater than $8,180,000 and the equity is equal to or greater than $1,933,334.

In the above fact pattern, the result of the paper being caried back is an installment sale coupled with a partial tax deferred exchange.

Please refer to Exhibit 8.3 for a graphic depiction of the significant events set forth in Problems Number 2 and Number 3.

Problem Number 4

Let us assume that the Bell Center was owned by Bell Center, LLC, and that entity is solely composed of the three principals, John, Bill, and Fred. In December of 2004, as in Problem Number 2, a loan is applied for from Securitization Bank. In conjunction with the refinance, in anticipation of the eventual sale of the Bell Center, the managing members decide to convert the LLC ownership into three tenants-in-common: John, LLC, Bill, LLC, and Fred, LLC, with each LLC owning a one-third interest in the property. In February of 2005, a 10-year loan for $10,000,000, interest-only for the first five years, is closed.

The borrower under the new loan is John, LLC, Bill, LLC, and Fred, LLC, jointly and severally. The deed of trust contains a provision that indicates that the lender may call the loan "upon the sale or transfer of (i) all or any part of the Property, or interest therein, or (ii) beneficial interest in Borrower (if Borrower is not a natural person or persons but is a corporation, partnership, trust, or other legal entity) . . ." The Deed of Trust goes on to say that it is deemed a sale or transfer only if, after the sale or transfer, the result is "an aggregate of more than 49 percent of such corporation's or limited liability company's stock or membership interests . . . being held directly or indirectly by a party or parties who are not now holders of more than 49 percent of such corporation's or limited liability company's stock or membership interests."

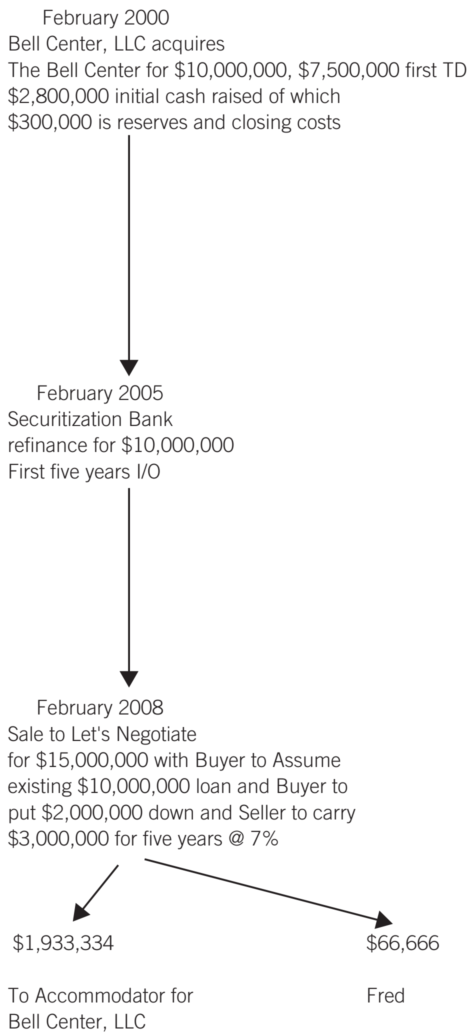


Exhibit 8.3 Problems Number 2 and Number 3

Fred has decided to retire. The work of arranging financing has been good to him, but he is burnt-out, especially given that the mortgage market has tightened and it is now quite difficult to obtain commercial mortgages—and if they are available, the loan-to-value usually does not exceed 60 percent. Fred desires to sell his interest and John and Bill have agreed to purchase his share of the real estate. Fred wants to defer his tax liability by trading his interest into a vacation home in Florida.

In February of 2008, the parties enter into an escrow wherein John and Bill agree to buy Fred's one-third interest in the Bell Center for $500,000. Fred trades into the Florida house at his LLC level. Fred puts all of the money he receives from the sale of his interest in the Bell Center into the Florida vacation home and finances the balance with a $1,000,000 mortgage.

What issues does this fact pattern raise? (Please refer to Exhibit 8.4 for a graphic description of the preceding facts.)

1. Arguably the transaction as documented violates the deed of trust provisions, allowing the lender to call the loan. John and Bill are buying an interest in the property that triggers the general prohibition. The exception is not applicable since John and Bill are not buying a "beneficial interest in Borrower." One way to arguably circumvent the effect of the "due on sale" provision is to have John and Bill purchase Fred's entity, that is, Fred, LLC. Now, arguably, John and Bill are buying a one-third interest in the Borrower.

   The crucial issue is, Who is the "Borrower"? The exception language is geared to the situation wherein there is one entity, and as long as no more than 49 percent is sold to an outside party, the due on sale clause is not triggered. If the Borrower is collectively the three tenants-in-common, then it would seem to follow that by buying Fred, LLC, John and Bill are purchasing a one-third interest in the Borrower. Care must be taken, however, since the lender could argue that each tenant-in-common is a "Borrower" and therefore John and Bill can only purchase up to a 49 percent interest in Fred, LLC, to fall within the definition of what is not a sale or transfer. In hindsight, the language could obviously have been clearer in order to provide that a permissible transfer include a sale of one of the tenants-in-common's interest to either or both of the other tenants-in-common. Nonetheless, the most reasoned approach, given the language and the ownership as three separate TICs, would be that the Borrower is all three TICs collectively and therefore John and Bill could buy Fred, LLC, without triggering the due on sale clause. Nonetheless, prudence might suggest obtaining the lender's consent prior to consummating the purchase of Fred, LLC, especially if the loan contains favorable loan terms such as a below market interest rate. Unfortunately, Mindless Service Corp., the entity servicing the loan, may require John, Bill, and Fred to complete a loan assumption package with the implication that its approval is necessary and a transfer fee would be due if approved without addressing the threshold key question of whether or not this is a transfer within the meaning of the Deed of Trust (and if it is not, you therefore never get to the assumption stage).

2. If the sale is structured so that John and Bill purchase Fred, LLC, how will it affect Fred's trade? Fred's entity, Fred, LLC, is a single member LLC, and as such it is a disregarded entity for purposes of Section 1031. In other words, Fred uses his individual social security number for reporting purposes in connection with Fred, LLC. If he sells Fred, LLC, to John and Bill, he can trade individually again using his individual social security number or he can form a new single member LLC, which again will use his individual social security number. The IRS wants to verify that when Fred trades his down-leg into his up-leg the same social security number or tax identification number is utilized; the name of the entity does not matter.
3. Fred has mortgage relief. His interest in the Bell Center debt is \$3,333,333 (\$10,000,000 × .33 percent), yet when he acquires the Florida single-family residence, the new debt is only \$1,000,000. The taxable mortgage relief is \$2,333,333.
4. Does the vacation home qualify as like-kind property? Like-kind property must be either held as investment property or as a trade or business property. The taxpayer's primary residence does not qualify. A vacation or second home will qualify if it is held for profit or resale since then it would be characterized as investment property. This standard enters into the nebulous area of intent. If Fred can show that his intent is to hold the Florida home as investment property,

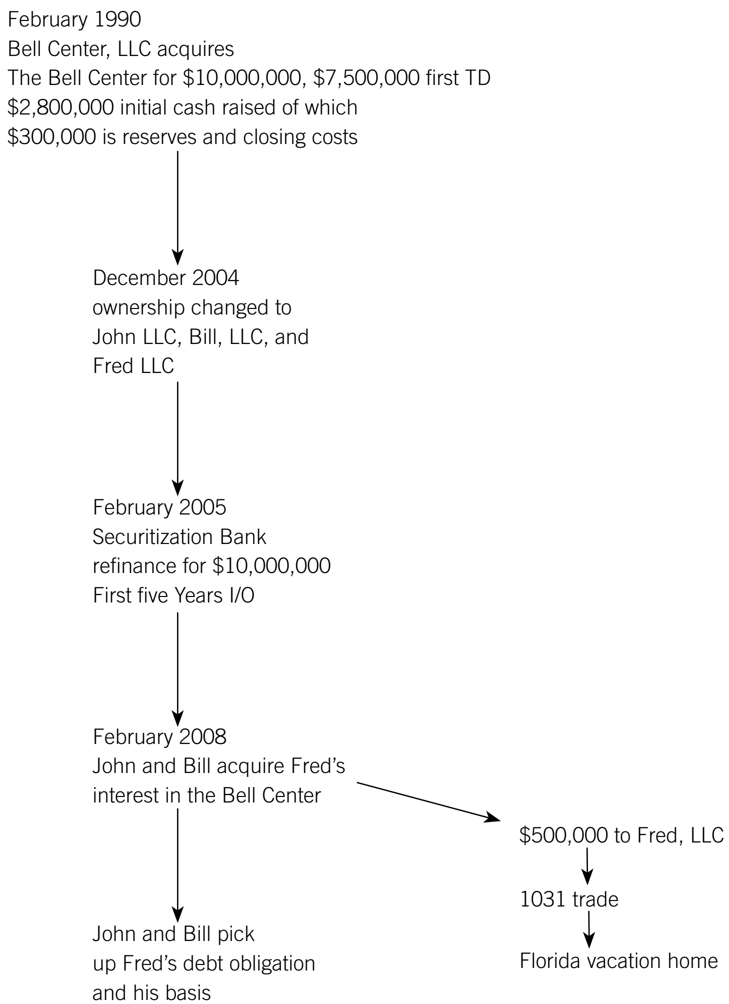


Exhibit 8.4 Problem Number 4

or as a trade or business property, then the vacation home would qualify as Section 1031 property.

Problem Number 5

1. The Home Run Shopping Center (the "Home Run Center" or the "Center") is owned by HRC, LLC (HRC). HRC, LLC, is a single member limited liability company whose sole

member is Dan Entrepreneur. Dan spends at least 750 hours per year in the real estate business and related activities and therefore is a real estate professional for federal income tax purposes. The Center contains 170,000 net rentable square feet. It is anchored by a national supermarket chain, Go Dark Grocery. Of the 170,000 net rentable square feet, 85 percent of the Center, or 144,424 square feet, is leased. Fifteen percent of the Center, or 25,576 square feet, is vacant.

2. HRC purchased the Home Run Center from Johnny Babe Ruth Palmer (Palmer) in January of 2007 for $15,000,000. A purchase money mortgage of $11,250,000, interest-only for the first three years, was placed by High Roller Bank against the property at acquisition.
3. In July of 2008 the Center's anchor retailer, Go Dark Grocery, closed its doors. It was losing money on its operations and the ownership felt it would have less of a loss if it were required only to pay the monthly rent and its share of the Center's operating expenses. Go Dark, when closed, had five years left on its lease. The Go Dark lease does not bar the tenant from ceasing operations. When the lease was being negotiated with Palmer, Go Dark had argued that as long as they are obligated to continue to pay their rent, why should the landlord complain? Palmer had pointed out that if the anchor closes its doors, there could be a chilling effect on the Center, causing other tenants to lose significant foot traffic, and consequently business failures might result. Also, why would other prospective tenants want to come to the Center if the main tenant is not open for business? Go Dark insisted on their having the right to "go dark," but as a compromise agreed that if they did close the store their Base Rent would increase to 125 percent of the Base Rent then in effect.
4. It is now July 2009. (A current rent roll is found in Exhibit A.4 on the companion website.) The loan to High Roller Bank is current. HRC has never been late on its mortgage. High Roller Bank has not been able to sell its loan because the anchor tenant space in the Center is vacant. It offers HRC a $3,000,000 discount if it pays off the existing loan balance within 90 days.
5. HRC wants to take advantage of the discounted pay-off, but realizes that if it arranges new debt at $8,250,000

($11,250,000 less $3,000,000), it will incur a huge tax liability, given that forgiveness of debt is a taxable event.

6. HRC considers selling the Home Run Center to Mortgage NoteBuyer, LLC (MNB). MNB is a mortgage fund with approximately $200 million in liquid assets. MNB is run by Manny Rodreguz, Nathanial Black, and Bill Thime. MNB's mission is to purchase discounted notes, but MNB is not a real-estate operator. It needs an entity or individual to run the property, lease up the vacant space, and replace Go Dark. MNB and Dan Entrepreneur form a new venture, Opportunity Knocks, LLC (OK), wherein MNB and Dan each own a 50 percent interest. They capitalize OK with $1,000,000. MNB contributes $750,000 and Entrepreneur puts in $250,000.
7. The parties come up with two ways to structure the transaction. They are not sure which route they should take. OK could buy the loan for $8,250,000. OK has been offered a loan from Relationship Bank for the entire loan purchase price of $8,250,000 provided Manny, Nathanial, Bill, and Dan, jointly and severally, guaranty the loan. If Relationship Bank originates a loan, it would be a collateralized mortgage; that is, its security would not be the Shopping Center, but the debt currently held by High Roller Bank. Alternatively, MNB could purchase the loan and have OK assume the obligation in conjunction with the property purchase. The parties decide to have MNB acquire the loan since they do not want to incur personal liability.
8. MNB purchases the $11,250,000 mortgage for $8,250,000 with proceeds from the mortgage fund. As part of a packaged deal, HRC then sells the Home Run Center to OK for $9,000,000, OK assumes the existing debt held by MNB of $8,250,000 at an interest-only rate of 7.5 percent and a five-year term. OK disburses $750,000 to HRC, representing the balance of the purchase price.

What issues does this fact pattern raise?

1. The underlying assumption is that if HRC arranges alternative financing to take advantage of the offered discounted pay-off (DPO), they would create a huge tax liability given that forgiveness of debt is a taxable event. Since an unrelated

third party is purchasing the debt and since Dan's subsequent involvement is through another entity that has a legitimate business purpose and is not the note purchaser, the IRS would have a very weak case if they attempt to attribute a gain back to Dan Entrepreneur due to the forgiveness of debt scenario. Under new legislation, HRC may reduce its basis in lieu of recognizing a taxable gain.

2. HRC sold the Center for $9,000,000. Was the property sold at its fair market value? A determination of value must take into account that the anchor, which represents 28 percent of the Center's square footage, is dark and has only four years to run on the existing lease term. It must also be remembered that in addition to the closed anchor, the Center has 25,578 square feet of vacancy, that is, 15 percent of the Center. Whether a replacement tenant is or is not located, the potential exists for a significant amount of downtime in connection with Go Dark's 47,430 space. Time, effort, and money must be spent to release Go Dark's space and lease up the remaining vacant space.

   In order to evaluate the current fair market value of the Home Run Center, assumptions must be made that create the foundation for the analysis. For purposes of the analysis the following assumptions apply.

General Project Assumptions	
Commencement Date of Analysis	July 2009
Length of Analysis	10 years
Building Square Footage	170,000 net rentable square feet
Revenues	
Market Base Rent for renewals regardless of time frame	Less than 2,500 square feet = $1.00 per square foot per month; 8,000 – 15,000 square feet = $.60 per square foot per month Over 15,000 square feet = $.50 per square foot per month
Market Rent Growth Rate	3%
Other Income Growth Rate	3%
Consumer Price Index (CPI)	3%
Parking Income	None
Storage Income	None

(continued)

Expenses	
Vacancy and Collection Loss	5%
Operating Expenses	$.35 per square foot per month includes management fee of 5% of Effective Gross Revenue
Operating Expense Growth Rate	3%
Capital Reserves	$.15 per square foot per year
Tenant Improvements	Up to 15,000 square feet = $10 new, $5 renewals; over 15,000 square feet = $20 new, $10 renewals
Leasing Commissions	6% new, 3% renewals
Expense Recovery	All leases NNN
Valuation Assumptions	
Purchase Price	$9,000,000
Initial Cash Investment	$750,000
Residual Capitalization Rate	9.50%
Residual Cost of Sale	3%
Second Generation and Vacant Space Assumptions	
Retention Rate	70%
Releasing Down Time	Up to 15,000 square feet = lease-up spread over 36 months; over 15,000 square feet = at the end of 36 months
Rental Concessions	
Tenant Improvements	Up to 15,000 square feet = $10 new, $5 renewals; over 15,000 square feet = $20 new, $10 renewals
Free Rent	None
Lease Term	5 years
Leasing Commissions	New 6%, Renewals 3%
Financing Assumptions	
Loan Amount	$8,250,000
Term	10 years
Interest Rate	7.50%
Amortization	I/O for first 5 years, then 30-year amortization

Summarizing the key assumptions relating to the lease-up of the vacant space, please note the following: (1) the Center will lease up to 95 percent occupancy; (2) space for rent less than 2,500 square feet totals 17,576 square feet. This space, less the 5 percent vacancy factor, will be absorbed over a 36-month period at an average rent of $1 per square foot per month with a $10 per square foot tenant improvement allowance. Suite 6030A, which contains 8,000 square feet, will take 36 months to lease at $.60 per square foot per month with a $15 per square foot tenant improvement allowance. Suite 6120, Go Dark's leased space, will take 36 months to lease at $.50 per square foot per month with a $20 per square foot allowance. During the three-year period, it is assumed Go Dark will continue to pay its contractual rent. Go Dark's rent increase of 25 percent is treated as a negative capital account in the Schedule of Prospective Cash Flows in Exhibit B.4 on the companion website. The assumption is that this "penalty" increase for moving out is above market and therefore should not be capitalized. Hence, it is not included in NOI, but rather is a below-the-line income item since it enhances cash flow. In other words, as a negative capital account, it will reduce the Leasing and Capital Costs expense line items, thereby increasing cash flow.

Exhibit B.4 contains an Argus analysis reflecting a leveraged IRR of 64.92 percent over a 10-year holding period. This is an excellent return. Why is the IRR so high? It is high for several reasons: (1) the initial cash investment is very small in relation to the purchase price, that is, $750,000 on a $9,000,000 purchase; (2) under the Argus assumptions, OK bought the Center based upon a 12.92 percent cap rate ($1,163,091/$9,000,000) and then sold the Center 10 years later at a 9.5 percent cap rate; (3) although the anchor tenant, Go Dark, abandons the Premises, there is no disruption in income, that is, Go Dark continues to honor its contractual lease obligation; (4) at a reasonable cost, the entire vacant 25,576 square feet is leased within a 36-month period without losing one tenant. Based upon a 12 percent discount rate, the Argus run shows an approximate 11.5 million value versus a purchase price of $9,000,000.

The conclusion is that if the assumptions are correct and Go Dark continues to honor its contractual obligation, and if OK is able to lease up all of the vacant space in a reasonable time frame at a reasonable cost, the $9,000,000 purchase price was a very good buy.

3. What are the tax consequences to Dan Entrepreneur at the time of the sale? Dan purchased the Home Run Center in January of 2007 for $15,000,000 and sold it in July of 2009 for $9,000,000. Based on these figures, without getting into a detailed calculation, it appears that a loss occurred. The threshold question is, assuming Dan bought and then sold at a loss, may he recognize the loss? This issue concerns the related party rules contained in IRC Section 267 and subchapter K of the 700 series dealing with partnerships. Dan owns 100 percent of HRC and he sold to OK, in which he holds a 50 percent interest. The related party rules dictate that he cannot recognize the loss if he owns greater than 50 percent of the acquiring entity. Therefore, since Dan owns 50 percent or less of OK, he may recognize any loss.

When Dan originally acquired the Home Run Center in 2007, Dan's CPA allocated the building/land ratio as 80 percent/20 percent. Therefore, the structures were, at acquisition, valued at $12,000,000 (80 percent of $15,000,000). Using a 39-year estimated useful life results in depreciation taken of $307,692 per year ($12,000,000/39) for a two-year period. The adjusted basis is therefore $14,384,616 ($15,000,000–$615,384). HRC sold the Center for $9,000,000. The result is a Section 1231 loss, calculated as follows:

Adjusted Basis	$14,384,616
Less Sales Price	9,000,000
Loss on Sale	–$5,384,616
Plus Cash Boot	750,000
Plus Debt Forgiveness	3,000,000
Taxable Loss	–$1,634,616

The fact pattern in the hypothetical is somewhat complicated and can therefore lead to controversies. Our assumption is that Dan sold the Home Run Center for fair value to an independent third party and therefore is entitled to take the loss on sale. The Internal Revenue Service could argue that the formation of the limited liability company should be disregarded, and that what occurred was in fact the contribution of real property by Dan to a partnership that results in neither the recognition of a gain or loss and the receipt of $750,000 for his one half interest. Alternatively, the IRS could argue that the transaction was the discharge of a debt that results in a taxable event and the concurrent sale of a one half interest in the Home Run Center for $750,000.

Assuming a sale to a third party by Dan, the question arises as to what income Dan may offset the loss against? This loss may offset other real estate income Dan has earned in 2007, and any unused portion of the loss may be carried forward.

Section 469 of the Internal Revenue Code makes a distinction between active and passive losses. If you "actively participate" in managing and renting the subject real estate, as Dan has done in the hypothetical, then your loss is an active loss and may offset income earned through managing other real estate properties. Additionally, the passive loss rules allow you to write-off up to $25,000 in losses against ordinary income. If your adjusted gross income exceeds $100,000, however, you lose a portion of the write-off. The write-off evaporates completely if your adjusted gross income exceeds $150,000. In contrast, if Dan was not an active real estate professional, the passive loss rules would dictate that the passive loss is only deductible against passive activity gains. The only good news is that the passive losses do not expire, so that if your investment generates a gain many years later it is appropriate to offset that gain with any unused passive loss.

Also, income and expenses from operations may generate a loss in the year of sale, especially in light of the fact that all unamortized costs, such as those relating to loan fees, tenant improvement expenses, and leasing commissions, may be expensed in that year.

Problem Number 6

Let us assume that after six months, OK locates a replacement tenant for Go Dark: the Discount Factory. The Discount Factory sells varied merchandise at low, discounted prices. The Discount Factory agrees to a new 15-year lease at $.75 per square foot per month, $9.00 per square foot on an annual basis. The lease rate increases by $.15 per square foot per month every fifth lease year. The Discount Factory bargains for and receives the first two months Base Rent at $.375 per square foot per month. In other words, the landlord grants one month of free rent based upon the Base Rent, which excludes the operating cost charges. The lease is structured as a triple net lease. The landlord also agrees to disburse $1,000,000 as a tenant improvement allowance and to take over Discount Factory's existing lease obligation. The Discount Factory's existing lease of 20,000 square feet has three years to run at $.50 per square foot per month.

During this six-month period, OK renewed two leases, that is, suite A-100, Batters Box Storage, and suite A-103, Catcher's Nite & Day Lingerie. OK also was able to finalize two leases: one for 1,300 square feet and the other for 2,241 square feet. The initial Base Rent for the new leases are, respectively, $1.25 per square foot per month and $1.29 per square foot per month.

(Please refer to Exhibit A.5 on the companion website, which reflects a current rent roll based upon the information contained in Problem Number 5 as modified by the comments set forth earlier).

What issues arise given this fact pattern?

1. Go Dark has four years left on its lease. Its rent is now $35,572.50 per month ($.60 rent per square foot × 1.25 penalty percentage × 47,430 square feet). During Go Dark's remaining term, its lease provides for one rent increase to $.75 per square foot effective in two years. Over the next four years, its potential Base Rent cost is therefore $1,920,916.12 ($35,572.50 Monthly Base Rent × 24 plus $44,465.63 Monthly Base Rent × 24 months). Additionally, Go Dark must pay its triple net charges. Operating expenses vary for shopping centers, depending on type, location, and so forth; however, for purposes of this analysis $.35 per square foot per month is utilized. Therefore, Go Dark could expect to incur over the remaining term of its lease an additional $796,824 ($.35 rent per square foot × 47,430 square feet × 48 months) in CAM charges. The total rent expense to Go Dark for the remainder of its lease term is $2,717,740.12. Based upon this potential monetary exposure, negotiations with Go Dark to terminate its lease can be expected to result in Go Dark agreeing to contribute all or most of the committed tenant improvement allowance to the Discount Factory.
2. The Home Run Center is a fairly large shopping center with four other "mini-anchors." Prior to entering into a lease with the Discount Factory, it should be verified that there are no restrictions in other tenant leases in the Center, such as the

lease with Discounts R Us, which prohibits the sale of products or services that the Discount Factory intends to market. If there are restrictions that are objectionable to the Discount Factory, then these restrictions must be addressed. A written waiver should be obtained from the party whose lease contains the restrictive covenants. Alternatively, the Discount Factory's lease must reflect the restrictions.

3. As part of the transaction, OK has agreed to take over the Discount Factory's existing lease. OK has therefore obligated itself to pick up Base Rent of $10,000 per month (20,000 square feet × $.50) plus any operating expense obligations associated with this lease. OK's strategy might be to either assign or sublease the space to another user. OK views this cost as a nonproductive sunk cost, so even if it can severely discount the rental amount in favor of another tenant, it is worth it. It offers the space at $.25 per square foot per month, all or any part. OK also intends to approach the owner of the shopping center where the Discount Factory was based to explore whether an economic buyout can be arranged.
4. What is the estimated value of the Center after the Discount Factory is in place paying rent? Please refer to the Argus spreadsheet shown in Exhibit B.5 (on the website). The basic assumption underlying this analysis is that it is viewed from the perspective of a potential buyer. The Argus spreadsheet assumes a going-in cap rate of 8.5 percent, which results in an initial fair-market value of $15,044,447 ($1,278,778/.085). Given the assumed debt equals $8,250,000, the result is an assumed initial equity contribution of $6,794,447. The result is a significantly reduced leveraged return of 13 percent. Also, at the same discount rate that was used on OK's acquisition, that is, 12 percent, the fair-market value is approximately $13,500,000—up from $11,500,000 computed at OK's acquisition in Exhibit B.4. When compared to Exhibit B.4, the value and leveraged return is understandable, since in the prior Argus we looked at the project from OK's standpoint and assumed the going-in value was $9,000,000 based upon the purchase price, a 12.9 percent cap rate, while in this Argus run, the going-in value is $15,044,447, an 8.5 percent cap rate. The equity assumption in Exhibit B.4 was only $750,000, which drove up the leveraged return to 64.92 percent! In

Exhibit B.5, the assumption is that the invested capital is \$6,794,447. Hence, with similar cash flows, the leveraged return in Exhibit B.5 is significantly reduced to 13 percent. However, since the cap rate in Exhibit B.5 is much lower than the cap rate in Exhibit B.4, the result is an enhanced FMV from 11.5 million to 13.5 million. Please note that it is also assumed in this Argus run that Go Dark bears the entire cost of the \$1 million tenant improvements to put the Discount Factory in place. Furthermore, OK will have to shoulder the cost of The Discount Factory's existing lease for four months, then one-half of such cost for the balance of the three years during which the space is vacant. The assumptions set forth that The Discount Factory's existing lease cost was \$10,000 per month (20,000 square feet at \$.50 per square foot per month) plus triple net charges of \$7,000 per month (20,000 square feet at .35 per square foot). The model assumes that the base rent is incurred by OK for the first four months, that is, \$40,000 and then 50 percent of the base rent for the balance of year one, that is, \$5,000 × 8 = \$40,000. Consequently, it is assumed OK picks up \$80,000 of base year expense in year one for The Discount Factory's existing space. In year two and year three the charge is 50 percent of the base rent or \$60,000 per year (\$5,000 × 12). It is also assumed that after the fourth month, a replacement tenant covers the triple net charges under this lease.

Problem Number 7

Three years have passed. The Discount Factory has 12 years to go on its lease. The tenant is current, although its payment history has not been perfect, and it has often paid the rent at the end of the month. The Discount Factory is a public company. The company's earnings for the past couple of years have been dismal. It has posted declining sales and increasing losses for each of the past 10 calendar quarters. Its stock has fallen from a high of \$65 three years ago to its current value of \$6. The Discount Factory's sales at the Home Run Center have also steadily decreased over the last couple of years. It is currently doing approximately \$550,000 in projected annual sales. The breakeven sales point is approximately \$800,000. Over the last three years, OK has managed to renew 51,410 square feet of tenant space and lease up a good portion of the vacancy in the Center so that only 3,230 square feet in the Center is vacant (approximately 1.9 percent of the total square footage of the Center). OK feels that they have created a tremendous value since they took the Center from essentially a 57 percent leased Center (counting the supermarket as vacant) to a property whose occupancy exceeds 98 percent. Exhibit A.6 on the companion website shows the new rent roll. The Home Run Center is listed for sale at $15,000,000. A potential buyer, Grand Slam, LLC (Grand Slam), is located through a broker. Grand Slam, LLC, is owned by Ethan Honorable and Andrew Letswalkaway. Grand Slam agrees to give OK its asking price. The parties enter into escrow. The first thing Grand Slam, LLC, asks to see is a copy of OK's delinquency list. Exhibit 8.5 reflects an accounts receivable aging report as of January 21, 2013.

After Grand Slam reviews the accounts receivable aging report and otherwise completes its due diligence of the Center, Grand Slam tells OK that based upon rents it can count on, the most it can pay for the Center is $14,000,000. OK feels that Grand Slam is doing a "bait and switch," but upon reflection accepts the revised price, especially in light of the fact that OK realizes that it did not, prior to the initial $15,000,000 initial agreement, disclose the Discount Factory's delinquency nor the poor payment history of many of the other tenants. Grand Slam buys the Home Run Center on May 1, 2013. Ethan and Andrew each put up $2,000,000 for the down payment. They obtain a $10,000,000 (71 percent LTV) nonrecourse loan from Credit Rated Bank. The loan is at 7.5 percent interest-only for the first year, then moves to a 20-year amortization. The Credit Rated Bank required impounds for taxes and insurance, estimated capital expenditures, tenant improvements, and leasing commissions.

What are the tax consequences to OK of the sale?

OK purchased the property for $9,000,000 in July of 2009 and sold it for $14,000,000 in May of 2013. The IRC 1231 long-term gain is $5,000,000. In addition, OK must pay taxes on the recapture of the depreciation taken.

Is Grand Slam paying a reasonable price for the Home Run Center?

No, the Discount Factor is a huge credit risk. Eliminating from the rent roll any tenant over three months delinquent, the Center is 73.39 percent leased, not 98.10 percent leased. Realistic assumptions must be made as to the viability of certain tenants given their rent payment history. The accounts receivable aging schedule, Exhibit

Exhibit 8.5 Aged Receivables Report

Unit	Tenant	Charge Code	Total Unpaid Charges	0–30 days	31–60 days	61–90 days	Over 90 days	Prepay-ments	Balance
6024	Discounts R Us	Discounts R Us							
		CAM	49,654.15	7,093.45	7,093.45	7,093.45	28,373.80	–0.00	
		Rent	75,072.34	10,724.62	10,724.62	10,724.62	42,898.48	–0.00	
		Total:	**124,726.49**	**17,818.07**	**17,818.07**	**17,818.07**	**71,272.28**	**–0.00**	**124,726.49**
6030	The Dollar Store	The Dollar Store							
		CAM	5,300.00	2,800.00	2,000.00	500.00	0.00	–0.00	
		Rent	10,660.12	5,220.04	3,220.04	2,220.04	0.00	–0.00	
		Total:	**15,960.12**	**8,020.04**	**5,220.04**	**2,720.04**	**0.00**	**–0.00**	**15,960.12**
6030B	Steals Flooring Inc.	Steals Flooring Inc.							
		CAM	20,188.01	2,884.01	2,884.00	2,884.00	11,536.00	–0.00	
		Rent-tax	36,715.63	5,245.09	5,245.09	5,245.09	20,980.36	–0.00	
		Total:	**56,903.64**	**8,129.10**	**8,129.09**	**8,129.09**	**32,516.36**	**–0.00**	**56,903.64**
6136	Swing Batter Fabrics & Crafts #13	Swing Batter Fabrics & Crafts #13							
		CAM	27,907.60	3,488.45	3,488.45	3,488.45	17,442.25	–0.00	
		Rent	58,525.32	7,624.76	7,624.76	7,624.76	35,651.04	–0.00	
		Total:	**86,432.92**	**11,113.21**	**11,113.21**	**11,113.21**	**53,093.29**	**–0.00**	**86,432.92**
A-102	Bases Loaded Boutique	Bases Loaded Boutique							
		CAM	910.00	455.00	455.00	0.00	0.00	–0.00	
		Rent	2,770.00	1,885.00	885.00	0.00	0.00	–0.00	
		Total:	**3,680.00**	**2,340.00**	**1,340.00**	**0.00**	**0.00**	**–0.00**	**3,680.00**

A-103	Catcher's Night & Day Lingerie	Catcher's Night & Day Lingerie							
		CAM	3,640.00	455.00	455.00	455.00	2,275.00	–0.00	
		Rent	32,787.99	3,643.11	3,643.11	3,643.11	21,858.66	–0.00	
		Total:	**36,427.99**	**4,098.11**	**4,098.11**	**4,098.11**	**24,133.66**	**–0.00**	**36,427.99**
B-102	Change Up, Inc. Store #237	Change Up, Inc. Store #237							
		CAM	2,100.00	700.00	700.00	700.00	0.00	–0.00	
		Rent	5,548.00	2,516.00	2,516.00	516.00	0.00	–0.00	
		Total:	**7,648.00**	**3,216.00**	**3,216.00**	**1,216.00**	**0.00**	**–0.00**	**7,648.00**
B-103	Bunt's	Bunt's							
		CAM	1,750.00	875.00	875.00	0.00	0.00	–0.00	
		Rent	3,166.66	2,083.33	1,083.33	0.00	0.00	–0.00	
		Total:	**4,916.66**	**2,958.33**	**1,958.33**	**0.00**	**0.00**	**–0.00**	**4,916.66**
C-104	Pop Up Specialty TV & Stereo	Pop Up Specialty TV & Stereo							
		CAM	1,543.50	514.50	514.50	514.50	0.00	–0.00	
		Rent	6,262.20	2,087.40	2,087.40	2,087.40	0.00	–0.00	
		Total:	**7,805.70**	**2,601.90**	**2,601.90**	**2,601.90**	**0.00**	**–0.00**	**7,805.70**
C-106	Foul Ball	Foul Ball							
		CAM	1,065.75	355.25	355.25	355.25	0.00	–0.00	
		Rent	3,342.23	1,447.41	1,447.41	447.41	0.00	–0.00	
		Total:	**4,407.98**	**1,802.66**	**1,802.66**	**802.66**	**0.00**	**–0.00**	**4,407.98**
D-102	The Home Run Batting Cage	The Home Run Batting Cage							
		CAM	3,137.40	784.35	784.35	784.35	784.35	–0.00	
		Rent	12,611.32	3,152.83	3,152.83	3,152.83	3,152.83	–0.00	
		Total:	**15,748.72**	**3,937.18**	**3,937.18**	**3,937.18**	**3,937.18**	**–0.00**	**15,748.72**

(*continued*)

Exhibit 8.5 continued

Unit	Tenant	Charge Code	Total Unpaid Charges	0–30 days	31–60 days	61–90 days	Over 90 days	Prepay-ments	Balance
D-106	The Home Run Beauty Salon	The Home Run Beauty Salon							
		CAM	1,383.90	461.30	461.30	461.30	0.00	–0.00	
		Rent	5,131.70	2,043.90	2,043.90	1,043.90	0.00	–0.00	
		Total:	**6,515.60**	**2,505.20**	**2,505.20**	**1,505.20**	**0.00**	**–0.00**	**6,515.60**
Pad F	Striker Oil Change	Striker Oil Change							
		CAM	2,339.40	584.85	584.85	0.00	1,169.70	–0.00	
		Rent	14,184.50	6,061.50	0.00	0.00	8,123.00	–0.00	
		Total:	**16,523.90**	**6,646.35**	**584.85**	**0.00**	**9,292.70**	**–0.00**	**16,523.90**
		Total HR	**387,697.72**	**75,186.15**	**64,324.64**	**53,941.46**	**194,245.47**	**–0.00**	**387,697.72**
		Grand Total	**387,697.72**	**75,186.15**	**64,324.64**	**53,941.46**	**194,245.47**	**–0.00**	**387,697.72**

8.5, shows six tenants that are three months or more delinquent in rent. Exhibit B.6 Argus run counts their rent initially as zero, but reinstates a rental amount based upon a staggered schedule. It assumes that the delinquent tenants are replaced or that they cure their financial problems and therefore a replacement tenant(s) or the healthy existing tenant(s) enters into a new five-year lease based on the following: Discounts R Us beginning in month 10, Steals Flooring beginning in month 7, Swing Batter Fabrics beginning in month 12, Catcher's Night & Day Lingerie beginning in month 20, The Home Run Batting Cage beginning in month 25, and Striker Oil Change beginning in month 20. Exhibit B.6 reflects an analysis from the buyer's, Grand Slam's, perspective. It shows a fair market value of approximately $10,330,000 based upon a discount rate of 12 percent with a leveraged return of 8.03 percent. This is not a very good deal on a $14,000,000 purchase. The obvious reason for the decline in value is the income loss due to the delinquent tenants. The lower return of 8.03 percent is a result of the $4,000,000 investment ($14,000,000 purchase price less loan amount of $10,000,000) and the reduced cash flow because of nonperforming tenants.

Let us assume that based upon actual rent collections, what occurred during Grand Slam's first year of ownership was that the NOI varied from $100,000 to $140,000 per month depending upon the tenants meeting their contractual rent obligations. The monthly interest payment plus reserves equaled $91,167 per month. The breakdown of the monthly payment to the lender was as follows: interest $62,500 ($10,000,000 × 7.5 percent/12), tax impounds $13,417 ($14,000,000 FMV × 1.15 percent/12), insurance impound $2,500 ($30,000/12), capital reserves $4,250 (170,000 square feet × $.30 per square foot), and tenant improvements and leasing commissions $8,500 (170,000 × $.60 per square foot). The result was an average positive monthly cash flow of about $32,000. Ethan and Andrew in year one of operations received $220,000 of distributions. In year one of operations, Ethan's and Andrew's cash-on-cash return was 5.5 percent ($220,000/$4,000,000).

Starting in May of 2014, year two of Grand Slam's ownership, the economy started to enter into a recession and many of Grand Slam's tenants experienced an extreme drop in sales and therefore earnings. Discounts R Us and Swing Batter Fabrics & Crafts filed for bankruptcy and did not affirm their leases at the Center. Also, Steals Flooring, Inc., and Catcher's Night & Day Lingerie closed their doors and no rent has been forthcoming from these tenants. The result of these events was a decrease in the NOI by approximately $41,158 per month to an average monthly collection of about $79,000. In addition to the severe hit to income due to the tenants' defaults, the interest-only feature to the loan expired and Grand Slam is now required to pay principal on the loan based on a 20-year amortization. The result is that the monthly mortgage payment with impounds has increased to $106,226 while the average monthly collections dropped to $79,000. Based upon the foregoing, the cash flow is negative approximately $27,000 each month.

Based upon realistic rental collections and eliminating rents from tenants significantly delinquent, the partners constructed an Argus analysis to determine the project's value. Please refer to Exhibit B.6 found on the companion website.

Given the negative cash flow, Ethan writes a letter to Credit Rated Bank care of Mindless Service Corp., the servicing agent. Ethan outlines the dire financial straits currently affecting the Center, but expresses his company's willingness to work to lease up the project and get it back in shape financially. Ethan requests that for a temporary time period, the lender accept interest-only payments on the loan and suspend Grand Slam's obligation to fund money into the Cap X, tenant improvement, and leasing commission buckets, especially in light of the fact that these buckets currently contain over $100,000. Grand Slam points out that if the servicer works with Grand Slam in this manner, the approximate net income would be $79,000, which would match the debt service and the tax and insurance impounds ($62,500 + $13,417 + $2,500 = $78,417). Mindless Service Corp. responds that no modification will be granted since it expects the borrower to meet its contractual obligations.

Ethan and Andrew meet and discuss their predicament. Ethan Honorable acknowledges that the loan is his obligation and expresses his willingness to write a check to support the loan obligation if necessary. In contrast, Andrew points out the nonrecourse nature of the loan and says, "I'm out of here. Let the lender take back the project." In late October of 2014, Ethan buys out Andrew's ownership of Grand Slam for $1. Andrew Letswalkaway is ecstatic. He has lost quite a bit of money, but at least he has "stopped the bleeding." Also, most important to Andrew, he believes that his relinquishment of his interest means he can walk away without any negative consequences. After all, he is no longer an owner! Ethan supports the negative cash flow for another six months, until

April of 2015, and then simply does not have the funds to pay the monthly loan obligation in full. He tenders a check for less than the full amount due. Mindless Service Corp. returns the check, forecloses on the mortgage and, at a trust deed sale in August of 2015, acquires title to the Center in the name of the lender.

What issues are raised by this fact pattern and what effect does the foreclosure have on Ethan and Andrew?

First of all, the purchase of Andrew's ownership interest in Grand Slam probably violates the Deed of Trust, which would allow the lender to call the loan. This is somewhat academic given the subsequent foreclosure by the lender.

The more important issue is, What are the tax consequences of the foreclosure to Ethan and Andrew? The property was bought in May of 2013 for $14,000,000. Assuming an 80/20 allocation between building and land, the depreciable base would be $11,200,000. Based upon a 39-year useful life, $287,179 ($11,200,000/39) in depreciation would be allowable depreciation per year. Ethan's share of the depreciation deduction would be 50 percent for the first year and a half, that is, from May 2013 through October 2014, or $215,385 plus 100 percent during his sole ownership for the next 10 months, that is, from November 2014 through August 2015, or $239,316. Ethan's total depreciation taken would therefore be $454,701. Given the foreclosure, the effect of the depreciation will be to reduce Ethan's basis and, ultimately, his loss. Ethan's basis equals his allocated share of the debt at acquisition of $5,000,000 plus his cash investment of $2,000,000 plus the debt he assumed when he purchased Andrew's share, $5,000,000 less the depreciation taken of $454,701. Therefore, Ethan's adjusted basis is $11,545,299. His loss equals his adjusted basis less the amount of discharged debt, which is considered proceeds. His loss therefore equals $1,545,299 ($11,545,299 less $10,000,000).

Real estate taxes in California are due in arrears and payable semiannually. The second installment for 2014, which covers the tax period from July 1, 2014, through December 31, 2014, is due February 1, 2015, and delinquent April 10, 2015. Let us assume Ethan timely paid the second installment. The first installment for 2015, which covers the tax period from January 1, 2015, through June 30, 2015, is due November 1, 2015, and delinquent December 10, 2015. Since the foreclosure occurred in August of 2015, the tax bill would not have even been issued for the first installment of 2015. The point is that Ethan should be liable for real property taxes for his period of ownership from January 1, 2015, through August of 2015. A pro ration should be made, with Ethan liable for 67 percent (8/12) of the real-estate taxes for the first installment taxes.

There also is an issue of to what extent, if any, Ethan must return rents to the lender, given that he took cash flow including (possibly) a management fee from the property prior to the foreclosure. In general, even if the loan is in default, a management fee is a proper and reasonable expense and therefore would not have to be returned to the lender. The loan documents control, but in general, once there is a default, only ordinary and reasonable operating expenses may be paid by the borrower. To the extent distributions are made back to the owner, they are subject to recapture by the lender.

Andrew owned the property for one and half years. His share of the depreciation would be $215,385. His IRC 1231 loss would be calculated by first determining his basis, which equals his allocated share of the debt, $5,000,000 plus his cash investment of $2,000,000 less the depreciation taken of $215,385 or $6,784,615. The adjusted basis is then reduced by what he received: $1 and discharge of the $5,000,000 debt. Hence, his loss is $1,784,614 ($6,784,615 less $5,000,001).

In addition to the above, although the loan is nonrecourse there are usually certain carve-outs built into the loan documents that impose personal liability on the principals. These carve-outs should be read carefully. For example, personal liabilities usually include the tenant security deposits. The total security deposits for the Home Run Center equal $71,638. Usually, the loan documents provide that this personal obligation is joint and several. Hence, Ethan and Andrew are both 100 percent liable for this amount to the lender. The allocation of this liability between Ethan and Andrew might be covered in the operating agreement or, alternatively, might be covered in the PSA when Ethan bought out Andrew's interest in October of 2014.

Please refer to Exhibit 8.6 for a graphic depiction of the significant events set forth in Problems Number 5 through Number 7.

This chapter is illustrative of the many ways and variations that are possible in applying real estate principles to a given factual scenario. Identifying issues is important to avoid potential pitfalls and to assist in economic and tax planning.

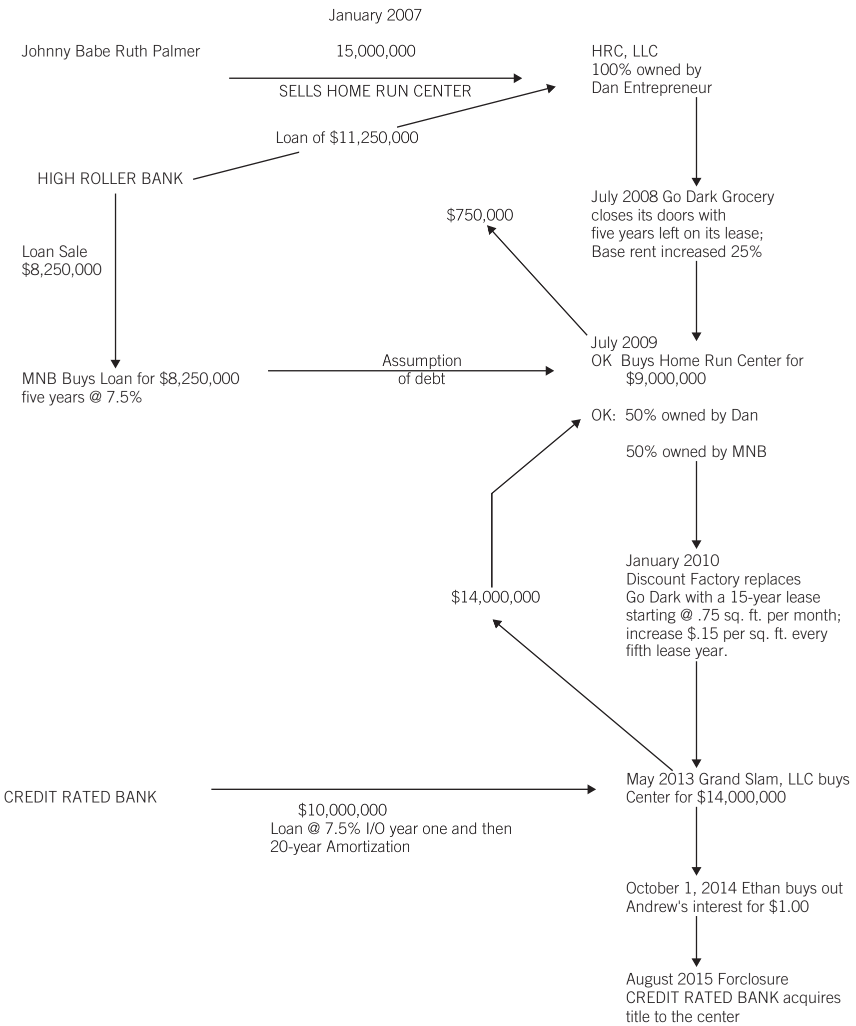


Exhibit 8.6 Problems Number 5 through Number 7

Wealth Opportunities in Commercial Real Estate: Management, Financing, and Marketing of Investment Properties
By Gary Grabel

CHAPTER 9

Development or Rehabilitation (Build to a 12 Percent Yield)

Getting involved with a construction project is usually more complex and time-consuming than the purchase of an existing real estate investment. If you are considering new construction or a major rehabilitation (rehab) project, there are many variables to consider.

The 10 Phases of a Construction or Rehab Project

A ground-up development or a major rehab project can be broken down into 10 distinct phases:

1. Equity assemblage
2. Feasibility study
3. Acquisition of the land and/or the project
4. Acquisition and development financing
5. Design and construction drawings
6. Governmental approvals
7. Construction of improvements
8. Marketing and leasing
9. Permanent loan
10. Management and operation of the project

A straight acquisition of a leased fee estate usually does *not* include four of these phases: the feasibility study, design and construction drawings, governmental approvals, and, of course, the construction phase. These four areas are discussed in this chapter, along with other construction-related matters. The other areas are covered in more depth in other chapters.

The 10 phases just listed are often interdependent and do not necessarily follow in a consistent, linear order. It makes sense to obtain your equity monies at the outset, but there is nothing wrong with seeding the project with your own funds and later, if you decide to move forward, assembling all of the needed capital. Similarly, in order to complete the feasibility study, it is crucial to understand the applicable construction costs, which are dependent on the design and the final construction drawings. A permanent loan is typically secured only once the project is fully built and substantially leased with tenants in place; however, it might be desirable or necessary to obtain a take-out commitment (a lender agrees to fund a specified dollar amount at a later date subject to certain conditions being fulfilled) prior to starting the project. The construction lender, for example, might require a take-out commitment as a condition of its construction loan. In addition, on income-producing projects, such as retail, office, or industrial construction, a preleasing level is often part of a construction lender's requirements. If preleasing is required, marketing and leasing predates all of the other phases. Governmental approvals, such as permits, are usually obtained after the construction documents are submitted to the building and safety department, although typically the developer has had multiple discussions with the city planning department or other governmental agencies well in advance of the formal submission. The point is that the phases interact and overlap. The foregoing are merely examples of the interrelationship of the various phases.

Assessing a Construction Project

Imagine you are driving in your car and you see a large vacant lot near a hospital with a huge sign on the property captioned "Land for Sale—Can Build 60,000 Square Foot Medical Office Building." The sign also has a broker's name and phone number.

How do you determine whether or not a project makes sense on this piece of dirt? What are the criteria for judging if a development project is viable? The sign suggested building a medical office building. The land is located in close proximity to a hospital. However, the question still remains: Is a medical office building the highest and best use for this property? Would it be better to build medical condominiums or a mixed-use project with retail in the area fronting the street, reserving the balance of the development for medical office space? What if there is already a medical office building on the hospital's campus that is almost entirely vacant, but the hospital employees are having a difficult time finding affordable living space? Would an apartment building make more sense? If you decide you would like to move forward and build a project, what should you pay for the land?

The first step is to collect additional information about the project. You call the broker listed on the "for sale" sign and ask general questions. Is the property still for sale and, if so, what is the asking price? How long has the lot been for sale? What is the profile of the seller? What is the seller's motivation for selling? Would the seller consider a joint venture? What is the lot size? What is the zoning? Is there any preleasing? Have there been any potential leasing inquiries? Where are the potential tenant-demand generators? Is there an architect involved and, if so, has he completed a preliminary site plan and/or construction drawings? Are there any potential problems with the site such as compacted land, drainage issues, or environmental problems? These questions are merely a starting point in the inquiry stage. There are many additional questions to raise and to which you must determine the answers. A potential buyer should, however, consider that, from a negotiation standpoint, it is important to show restraint in the amount and number of questions asked at the initial contact stage. It is important to establish a rapport with the seller and/or the seller's agent at this juncture. Making further inquiries as you go along, as well as retaining the proper experts to help you gather information, will hopefully clear up many of the unknowns. Let us assume that after a preliminary inquiry you decide to learn more about the project. You hire an engineer—and perhaps an architect—who reviews zoning and determines the type of construction that is permissible and the potential density of your project, given the site constraints. Usage will dictate parking requirements, which are often the constraining factor when ultimately configuring the size of the structure that can be built.

You might hold a meeting with the appropriate city planning official, with your engineer or architect in attendance, to better understand what the property is entitled for, that is, exactly what may be built on the site at this time. What does the City or the appropriate governmental entity want on this site? Additional questions might include: What are the set back restrictions? Are there any special assessments? Are utilities, for example, gas, water, electric, brought to the site? How far away is the hook-up to the city sewer system? Does the city have any special rules, such as unusual drainage requirements?

If you elect to go further with the project the site should be placed under contract, since money must be spent on due diligence items at this point, if not earlier. Ideally, from the buyer's perspective, the purchase and sale agreement (PSA) should allow the buyer an adequate period of time to conduct due diligence without risking capital with the seller. Enough money must be spent on due diligence at the initial stages of the project without additional nonrefundable funds being paid to the seller. Usually, at this stage, the seller will permit a buyer to tie up the property to conduct studies to determine if the site works for him. The issue becomes one of timing. What is a reasonable time to hold the property under a contract to purchase without a firm commitment from the buyer? From a developer's point of view, the ideal scenario is to tie up the dirt without committing nonrefundable monies until he is ready to put a spade in the ground. From the seller's perspective, a reasonable period should be given the buyer during which he may explore the viability of the project and the site—but then the buyer must commit so the refundable good faith deposit becomes a nonrefundable deposit, applied to the purchase price if the buyer closes, yet retained if the buyer fails to close. A compromise position might be for the seller to give the buyer a few months to explore the viability of the project and then, if the buyer desires additional time, for the seller to stipulate that the good faith deposit becomes nonrefundable and increases in size as additional time to close is given.

Developer as Conductor

In a construction project, the developer/owner becomes the conductor, orchestrating and managing the various parties who contribute their work to the project in an attempt to create a final product.

The orchestra must be assembled. An architect is needed to analyze the site to determine the size of the project that can be placed on the land as well as its configuration. The architect might consult with a civil engineer who focuses on grading, streets, and sewers, and overall utility systems. Later in the process the architect may consult with other engineers, such as a mechanical engineer, who designs the building's HVAC system, and an electrical engineer, who is usually retained to design the electrical power and distribution system. An attorney is needed to assist in, among other things, drafting the PSA, reviewing the survey in conjunction with the preliminary title report. Additional expertise might be needed in the following areas: an appraiser, an environmental assessment company, a soils engineer, a title company, a surveyor, a landscape architect, a bonding company, a leasing broker, a mortgage broker and/or a lender, a space planner, an interior designer, parking consultants, an artist who creates "public art," a public relations and/or an advertising agency, a property management company, and a contractor who oversees various subcontractors or other tradesmen. The long list of potential subcontractors to be hired by the contractor might include a grading contractor, a foundation expert, an electrician, a plumber, HVAC professionals, a flooring company, individuals to do demolition or framing, tile installers, insulation experts, painters, drywall installers, stucco/plastering specialists, sprinkler companies, elevator firms, lighting consultants, and the like.

The developer is ultimately responsible for overseeing the various parties in the orchestra. If something goes wrong, it is usually the owner who will bear the brunt of the problem in terms of time and money. It is therefore crucial for the developer to strike a balance between selecting expert, skilled members of the team, at an affordable price, and personally supervising the contracted parties. The developer cannot be everywhere. He cannot oversee all steps in the process, but, obviously, he should not close his eyes. He must monitor, at least on a spot basis, the construction flow and the activities of key project members. It is because of this reasoning that, especially on larger project, the developer often has a full-time construction manager onsite who is an employee of the developer and whose function it is to monitor and coordinate the project.

A soils report will answer questions about the condition of the soil, for example, whether or not there is any landfill, whether toxic materials are present, and whether the soil has the ability to support the planned structure. The architect, in consultation with an engineer, can draft a site plan for the project and lay out a building footprint and foundation. A preliminary title report and a survey are needed to set the site boundaries as well as locate easements and any potential encroachments. It is important to locate any underground utility lines or other cabling. If the grading company hits an unidentified large fiber-optic line, the necessary repairs can be costly. If the land is not on a level surface, the survey might include a topographic map showing elevations that may have a bearing on the ability to develop the site and on density issues.

In addition to working with advisors, the developer must also interface with various levels of the city government including the planning staff, building and safety, inspectors, and possibly the city council. Development can be controversial. The size, design, and scope of a project, along with its resulting traffic patterns and parking requirements, may result in neighborhood or homeowner associations having concerns that must be addressed.

Does the Project Hit Your Minimum Yield?

Let us say you learn that the project is zoned commercial, that it includes a medical office, that it comprises 132,605 square feet (3.047 acres), and that the asking price is $663,050 ($5.00 per square foot). How do you determine whether or not this project makes economic sense?

Referring back to the chapter's subtitle, what is meant by "Build to a 12 Percent Yield?" Put simply, you have to determine what minimum percentage yield or return is necessary to induce you and your investors to invest in the project. Factors such as area demographics, potential project size, preleasing levels and absorption assumptions, community acceptance or resistance, the structure of the financing, or the tenant mix and quality may be decisive factors in your decision to move forward or to back away. Yet, typically, the initial screening test revolves around the numbers: Does this potential project meet your yield requirements?

If we know the yield that we need to achieve is 12 percent and if we can also figure out the cost of building the project, the unknown, therefore, is the net income. What rental rate must be achieved to yield this return on a given cost? The formula we are working with is:

$$\frac{\text{Net Income}}{\text{Project Cost}} = \text{Yield} = \text{Return on Cost}$$

We therefore might build an economic model with the unknown being the rent you are going to charge tenants. We might work backwards, first estimating the total project cost. To simplify the analysis, we are going to assume that the building will be preleased to a single tenant and that it will take one year to build the building and get the tenant in place paying rent.

For the proposed 60,000-square-foot medical office building, the construction costs might be estimated as follows:

Hard Costs	
Improvements 60,000 @ $100 per sq. ft. plus One Elevator	$6,000,000
On/Off Site Improvements 81,000 sq. ft. @ $12 per sq. ft.	972,000
Tenant Improvements 56,000 sq. ft. @ $50 per sq. ft.	2,800,000
Hard Cost Contingency	600,000
Land Cost	
3.047 acres @ $5.00 per sq. ft.	663,050
Soft Costs	
Architectural and Engineering	113,000
Plans/Permits	110,000
Interest Carry ($10,000,000 Loan 50% Disbursed for 12 Months at 7.5% Interest-Only)	375,000
Loan Fee (1%)	100,000
Legal	30,000
Title, Recording, and Escrow Expenses	27,000
Appraisal	5,000
Cost Analysis & Review	1,250
Inspections	6,000
Environmental and Review	2,000
Operating Expenses during Construction	40,000
Return to Investors during Construction	255,700
Soft Cost Contingency	400,000
TOTAL PROJECT COST	**$12,500,000**

In this analysis, we are assuming that no leasing commissions are incurred. This project is a build-to-suit. The assumption is that the developer has a longstanding relationship with the tenant and therefore does not go through a broker to locate the tenant or negotiate the lease. This, of course, might not be a valid assumption if the tenant has a contractual agreement with a broker and insists that that broker be paid regardless of the circumstances or, of course, if the project is to be multitenant (in which case at least a portion of the lease up will probably result in leasing commissions paid to outside real estate brokers). Also, the operating expenses during construction are fairly minimal since the downtime revolves around construction rather than lease-up. During the construction phase, taxes and insurance must be paid, but the operating expenses really kick in once the building is constructed. It is then that, in addition to taxes and insurance, other operating costs such as utilities and janitorial expenses are incurred. Furthermore, when calculating the overall project cost, a return to the capital partners is often overlooked. Most analyses do not factor in this cost, but if the project is syndicated it is a real expense. In our hypothetical scenario, the construction loan is assumed to be 80 percent of the construction costs, or $10,000,000. Therefore, the equity portion is 20 percent, or $2,500,000. At a 10 percent return to the investors, $250,000 in additional costs, as a preferred return, must be paid out to the money side of the investment during the year the project is under construction.

If you desire to achieve at least a 12 percent return on your investment, you must, on the average, charge rents of at least $2.23 per square foot per month on a triple net basis. The calculation is as follows:

$12,500,000 total project costs times the target
12 percent return results in a required net operating
income of $1,500,000 divided by the project total net rentable
square footage of 56,000, equals an annual base rent of
approximately $26.79 or on a monthly basis
$2.23 net, net, net.

Relating this back to the chapter subtitle, "Build to a 12 Percent Yield" means, in this context, that the owner intends to construct the building so that after it is built and leased the yield on total cost will approximate a 12 percent return. The goal is to find a project that, based on reasonable assumptions, will be able to achieve the minimum acceptable yield. The 12 percent return on cost outlined above is based on the total estimated project cost.

In order to more fully evaluate the project, it is necessary to make assumptions as to projected income and expenses. Using the model developed for the Diamond Medical Center, which is a 60,000 medical office project, the income and expenses would look as follows:

Gross Income		**$1,440,000**
Expense Reimbursement		
Recapture over Base Year	18,000	
Utility Recapture	76,800	
Triple Net Charges	121,836	
Total Expense Reimbursement		216,636
Total Gross Income		$1,656,636
Vacancy and Collection Loss		(82,832)
Adjusted Gross Income		$1,573,804
Operating Expenses		
Elevator Contract	(11,197)	
HVAC Maintenance Contract and Repair	(5,413)	
Insurance	(5,000)	
Janitorial Contracts	(52,600)	
Landscaping	(6,410)	
Property Taxes	(97,067)	
Property Management Fee	(49,699)	
Repairs & Maintenance	(13,470)	
Security and Fire	(27,931)	
Taxes & Licenses	(420)	
Trash Disposal	(6,336)	
Utilities	(180,956)	
Total Operating Expenses		(456,499)
Net Operating Income		**$1,117,305**

Based on the foregoing, conclusions can be made as to the project's projected profitability, return on equity, and so on. For example, if we assume an 8 percent cap rate at sale, the net sales price, if we marketed the project after it was built and occupied, would be $13,547,323 ($1,117,305/.08 less a 3 percent sales commission). The result is an approximate $226 value per square foot ($13,547,323/60,000 square foot): Approximately a $1,000,000 profit on a $2,500,000 investment; and a 40 percent return on equity (ROE). This is a very respectable return, especially in light of the fact that we assumed that this project was a build-to-suit and, hence, the leasing risk was essentially eliminated. However, please note that the projected NOI of $1,117,305 falls short of the required $1,500,000 needed to achieve the 12 percent yield on cost. The question then becomes, Is the yield sufficient to induce the developer and his investors to move forward with the project?

There must be a gap between the return on cost and NOI/Project Cost in order for there to be a profit. Here the return on cost is 12 percent and the NOI/Project Cost is assumed to be 8 percent. The result is a profit. If the return on cost is 8 percent, then by definition the NOI is $1,000,000 (*X*/$12,500,000 = .08, hence *X* equals $1,000,000). Unfortunately, under these assumptions, if the cap rate is also assumed to be 8 percent, then the fair market value is $12,500,000 ($1,000,000/.08). No profit would result.

From a cash flow perspective, if we assume a permanent loan replaces the construction loan for the same amount, $10,000,000, at the same interest rate, 7.5 percent interest only, again using our prior assumptions the cash flow would be as follows:

Net Operating Income	$1,117,305
First Trust Deed of $10,000,000 @ 7.5% I/O	(750,000)
Cap X Reserves	(18,000)
Tenant Improvements and Leasing Commissions	(60,000)
Net Cash Flow	$289,305

Based on a $2,500,000 cash investment, the annual leveraged return on equity (ROE) is 11.57 percent ($289,305/$2,500,000).

(Please note: The acronym ROE is also often used interchangeably with the phrase “return on investment” [ROI]). Again, the issue becomes, Is this a sufficient return to motivate the builder and his capital sources to further explore the project?

Argus Developer

Argus has a specific program designed to assist a developer in analyzing a construction project. The program is called “Argus Developer.”

Exhibit 9.1 contains an Excel “Project Pro Forma” that restates the project’s projected income and expenses and development costs.

Exhibit 9.1 Argus Developer: Pro Forma

Project Pro Forma

REVENUE	%	$	$	$	$	$
Rental Area Summary	Units	ft²	Rate ft²	Unit Amount	Rent at Lease Start	Rent at Sale
Medical Offices	10	56,000	$2.14	$144,000	1,440,000	1,440,000
Investment Valuation						
Medical Offices – $82,832.00 non recov. cost						
Capitalized Rent	1,357,168	Cap Rate	8.00%	16,964,600		
Operating Expenses	–456,499	Cap Rate	8.00%	–5,706,238		
Tenant Reimbursements	216,636	Cap Rate	8.00%	2,707,950		
					13,966,312	
Sales Commission		3.00%	–508,938		–508,938	
Income from Tenants					1,357,168	
Additional Rent Revenue						
Tenant Reimbursements—Medical Offices					216,636	
Additional Rent Cost						
Operating Expenses—Medical Offices			–456,499			
Capital Reserves—Medical Offices			–18,000			
Tenant & LC—Medical Offices			–60,000			
					–534,499	
TOTAL PROJECT REVENUE						$14,496,679
DEVELOPMENT COSTS						

Exhibit 9.1 continued

Project Pro Forma

REVENUE	%	$	$	$	$	$
Rental Area Summary	Units	ft²	Rate ft²	Unit Amount	Rent at Lease Start	Rent at Sale
ACQUISITION COSTS						
Land Cost	132,605 ft²	$5.00	663,025			
				663,025		
CONSTRUCTION COSTS						
Construction	ft²	Rate ft²	Cost			
Medical Offices	60,000	$100.00	6,000,000	6,000,000		
Contingency		10.00%	600,000			
Offsite Improvements	81,000 ft²	12 pf²	972,000			
				1,572,000		
TI Costs						
TI Cost Area Rate —Medical Offices		$50.00	2,800,000			
				2,800,000		
PROFESSIONAL FEES						
Architect & Engineering			113,000			
Plans/Permits			110,000			
Legal			57,000			
Appraisal			6,250			
Inspections			6,000			
Environmental Review			2,000			
Soft Cost Contingency			400,000			
Operating Expenses during Construction			40,000			
				734,250		
Total Costs before Interest and Fees						$11,769,275
Interest and Fees Included in Project Costs						
Interest Paid for Debt Sources: Construction Loan (7.50%)		267,006				
Total Interest Paid for Debt Sources:			267,006			

Exhibit 9.1 continued

Project Pro Forma

REVENUE	%	$	$	$	$	$
Rental Area Summary	Units	ft²	Rate ft²	Unit Amount	Rent at Lease Start	Rent at Sale
Total Interest Included in Project Cost				267,006		
Fees Paid for All Sources: Construction Loan —Loan Fee (1.00%) (Single)			100,000			
Total Fees Paid for All Sources				100,000		
Total Interest and Fees Included in Project Costs				367,006		
Total Costs Including Funded Interest and Fees				12,136,281		
Interest and Fees not Included in Project Costs						
Mortgage Interest (7.50%)		746,874				
Total Interest Paid			746,874			
Debt Financing Fees Mortgage—% Fee (1.00%) (Single)			100,000			
Total Interest and Fees not Included in Project Costs				846,874		
TOTAL PROJECT COSTS						$12,983,155
PROFIT						$1,513,525
Performance Measures						
Profit on Cost%				11.66%		
Profit on GDV%				10.84%		
Development Yield% (on Rent)				15.03%		
Pre-Finance IRR%				15.03%		
Project IRR% (with Interest)				16.41%		
Equity IRR% (with Interest)				26.95%		
Return on Equity%				62.36%		

The vacancy and collection loss is referred to as "nonrecoverable costs." Used in connection with the inputted Excel figures is an Argus spreadsheet (see Appendix E on the companion website) outlining the income and expenses over a 31-month time frame. It is assumed it will take about six months to complete the plans and secure a permit, another year to build all of the off-site improvements, the medical office building, and the tenant improvements for the user, and another year to season and sell the project.

In the model, as is typically done, the preferred return to the investors is considered a distribution of profits shown when available rather than as a project cost. Assumptions are made in the spreadsheet as to when the construction funds are actually expended. For example, in month one, the land is purchased and hence $663,025 is disbursed. During the first six months of the development, plans and permits must be secured, and therefore monies are spent on soft costs such as architectural fees, appraisal costs, legal expenses, and so on. In month seven, actual construction activities commence and funds are expended for offsite improvements such as grading, curb cuts, sewer, and so forth, as well as the foundation for the building. The interest calculation in the previous section was calculated based upon an average outstanding balance. The Argus spreadsheet calculates the interest expense based on the assumed outstanding loan balance based upon the assumed disbursement schedule. A distinction is made in the pro forma between "Interest and Fees Included in Project Costs" and "Interest and Fees not Included in Project Costs." The distinction is based on timing. The included costs are assumed to be incurred during the build-out. The excluded costs relate to interest and fees on the permanent $10,000,000 loan originated after the construction is completed.

The Project Pro Forma then summarizes the project results under the heading "Performance Measures." The "Profit on Cost%" is equivalent to the previously discussed Yield. It is calculated as the profit of $1,513,525 divided by the Total Project Cost of $12,983,155. The Total Project Cost includes the interest and fees associated with the permanent financing. "Profit on GDV %" is the profit as a percentage of the Gross Development Value. This calculation equals the profit of $1,513,525 divided by the derived value. In the first part of the Excel pro forma, the "Investment Valuation" shows a $13,966,312 value based upon an 8 percent cap rate. The "Development Yield" is the project net cash flow including reductions for reserves of $1,039,305 over the Total Project Cost of $12,983.155. The "Return on Equity%" shows a healthy 62.36 percent. It is a function of the profit of $1,513,525 divided by the cash equity spent of $2,427,256. The cash equity could be a specified dollar amount or, as in this analysis, assumed to equal 20 percent of the Total Costs including Funded Interest and Fees. In other words, the equity is assumed to equal 20 percent of the Total Project Costs excluding costs associated with the permanent loan.

These ratios certainly give an indication of the project's health, but they are a snap shot in time. In contrast, the Internal Rate of Return (IRR) reflects a yield over the 31-month holding period. As discussed in Chapter 3, the internal rate of return is the discount rate when the present value of the project's cash flow equals the initial investment plus the present value of any additional capital contributions. In other words, the IRR is the discount rate when the net present value is zero. When you are acquiring property, you want a high IRR because that means that you need a low present value of the cash flow to achieve the present value of the cash investment. Conversely, when you are selling, you seek a low discount rate because hopefully the present value of the project's cash flow will far exceed the present value of your investment.

Feasibility or Market Study

The problem with the preceding analysis is its simplicity. We assumed a build-to-suit scenario. We assumed we had the building 100 percent preleased prior to the start of construction. Based on our construction costs, we determined what the tenant had to pay as rent in order for us to achieve a 12 percent return on total costs. In this hypothetical example, we can go to the tenant and inquire if $2.23 per square foot per month triple net is an acceptable rent level and, if so, we could possibly finalize a lease on that basis. The problem is in the real world things are usually not so simple. Most of the time at least part of a project is built without knowing who the eventual tenant or tenants will be. Based on the nature of development, it is rare that all of the pieces are in place at commencement of construction. There is a level of preleasing that is necessary to get the project off the ground, but usually 100 percent of the project is not preleased. Additionally, if tenants commit to space up front, often maximum rents cannot be achieved. If a tenant is committing to lease space significantly in advance of the finished product, it usually can negotiate a discount in rent as compared to what the market rent will be once the project is fully built-out. In our example, we knew who the tenant would be, so we would potentially be able to negotiate a rate of $2.23 per square foot per month prior to commencement of construction. Notwithstanding the above, in the real world, depending on the market, a landlord might have to make concessions in terms of free rent and/or a tenant improvement allowance in excess of the budgeted $50 per square foot amount in the construction costs.

Usually, we might be able to figure out our costs, and we know our target yield, but then we would have to "guesstimate" if we could achieve this rent and how long it will take to lease-up the project. Enter the concept of a feasibility study. The objective of the feasibility study is to determine what rents are achievable and how long it will take to fill the vacant space.

The Composition of a Feasibility Study

A feasibility or market study focusing upon what current competitive rents are is needed to determine if $2.23 per month net, net, net can be achieved and, if so, within what time frame. The study should show what comparable competing space is renting for as well as the vacancy factor in the trade area. Obviously, in order to determine the answers to these questions, you must define what you intend to build and the trade area. The problem is that to some extent the feasibility study is intended to enlighten you as to what you should build, but in order to effectively generate the feasibility study you must make assumptions as to what you are going to build. The reality is that the developer usually has a fairly good idea of what he wants to build going into a project based upon zoning, his past experience, preleasing, and the "logical fit" for the project. Of course, in hindsight a different usage might have been "better" for a site, but that is what makes a ballgame. The point is that the developer's vision of what should be built and the feasibility study are interdependent. The developer's ideas affect the study and the study should influence the final product. Once the product and the location are selected, it can be determined which boundaries should be considered to be within the subject property's competitive market area, and therefore which projects should be scrutinized to determine rent and occupancy levels. Interviews with leasing brokers help to solidify conclusions.

A list of some of the questions that might be asked to generate a feasibility study is shown in Appendix F on the companion website.

Residual Land Value

The preceding fact pattern makes several assumptions: the project cost, the absorption time period, the interest rate that will be charged against the outstanding construction loan balance, and the purchase price of the land.

What if the feasibility study shows that the $26.79 net, net, net annual base rent cannot be achieved? It is possible that you can reduce the project cost, or that the project will lease up in eight months rather than 12 months, or that the interest rate will fall below 7.5 percent. However, it is also possible that the construction costs will exceed the budgeted amount, or that the project will take more than 12 months to achieve stabilized occupancy, or that the prime rate will balloon to 18 percent. In order to construct a rational analysis it is necessary to make realistic assumptions. Nonetheless, if the target yield cannot be achieved based upon the assumed numbers, which variable most likely must give in order to hit the target yield? The answer is the purchase price of the land, since this variable can be controlled.

What value should be ascribed to the land in order to achieve the given yield goal? If we assume our target yield is 12 percent and we can achieve rents of $21 net, net, net, then up to what figure can we afford to pay for the land? A simple formula for determining the applicable project cost would be as follows:

$$\text{Total Project Cost} \times 12\% = \text{NOI}$$

We know that at $21 base rents, the NOI would be $1,176,000 ($21 × 56,000). Inserting $1,176,000 for NOI and dividing by 12 percent the result is:

$$\text{Total Project Cost} = \$9{,}800{,}000$$

Based on our assumptions, the Total Project Cost was \$12,500,000. Even if we attribute zero value to the land we still cannot come in at the cost of \$9,800,000, which is needed to achieve the target yield. The conclusion is that the project does not meet our yield criteria.

In contrast, if we lower our yield expectations to 8 percent with assumed base rents of \$21, the formula results in a maximum acceptable total project cost of \$14,700,000. The total project cost based on a land value of \$663,050 (\$5.00 per square foot on 3.047 acres) was \$12,500,000; hence there is plenty of room to negotiate the land price.

This method of determining land value is often referred to as the *residual land value approach.* Essentially, you determine your target value and then working backward, back out all of the hard and soft costs needed to get there. What you are left with is a land value. If value or sales prices decrease and construction costs remain constant, then the amount that you can afford to pay for the land decreases. Similarly, if values or sales prices increase and everything else remains constant, you have more negotiation room in purchasing the land component.

Preleasing

Let us assume that you have completed your due diligence sufficient to conclude that you wish to pursue the project. The site does not have soil issues, the title is clean, and the survey does not reflect any problems with easements, encroachments, or similar matters. You have consulted with an architect and possibly an engineer and have verified what you can build corresponds with what you want to construct. Also, market research has shown that \$2.23 per square foot per month is achievable, that there is a strong demand for medical office space, and that the geographic area where the property is located is not "thin," that is, there is a strong demand for medical services and there are several competitive medical buildings and therefore many doctors in the trade area to compete for the available rentable space. Should you start building?

Most commercial projects require some level of preleasing before a construction project should be started. The level of required preleasing is a function of the developer's comfort level, the requirements of his lender and, possibly, based upon input from investors. There is no right answer as to what the proper level of preleasing should be. Should the rents to be generated from the preleased tenants be at least sufficient to cover (1) operating expenses, or (2) operating expenses and the principal and interest obligations, or (3) operating expenses, principal and interest obligations, and a sufficient amount to pay a reasonable return to the investors?

Equity and Financing

In addition to an acceptable level of preleasing, the developer should also have his equity monies lined up. Ideally, the project construction financing should also be in place.

Having adequate reserves is often the key to a successful project. Development contains a lot of unknowns and, therefore, having an adequately funded contingency reserve is very helpful.

Construction financing is typically secured before a spade is placed in the ground. The developer wants to ensure that he has sufficient monies to complete the project. What is more, as mentioned below, mechanics' lien issues arise if work, however small, is started before the construction loan is recorded. Construction financing is typically issued by a bank and is usually structured as full recourse. In addition to the pitfalls of not providing for adequate reserves, success or failure of a development project can be a function of not anticipating and planning for contingencies relating to financing. It is therefore highly recommended that an extension and a miniperm (intermediate loan of three to five years) be built into the loan commitment. No one can know what the economic climate will be when the project is completed. No one has a crystal ball that can foretell whether funding will be readily available or severely constricted, or whether the pricing will be affordable or very expensive. Therefore, building flexibility into the loan in terms of extensions, an intermediate-term additional time frame for the loan, as well as agreed-upon pricing assists the owner in cushioning risk.

Mechanics' Liens

One of the important issues that should be focused on at the outset in conjunction with a construction project is mechanics' liens. Mechanics' liens relate to claims made by contractors and/or subcontractors or other venders who have supplied material or services to the project. In California, as well as many other states, mechanics' liens relate back in priority to the commencement of construction. In other words, if you start construction on January 1 and you record the trust deed for the construction loan on January 10, you have created a potential problem. Any claim for services rendered in July made by a contractor or subcontractor, such as an electrician, relates back to January 1, the beginning of construction, and takes priority over the construction loan. Lenders tend to frown on a loss of priority.

The simple way to avoid this problem is to record the construction loan before any work whatsoever is commenced on the project. Sometimes, however, this orderly process does not work. For example, what do you do if you must start construction to meet a tenant's occupancy needs and the construction lender is not in a position to record? An alternative solution is to work with the title company so that the title company takes the risk on mechanics' lien priority and issues a clean policy to the lender. For the title company to make this accommodation, they will usually insist on an indemnity from the borrower. Before accepting the indemnity, the title company will want to approve the financial soundness and the creditworthiness of the debtor. If approved, the lender in actuality is in a far superior position after the indemnity than before, since now it has as a contractual obligation to both the title company as well as the borrower, ensuring that there are no mechanics' liens ahead of the lender's loan. The lender, in essence, obtains an additional guarantor relative to this issue. Please note: If the title company does not accept the owner's indemnity (or, as is the case in some states, the title company will not, in any event, write around mechanics' liens), then possibly the lender will accept a performance bond and/or additional collateral.

Liability under the Construction Loan

It is typical for a construction loan to be recourse. The borrower personally guaranties the debt. It is possible, although rare, to obtain a nonrecourse construction loan or to negotiate a cap on your personal exposure. Both the nonrecourse feature and the cap are typically a function of the amount of the borrower's equity in the project. The greater the equity, the more likely the lender will bend on this issue.

Furthermore, a distinction must be made between a *guaranty of completion* and a *guaranty of payment*. Under a guaranty of completion, the borrower is personally liable to complete the project lien free. A guaranty of payment goes beyond this obligation and obligates the borrower to be personally responsible that the loan is paid timely in accordance with the contractual agreement with the lender.

Design and Construction Drawings

Okay, the developer has approved the contingencies in the contract to buy the dirt, has his equity and financing in place, and then closed escrow and purchased the land. The developer, if he has not done so already, must select an architect with whom to work. The choice may be obvious if the developer is seasoned and has successfully worked with a particular architect on this type of project in the past. However, if the developer is starting out or has not developed this type of project before, then a selection process should be established. Face-to-face interviews with candidates are essential. The developer should understand who is going to do the preliminary work, who will do the construction drawings, who will oversee the project to ensure compliance with the plans and specs, and so on. Often, in a large architectural firm, you might meet with the chief architect only to find subordinates actually doing the key work. This might be acceptable, but it should be an informed choice with a possible caveat that the senior partner remains primarily responsible for the services and is required to sign off at all of the crucial steps.

Once an architect is selected, a contract should be entered into. Usually, the American Institute of Architects (AIA) form is utilized. Bear in mind that this agreement is drafted to protect the architect. From the developer's perspective, modifications to the form should be made or a different format might be utilized. For example, the AIA form does not clearly spell out who is hiring the structural and mechanical engineer. Are the engineering fees included within the architect's contract?

The developer must meet with the project architect, since architectural plans and specifications must be drawn as agreed-to between the parties.

Governmental Approvals

In general, before any major work can be done, a permit is required—although it might be permissible to do some minor improvements to the site first. For example, at times, a municipality may issue a grading permit over the counter without full plans and specifications, but this is an exception rather than the rule. In most jurisdictions, the time frame to obtain governmental approval for a new project has increased over the last few decades. Residential projects can take years; commercial approval is usually measured in months, that is, usually three to six months.

Development is tied into governmental approvals. The nature of what can be built, as well as specific zoning regulations, access rules, permissible use, set backs, density, height restrictions, parking requirements, floor/area ratios (FAR), hours of operation, and so on are all a function of the applicable codes and of what the planning commission and city counsel will allow. If you desire to build a project, it is therefore crucial, if at all possible, to establish a working relationship with the local homeowners associations and other citizen groups as well as with city planners, the city manager, the city attorney, and the members of the city counsel. Having a dialogue with and listening to the needs and desires of these key players is very helpful in achieving what you desire to accomplish. Litigation, although unfortunately all too common in residential development, is infrequent in a commercial ground-up project. Needless to say, creating a dialogue, being a good listener, and compromising all go a long way toward avoiding litigation.

Complications often arise when a developer seeks a variance or a conditional use permit. In other words, issues often occur when the developer asks the applicable governmental entity to approve an exception to the stated codes and rules. Typical concerns of the planning commission or city counsel usually revolve around interrelated areas of congestion, parking, noise, traffic, fumes, environmental concerns, and the like.

Environmental issues have become more and more prevalent over the years. Residential development usually feels the greatest impact; however, commercial development may also be impacted, especially if the development is to be located in an environmentally sensitive area, such as wetlands. If environmental issues surface, the developer may be required to commission an environmental impact study (EIS) or even possibly an environmental impact report (EIR). These studies are intended to show the impact of the development on public services such as roads, schools, the police force, fire stations, and utilities such as water, sewer, and electric power. A full EIR might further reflect the development's potential impact on traffic, congestion, local vegetation, air quality, archaeology, animal habitat, and so on.

Very often, the negotiation process boils down to trading for a variance in return for delivering what the various opposition parties or approval entities deem desirable. If I dedicate open space for a park, will the counsel allow me to build an additional 50,000 square feet? If I give $25,000 in free parking validations, will the mayor vote to allow me to charge for parking? Assume a project is zoned for office usage. What if the office market has a high vacancy factor, but the medical office market is still robust. The trick is to determine what concessions must be made to allow a portion of the project to be approved for medical office usage. Assume your project is in a redevelopment area. You want to obtain a matching fund grant from the city. City counsel elections are coming up next quarter. Who you support and whose election you work for could have a huge impact on whether you will obtain a grant and on the amount of that grant. It is not uncommon for governmental approvals, especially in times of economic stress, to be conditioned upon the developer paying impact fees and/or making significant improvements to the area's infrastructure. Typically, street access to the project and possibly freeway on-ramp or off-ramp improvements might be conditions for approval.

Covenants, Conditions, and Restrictions (CC&Rs)

In addition to the governmental codes and rules that affect a property, the developer or the owner of a project might have recorded *covenants, conditions, and restrictions* (CC&Rs) that might affect the development. These CC&Rs supplement code. To the extent that a CC&R violates an existing law, it is not enforceable. An obvious example of this would be a racial or religious restriction. It would be unenforceable for a CC&R to bar people of a certain race or religion from being a tenants in a retail or office project. However, wide latitude is given to other restrictions that do not run afoul of the law. CC&Rs might prohibit specific usages and goods that can be sold. They might also dictate who manages the property, its hours of operation, permissible delivery areas, and so forth. The main point is that if a development opportunity is contemplated, the CC&Rs should be read and thoroughly understood prior to moving forward with the project.

Ground Lease Restrictions

Similar to CC&Rs, restrictions might be found in a ground lease that affects the property to be built prior, during, and after construction. For example, it is common for a hospital to control the land surrounding the hospital campus. If the hospital and the developer seek to enter into a ground lease with the objective being for the developer to then build a medical office building on the land (to the hospital's and developer's mutual benefit), the developer must be careful to scrutinize what, if any, restrictions the hospital imposes. It is common for the hospital to seek to avoid competition by providing that, for example, all tenants in the contemplated medical building be medical doctors on the hospital's staff. It is also possible that certain uses might be prohibited; for example, a surgical center, physical and occupational therapy, or imaging (including MRI, CAT scan, X-ray, etc.). The developer should be primarily concerned, especially in light of these restrictions, that he may not be able to completely lease the building. To address the developer's fear, a compromise might be drafted to provide that in the event the building is less than a certain percentage leased after a certain time frame, some or all of the restrictions might be lifted.

Construction of Improvements in a Ground-Up Development

When hiring a general contractor, it is important to interview several prospects. As in any hiring process, it is helpful to obtain references, but I have never had a prospect give me a bad reference. The most important question is one you ask of yourself: Do you feel you can get along with this individual?—since the construction process is usually long and involves interfacing with the contractor often in terms of decisions that must be made. Fostering a dialogue that results in good communication is paramount.

Another key question to ask is how the general contractor works in terms of staffing versus contracting out various services. Does the general contractor have a crew that performs some or all or the work, and to what extent does the general contractor use subcontractors? There is not necessarily a negative taint on billing out some or all of the work to other parties, but the key is to know what you are getting. By meeting with several contractors and obtaining bids from those parties, you will be able to compare costs and quality. Your education starts with inspecting and comparing the bids and asking why the line item for a specific trade, for example, carpentry, is so much higher here than in the other bid? Is it because one bid is based upon custom cabinetry while the other is based on off-the-shelf items from a hardware supply store? If the painting bids differ dramatically, does that mean that one party is using their in-house personnel while the other party is planning to use a painting contractor?

Who will be the on-site construction manager for the contractor? The manager is a key player and therefore his experience level and demeanor are crucial. Who are the subcontractors that the general contractor plans to use? The answer to these and other questions are crucial.

When reviewing the construction contract, there are three key areas to focus on, namely:

1. **Payment.** How is the payment to be structured? Does the contract envision a fixed priced amount or a time and materials agreement? Most agreements specify a maximum cost. Otherwise the developer is exposing himself to unknown, unlimited costs. The exception is when the job is so uncertain that a fixed price cannot be given without exposing the general contractor to significant unknown risks. A hybrid contract might set forth time and material with a maximum. Another way to structure the contract is to fix the general contractor's fee and agree that the general contractor will work with the developer to supervise, price out, and hire all of the subcontractors. In a sense, under this arrangement, the contractor becomes, at least for this job, more like an employee of the developer. Under this arrangement, to create an incentive, the developer might agree to give the general contractor a bonus contingent upon completing the project under budget.
2. **Timing.** Time is money. How long a project takes to complete from grading to finishes is usually a critical element in

the success or failure of a project. If the developer plans to come on line with his shopping center in the first quarter of the year, and if the project is delayed so it comes on stream toward the end of the year, that could have serious negative consequences. Financing rates might have increased dramatically or funding might no longer be readily available, or other competing projects completed during the delay might have captured a major portion of the targeted tenants, or the end of the year sale period—when retailers are more likely to enter into leases to capture this high-volume opportunity—might be missed.

3. **Final payment.** Assume the owner has held back 10 percent of the contract amount to be disbursed upon final completion, that is, issuance of a certificate of occupancy for the building. Is this adequate protection for the owner? Probably, it is not. There also must be a provision that indicates that funds will not be disbursed until all mechanics' liens are cleared. This is the standard that most contracts follow. I suggest, however, that additional protections for the owner should be built into the contract as a condition to final payment. Additional conditions should include obtaining an agreement from the contractor that all subcontractors will be paid in full. At times, a vendor who is owed money may not have taken the proper legal precaution to file a mechanics' lien. If they have a claim and have not filed a mechanics' lien and the contract between the developer and the contractor merely says, "if there are no mechanics' liens, then the owner must pay the contractor," the owner has no recourse but to honor the contract and pay the contractor in full. Litigation is likely to result. Also, the developer might consider including an indemnity provision into the agreement requiring the general contractor to indemnify and hold the owner harmless from any claims or causes of action from any subcontractor relating to the project. Furthermore, the contract should require the general contractor to deliver a list of all of the subcontractors who were involved in the project, detailing their involvement. The list can act as a handy reference if and when problems arise that must be addressed and it can also help to identify the contact parties for applicable warranties.

Inspections

Let us assume that your plans and specifications (P&S) have been completed, and that they have gone through the planning committee and all required modifications have been made. The P&S have also passed through all of the applicable city departments, such as the building department and the fire department. The controversial matters went before the city counsel and acceptable compromises were worked out. You have hired a construction company and it has started to build the improvements. Now your general contractor is in the process of putting up drywall for the central corridor and a city building inspector says, "This doesn't work, you need to have a fire-rated wall here with the drywall going to the ceiling." Your contractor responds "The P&S have been reviewed by your fire department and fully approved. The P&S do not call for a fire-rated wall here, just three-quarter inch dry wall."

The reality is that approval of the P&S is a conditional approval. It is conditional on interpretation of the applicable code provisions and subject to the city changing its mind. At some point in time, there is justifiable reliance on the part of the developer, but, in general, the developer remains subject to an inspector saying that, regardless of the prior approvals, a modification is required. As with other governmental officials, it is helpful to maintain a good working relationship with the city inspectors.

In addition to city building inspectors verifying that the build-out is being done per code, the construction lender will usually require an inspection prior to disbursement of funds. Draw requests are tied to completion of certain work. The lender wants to satisfy itself that the work represented has been completed.

Both the city building inspector and the lender's inspection company can be helpful to the sponsor in terms of pointing out problem areas that might need correction or areas that should be focused on to ensure that the build-out will not lead to problems down the road. However, a prudent developer will usually take additional precautionary steps and contract with experts to protect his interest. Most often, the architect is employed to check up on the project as it progresses to verify that it is being built according to the plans and specifications. The problem is that, in the real world, if the architect comes once a week to the site, it is a blessing. The point is that the architect's review is typically cursory. Depending on the size and scope of the project, it is wise for the developer to hire various experts at different stages of the development to ensure a quality outcome. For example, when the soil is being compacted, you might hire a company to verify that it has been properly compacted. When the foundation is being poured, an engineer should be hired to certify that it is level and properly placed and reinforced. While the framing, electric, and plumbing are being installed, you might retain a former building inspector or another general contractor to check up on the process to ensure that you are not being short-changed, and so on.

Insurance

During construction, the owner must maintain builder's risk insurance. He should also provide in the construction contract that the contractor and all subcontractors maintain workmen's compensation, general liability, and builder's risk insurance. The owner should be named as an additional insured on the general liability and builder's risk coverage. The problem is that contracting and requiring this coverage and actually securing the coverage are two different things. Assuming you are working with a reliable professional general contractor, you can expect to secure the applicable proof of insurance from this party, especially since you can hold up payment until the documentation arrives. The breakdown usually occurs in relation to the subcontractors. Some of the subcontractors will supply the requested documentation, but since their relationship is primarily with the general contractor, not the owner, it is much more difficult to obtain evidence of compliance from the subcontractors.

There is a clear differentiation in insurance requirements demanded by small to medium-size firms and large or institutional companies. The large or institutional companies commonly require coverage of at least $1 million per occurrence, $2 million aggregate, and $5 million excess. The result is often to eliminate potential contractors or subcontractors and clearly to increase the cost of construction.

Decisions, Decisions, Decisions

A ground-up construction project consists of making a thousand-plus decisions from the big picture to minute details. Appendix G, on the companion website, attempts to break down the decision process into the broad construction categories and then covers some of the big picture issues that must be resolved within the subcategories. I refer to Appendix G as a "Construction Decision Tree." The trunk or major issues leads to branches or minor issues that leads to smaller stems or more detailed concerns. In addition to highlighting major areas that must be addressed, Appendix G also focuses on Code-required areas such as building height or City-required landscaping or lighting. Furthermore, Appendix G attempts to point out some of the sensitive areas that are often overlooked and if so, may create serious problems in the future such as a failure to install separate electric meters for tenants that have equipment with heavy energy usage or the lack of planning for water shut-off values in dental offices so as to avoid after-hour breaks that might relate to dental equipment that could result in major flooding. A comprehensive outline of all of the potential decisions that might have to be addressed is beyond the scope of this text, but Appendix G on the companion website sets forth a rough outline of the major areas wherein decisions of construction type or other concerns must be addressed.

The developer must also be conscious that during the construction process, team members, that is, the architect, the contractor, and various vendors, may make decisions that affect the project without consulting with the owner. The developer must be diligent and focused on the project, since he wants to ensure that key decisions are not made without his knowledge and consent. I do not mean to suggest the decisions are going to be intentionally made in a "Machiavellian" style behind the developer's back, but rather, in the ordinary course of getting things done, frequently decisions will be undertaken extemporaneously. If the developer is not involved in the day-to-day process, many of these decisions will get past him.

Some of the one-thousand-plus decisions include:

How large will the building be? What kind of parking lots or structures will there be? How many parking spaces should be planned for? How many and where should the handicap parking spaces be located? What shall be the architectural style of the project? What building materials should be used? Is the building going to be wood frame with stucco, concrete tilt-up, brick, steel, and glass, or an all-metal structure? What will be the exterior paint color? What shall the exterior skin be composed of: stucco, brick, glass, and so forth? How many elevators will the building contain? Are they electric or hydraulic? What will the landscaping theme be? What type of signage will the project have? Will there be a pylon or a monument sign or both? Will the HVAC units be individual units or one system for the entire building? Where will HVAC units be placed? What should be the roof composition: clay tile, concrete tile, composition, or metal? Should the roof be sloped, flat, or sloped in part and flat in part? Should the windows open in or out or be such that they cannot be opened at all? Is solar paneling a viable alternative or is it more cost-efficient to apply a white coating to the roof surface to reduce energy cost? What style of the plumbing fixtures will be in the common area bathrooms? What type of lighting is the project going to have? What kind of hot water system will the project contain? What shall be the composition of the flooring in the common areas: carpet, hardwood, tile, vinyl, marble, or a combination thereof? What type of security system should the project contain? Should the security system be the landlord's concern or solely a concern of the applicable tenants? Are there any privacy issues, for example, requiring locked cabinets or above standard insulation?

The list of decisions to be made goes on and on. Some of the decisions are made based upon style preference. Other decisions are dictated by cost. Then again, the applicable building code may be the controlling factor. Other choices will be determined by the physical constraints of the site. Regardless, the point is that, in general, there is a lot of leeway for key decisions to be made by the developer. Some of these decisions are largely aesthetic and some can have a direct bearing on the project's economics. If, for example, your intention is to have modified gross or triple net leases in which utilities are billed directly to the tenants, constructing separate electric meters is preferable. It is exponentially harder and usually cost-prohibitive to construct separate meters after the building is built. Despite the sheer volume of decision making required, my point is that all your decisions should be reasoned, informed, and coordinated rather than haphazard choices that occur by default.

Communication, Communication, Communication

The key to a successful ground-up construction project is communication. The communication starts with the developer and the architect. The developer must, as clearly as possible, convey his vision of what he wishes to accomplish to the architect and then the architect must, as a design and plans develop, show the developer as clearly as possible how his vision is being translated into form and function. Communication with the architect is crucial, and this communication occurs not only at the design stage but also beyond, for typically the architect is retained to follow the construction project through from grading to finish, ensuring that the plans and specifications are being followed. The architect must then communicate with all of the other professionals involved in the development process and especially with the engineers: structural, mechanical, electrical, and civil. In addition, it is critical to maintain a dialogue between the developer and the general contractor and/or the on-site job foreman, if applicable. It is important to have frequent site visits to verify the work is going as intended. Depending on the nature of the project, the site visits may be monthly, weekly, or even daily. Problems are bound to arise. The owner should be consulted on the solution alternatives with regard to cost, timing, and method, so that an informed decision may be made.

Rule Number 23

The key to a successful ground-up construction project is communication.

Graphic Time Line

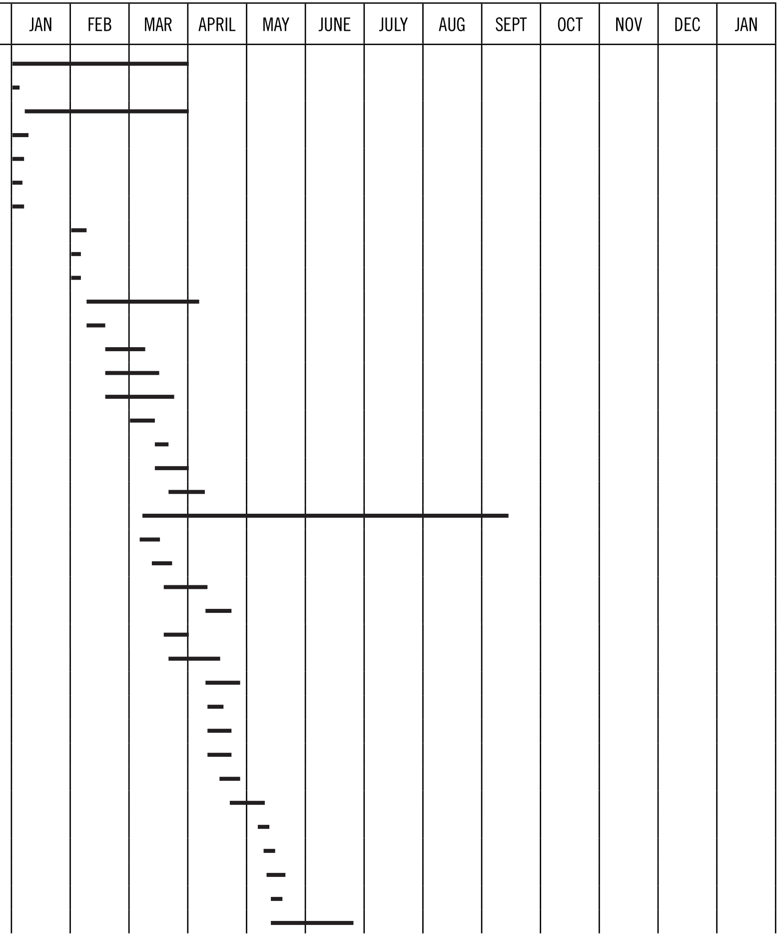
Usually, at the outset of a construction project, the general contractor will outline a rough time line for the project in graphic form. Exhibit 9.2 provides a sample time line for a project similar to that discussed in this chapter: namely, construction of a two-story medical office building of about 60,000 square feet with parking on grade. The time line divides the project into major categories, that is, preconstruction, site work, building shell, and tenant improvement work, and shows how in the dynamics of construction, the categories are interwoven. For example, it illustrates how, in practice, site work is usually being worked on concurrent with construction of the building structure.

Timing of construction is a key element in the success or failure of a project. Delays in construction are costly in terms of interest

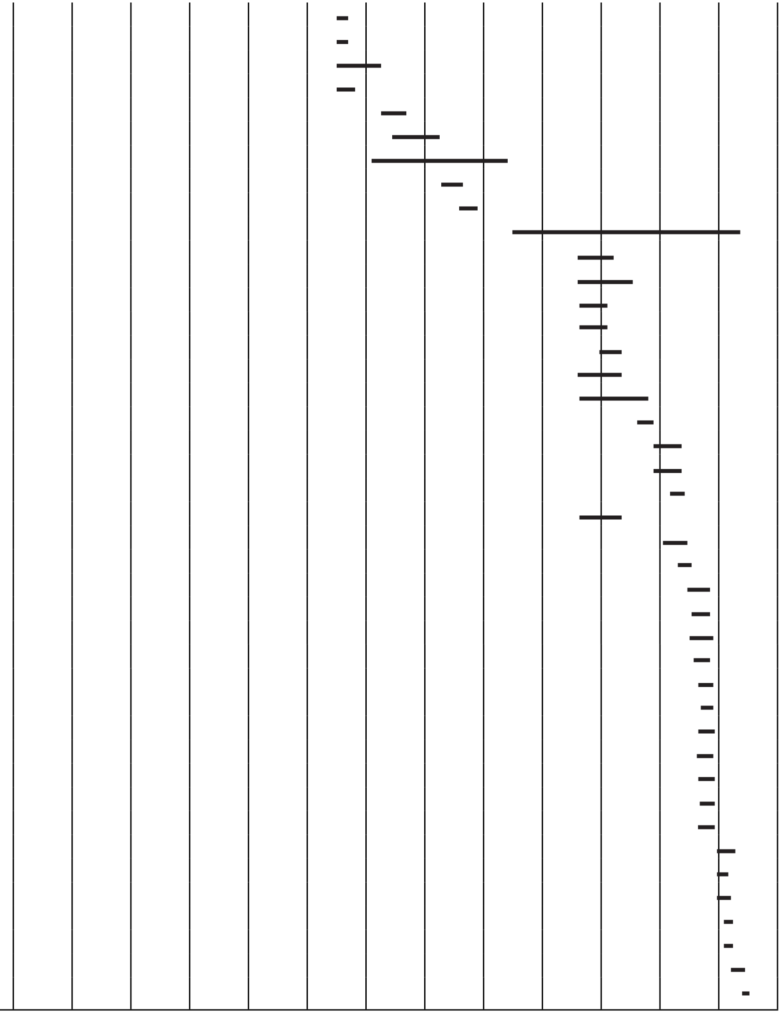
Exhibit 9.2 Construction Time Table Graph

MOB PRELIMINARY SCHEDULE—January 1, 2010

ID	Task Name	Duration	Start JAN	Finish
1	**Pre-construction**	**46 days**	Fri 1/1/10	Mon 3/29/10
2	Award Structure Steel to Subcontractor	1 day	Fri 1/1/10	Fri 1/1/10
3	Steel Lead Time	45 days	Mon 1/4/10	Mon 3/29/2010
4	Order Elevator	1 day	Tue 1/5/10	Tue 1/5/10
5	Building Shell Permit	1 day	Tue 1/5/10	Tue 1/5/10
6	Grading Permit Issued	1 day	Tue 1/5/10	Tue 1/5/10
7	Steel/Foundation Permit Issued	1 day	Tue 1/5/10	Tue 1/5/10
8	**Earthwork**	**5 days**	Mon 2/1/10	Fri 2/3/10
9	Clear Site	2 days	Mon 2/1/10	Tue 2/2/10
10	Building Pad Finish Grade	3 days	Mon 2/1/10	Wed 2/3/10
11	**Site Work—Perimeter Parking**	**93 days**	Tue 2/2/10	Fri 4/9/10
12	Driveway Curb Cuts and Demo	5 days	Tue 2/2/10	Mon 2/8/10
13	Site Sewer Line	15 days	Mon 2/15/10	Fri 3/5/10
14	Perimeter Site Curbs	5 days	Mon 2/15/10	Fri 3/19/10
15	Remaining Site Utilities	30 days	Mon 2/15/10	Fri 3/26/10
16	Light Pole Bases for Parking Aisles	10 days	Mon 3/1/10	Fri 3/12/10
17	Landscaping Fine Grade	3 days	Tue 3/16/10	Thur 3/18/10
18	Concrete Paving	10 days	Tue 3/16/2010	Mon 3/29/2010
19	Landscaping	15 days	Tue 3/23/10	Fri 4/9/10
20	**Building Shell**	**203 days**	Tue 3/2/10	Wed 9/23/10
21	Below Grade Utilities	5 days	Tue 3/2/10	Mon 3/8/10
22	Foundations Interior	10 days	Mon 3/8/10	Fri 3/19/10
23	Foundations 1st Floor Level	10 days	Tue 3/23/10	Mon 4/5/10
24	Floating Drain	5 days	Fri 4/9/10	Thur 4/15/10
25	Slab on grade 1st Floor Level	5 days	Wed 3/24/10	Tue 3/30/2010
26	Erect Structural Steel	15 days	Mon 4/24/10	Tue 4/13/10
27	Complete Welding	10 days	Tue 4/13/10	Mon 4/26/10
28	Metal Deck 1st Floor	3 days	Wed 4/14/10	Fri 4/16/10
29	Metal Deck 2nd Δ30Floor	3 days	Fri 4/16/10	Tue 4/20/10
30	Concrete on Metal Deck 1st Floor	5 days	Fri 4/16/10	Thur 4/20/10
31	Fireproofing 1st Floor	5 days	Thur 4/22/10	Mon 4/28/10
32	Concrete on Metal Deck 2nd Floor	5 days	Mon 4/28/10	Tue 5/4/10
33	Fireproofing 2nd Floor	5 days	Tue 5/4/10	Mon 5/10/10
34	Metal Deck—Flat Roof	4 days	Mon 5/10/10	Fri 5/14/10
35	Concrete on Flat Roof	5 days	Fri 5/14/10	Thur 5/20/10
36	Scaffold Exterior	3 days	Mon 5/10/10	Wed 5/12/10
37	Exterior Wall Framing	30 days	Wed 5/12/10	Tue 6/22/10



38	Exterior Wall Pluming Rough	2 days	Tue 6/22/10	Wed 6/23/10	
39	Exterior Wall Electrical Rough	2 days	Tue 6/22/10	Wed 6/23/10	
40	Build Up Roof	10 days	Tue 6/22/10	Wed 7/7/10	
41	Exterior Well Sheathing	5 days	Tue 6/22/10	Mon 6/28/10	
42	Exterior Lath	10 days	Fri 7/9/10	Thur 7/22/10	
43	Scratch and Brown Coat	10 days	Thur 7/22/10	Wed 8/4/10	
44	Exterior Glazing	35 days	Wed 7/4/10	Tue 9/21/10	
45	Color Coat	3 days	Mon 8/16/10	Wed 8/18/10	
46	Scaffold Removal	2 days	Tue 9/21/10	Wed 9/23/10	
47	**Interior Common Areas & Tenant Improvements**	**216 days**	Wed 9/23/10	1/14/w11	
48	HVAC Rough	10 days	Wed 10/19/10	Mon 11/1/10	
49	Stud Framing	20 days	Wed 10/19/10	Mon 11/15/10	
50	Blocking	5 days	Wed 10/19/10	Mon 11/1/10	
51	Fire Rough In	5 days	Wed 10/19/10	Mon 11/1/10	
52	One Side Drywall	10 days	Mon 11/1/10	Fri 11/12/10	
53	Electrical Rough In	20 days	Wed 10/19/10	Fri 11/12/10	
54	Plumbing Wall Rough In	30 days	Wed 10/19/10	Fri 11/26/10	
55	Insulation Interior	2 days	Fri 11/26/10	Mon 11/29/10	
56	Plumbing Overhead Rough	5 days	Tue 11/30/10	Mon 12/6/10	
57	Electrical Overhead Rough	5 days	Tue 11/30/10	Mon 12/6/10	
58	Fire Marshall Hydro	1 day	Mon 12/6/10	Tue 12/7/10	
59	Two Side Drywall	15 days	Wed 10/19/10	Mon 11/8/10	
60	Ceilding Grid	7 days	Fri 12/3/10	Mon 12/13/10	
61	Prime	5 days	Mon 12/13/10	Fri 12/17/10	
62	Paint	10 days	Fri 12/17/10	Thur 12/23/10	
63	Sprinkler Trim	5 days	Fri 12/17/10	Thur 12/23/10	
64	Interior Doors	5 days	Fri 12/17/10	Thur 12/23/10	
65	Ceiling Tile	5 days	Fri 12/17/10	Thur 12/23/10	
66	HVAC Trim	3 days	Thur 12/23/10	Mon 12/27/10	
67	Hardware	3 days	Thur 12/23/10	Mon 12/27/10	
68	Electric Trim and Fixtures	5 days	Thur 12/23/10	Wed 12/29/10	
69	Store Front Doors	5 days	Thur 12/23/10	Wed 12/29/10	
70	HVAC Start	3 days	Mon 12/27/10	Wed 12/29/10	
71	Tile	7 days	Thur 12/23/10	Fri 12/31/10	
72	Millwork Install	7 days	Thur 12/23/10	Fri 12/31/10	
73	Accessories	5 days	Fri 12/31/10	Thur 1/6/11	
74	Plumbing Trim	3 days	Fri 12/31/10	Wed 1/5/11	
75	Carpet	3 days	Fri 12/31/10	Wed 1/5/11	
76	Certificate of Occupancy	0 days	Wed 1/5/11	Wed 1/7/11	
77	Final Clean	2 days	Wed 1/5/11	Fri 1/7/11	
78	Fixtures and Furnishings Install	5 days	Fri 1/7/11	Thur 1/13/11	
79	Tenants Go Live Date	0 days	Fri 1/14/11	Fri 1/14/11	



carry and can be detrimental in that a prolonged time frame can potentially result in negative changed circumstances and intervening consequences or events.

The interest carry is obviously a cost tied into timing. The longer a project takes to complete before tenants can be put in place and income generated, the greater the loan interest expense is not set off by rents.

There are many negative consequences that may result from delays—some subtle, some direct and obvious. For example, assume a project is scheduled to be completed in four months; however, six weeks into construction, the majority of the work still remains unfinished. Let us say a major hurricane hits the Gulf States, causing a severe shortage of raw materials. The result is that oil prices and the cost of building materials, such as sheetrock and lumber, skyrocket. Alternatively, assume that a large 1,000-unit apartment building is in the framing stage. A fire destroys the complex. The developer rebuilds, but the fire results in a 10-month delay. During the downtime, another large competitive apartment project has been completed. The result is that leasing concessions such as free rent must be offered to prospective tenants in order to induce them to rent from our project rather than our competitor's project and the lease-up time frame has been significantly compromised.

To some extent, steps can be taken to protect against the cost of delays. If the contractor agrees, penalties can be imposed against the contractor if the project is not timely completed. Nonetheless, even if the contractor agrees to a penalty, logically there should be exceptions for acts of God and any other events outside of the contractor's control. Also, if the construction contract sets forth a downside, a penalty for failure to deliver substantial completion before a certain date, then possibly the contractor should be rewarded for bringing in the project early.

Project Operating Costs

When preparing a construction budget, developers plan for contingencies in both hard and soft costs, but often they do not anticipate the problem of carrying a project's operating costs if there are significant delays. Costs such as real property taxes and insurance continue, whether or not there is a tenant in occupancy. These costs must be budgeted for.

Lender's Disbursement Form

In order to obtain a disbursement from the construction loan, lenders typically require the borrower to complete a loan disbursement form. The form reflects the line items of the approved construction loan and shows what monies have been disbursed and what still remains to be disbursed. Exhibit 9.3 is an example of a loan disbursement form with numbers filled in for the hypothetical example in this chapter. The key is that the construction loan funds are allocated into categories and if you exhaust that category you must tap the contingency line item, if available. The goal is to, as best as possible, anticipate the possible categories and develop a strong working relationship with your construction loan administrator so that, if necessary, you can shift funds from one category that has not been significantly tapped into a category that requires funding.

It is also important to understand the lender's disbursement process. Often, the lender will require a site inspection prior to disbursement of funds. The inspection, if required, could easily add two weeks to the disbursement time frame. In addition, lenders typically will require, prior to disbursement, a conditional lien release from the general contractor. The lien release is issued conditional on receiving valid funds in payment of the submitted invoice.

Change Orders

During the course of construction of most large construction projects, it will either be discovered that an item has not been covered in the contractor's budget or that a correction must be made due to myriad reasons.

The key steps in a change order include (1) verifying that the change order was approved and (2) reviewing the contractor's budget to make sure that the change order was not already included in the budget or, if it was, at what amount. (In other words, if the budget has a $7,500 allowance for hardware and the contractor submits a $9,000 change order for hardware, is the change order in *addition* to the allowance, or does the allowance cover the first $7,500 of the bill with the change order actually covering only $1,500?)

Rehabilitation Project

The initial hypothetical example in this chapter deals with a ground-up construction project. This portion of the text discusses

Exhibit 9.3 Lender's Disbursement Form

LENDER'S DISBURSEMENT BUDGET & APPLICATION FOR PAYMENT

LOAN #: 457-2009
BORROWER: Medical Office Building, LLC
CONTRACTOR: Reliable Construction, Inc.
PROJECT: Medical Office Building

A	B	C	D	E	F	G
Item #	**Description**	**Initial Project Budget**	**Previously Approved Changes**	**Proposed Changes**	**Adjusted Project Budget (C + D + E)**	**Costs Paid or to Be Paid by Borrower**
1	Land/ Acquisition Cost	$353,773			$353,773.00	$353,773.00
2						
	SUBTOTAL LAND:	**$353,773**			**$353,773.00**	**$353,773.00**
1	Construction Costs Subtotal (Contract)	$3,333,754	$258,306.95		$3,592,061	
4	Tenant Improvements	$1,347,650			$1,347,650	$500,000
5	Contingency (Hard Costs)	$400,000	$(355,506.95)		$44,493	
	SUBTOTAL HARD:	**$5,081,404**	**$(97,200.00)**		**$4,984,204**	**$500,000**
Construction Soft Costs:						
1	Architectural & Engineering	$113,000			$113,000	$109,250
2	Permit & Gov't Fees	$73,480			$73,480	$28,480
3	Soils Testing	$12,000			$12,000	
4	Legal Fees	$63,500			$63,500	$44,438
5	Leasing Costs	$75,000			$75,000	
6	Contingency (Soft Costs)	$50,597	$97,200.00		$147,797	$42,211
Financing, etc. Soft Costs:						
1	Interest Reserve (Construction)	$367,575			$367,575	

LENDER: The Construction Bank

DATE:

REQUEST #: 1

H	I	J	K	L	M	N	O
Costs Paid by Borrower to Date	**Costs to Be Paid by Borrower (G – H)**	**Adjusted Loan Disbursement Budget (F – G)**	**Loan Percent Disbursed ([M + N] / J)**	**Adj. Project Budget % Disbursed ([H + M + N] / F)**	**Previous Loan Disbursements**	**This Loan Disbursement Request (Net of Retention)**	**Adj. Undisbursed Loan Budget (J – M – N)**
$353,773.00				100.00%			
$353,773.00			**0.00%**	**100.00%**			
		$3,592,061	102.20%	102.20%	$3,082,169	239,546.00	$270,345
	$500,000	$847,650	29.49%	18.55%	$249,999		$597,651
		$44,493	6.29%	6.29%	$2,800		$41,693
	$500,000	**$4,484,204**	**79.71%**	**71.72%**	**$3,334,969**	**$239,546.00**	**$909,689**
$109,250		$3,750	100.00%	100.00%	$3,750		
$28,480		$45,000	0.00%	38.76%			$45,000
		$12,000	100.00%	100.00%	$10,671		$1,329
$44,438		$19,062	100.00%	100.00%	$19,062		
		$75,000	0.00%	0.00%			$75,000
$42,211		$105,586	85.90%	89.93%	$89,041	$1,658.00	$14,887
		$367,575	20.31%	20.31%	$74,650		$292,925

Exhibit 9.3 continued

A	B	C	D	E	F	G
Item #	**Description**	**Initial Project Budget**	**Previously Approved Changes**	**Proposed Changes**	**Adjusted Project Budget (C + D + E)**	**Costs Paid or to Be Paid by Borrower**
2	Loan Fee	$52,000			$52,000	
3	Title, Recording, & Escrow Expenses	$27,073			$27,073	
4	Appraisal & Review	$4,000			$4,000	
5	Cost Analysis & Review	$1,250			$1,250	
6	Inspections	$3,000			$3,000	
7	Environmental & Review	$500			$500	
	SUBTOTAL SOFT:	**$842,975**	**$97,200.00**		**$940,175**	**$224,379**
	TOTAL:	**$6,278,152**			**$6,278,152**	**$1,078,152**

You, The Construction Bank, made the construction loan numbered above (the "Loan") to Medical Office Building, LLC, on March 21, 2009

By signing below, we ask you to make a payment of $_______ from the Loan. We certify that the amount requested is now payable and is in accordance with the Construction Loan Agreement we executed for the Loan. We have attached a copy of the contractor's requisition and other requests, copies of bills, and receipts for items we have paid.

According to our records, when you make the payment requested herein you will have paid a total of $_______________________________________ from the Loan.

WE CERTIFY THAT THERE HAS BEEN NO CHANGE IN THE PLANS AND SPECIFICATIONS, OR INCREASE IN COSTS, WHICH YOU HAVE NOT APPROVED.

WE ALSO HEREBY ACKNOWLEDGE THAT THIS FORM MAY BE TRANSMITTED ELECTRONICALLY AND THAT IT MAY NOT BE IN A SECURE ENCRYPTED ENVIRONMENT.

Borrower:
Medical Office Building

____

Authorized Signor Print Name & Title

H	I	J	K	L	M	N	O
Costs Paid by Borrower to Date	**Costs to Be Paid by Borrower (G – H)**	**Adjusted Loan Disbursement Budget (F – G)**	**Loan Percent Disbursed ([M + N] / J)**	**Adj. Project Budget % Disbursed ([H + M + N] / F)**	**Previous Loan Disbursements**	**This Loan Disbursement Request (Net of Retention)**	**Adj. Undisbursed Loan Budget (J – M – N)**
		$52,000	100.00%	100.00%	$52,000		
		$27,073	100.00%	100.00%	$27,073		$0
		$4,000	100.00%	100.00%	$4,000		
		$1,250	100.00%	100.00%	$1,250		
		$3,000	0.00%	0.00%			$3,000
		$500	100.00%	100.00%	$500		
$224,379		**$715,796**	**39.63%**	**54.04%**	**$281,997**	**$1,658.00**	**$432,141**
$578,152	**$500,000**	**$5,200,000**	**74.20%**	**70.66%**	**$3,616,966**	**$241,204.00**	**$1,341,830**

Authorized Signor Print Name & Title

an existing project that requires work to enhance its value. This work can be as simple as a cosmetic facelift, for example, paint, landscaping, and/or paving, or as extensive as a major makeover, for example, a new façade and new structural support columns. The subtitle to the chapter, "Build to a 12 Percent Yield" applies to any project, including a rehabilitation project, wherein value is to be created.

Let us assume that we are considering purchasing a 90,000 square foot shopping center, called The Metro Plaza. The existing rent roll is shown in Exhibit A.7 on the companion website. In the broker's sale package, the income and expense analysis suggests a current NOI of $800,000. (See Exhibit 9.4.)

Exhibit 9.4 Metro Plaza Income and Expense Analysis

The Metro Plaza
Tucson, AZ

Income and Expenses

Gross Lease Area (GLA)	90,000 SF	**CURRENT**	**PER SF**	**PRO FORMA**	**PER SF**
GROSS BASE RENT		$957,245	$10.64	$1,402,535	$15.58
Expense Reimbursements		$134,618	$1.50	$336,023	$3.73
GROSS POTENTIAL INCOME (GPI)		1,091,863	$12.14	$1,738,558	$19.32
Vacancy/Collection Allowance (% of GPI)		*		(5.0%) 86,928	
EFFECTIVE GROSS INCOME		$1,091,863	$12.54	$1,651,630	$18.35
Expenses					
Real Estate Taxes		150,000	1.67	190,000	$3.24
Insurance		25,000	0.28	30,012	0.33
Utilities		13,000	0.14	13,000	0.14
Repairs & Maintenance		70,000	0.78	70,000	0.78
Management Fee		33,863	0.38	33,011	0.37
TOTAL EXPENSES		$291,863	$3.24	$336,023	$3.65
NET OPERATING INCOME		$800,000	$8.89	$1,315,607	$14.62

COMMENTS
*Vacancy is already factored in at 40.50%

How do we decide what to offer for this property? We may find an answer to this question if we go back to the subtitle to this chapter, "Build to a 12 Percent Yield."

Since we have not as yet conducted any due diligence, let us assume that the financial numbers in the sales package are accurate, unless we perceive a modification is needed. The challenge boils down to solving for an unknown, the purchase price, after making assumptions about what the NOI will be at stabilized occupancy, what the cost is to get to stabilized occupancy, and what yield we desire to achieve on our capital.

One way to derive our purchase price would be to work backward, starting with an actual rent roll and making assumptions as to what rent can be achieved during lease up. From there, an income and expense analysis can be composed. This gives us an NOI. We can then figure out the cost to get there ("C"), except the purchase price ("P"). Also, we must decide what an acceptable yield on the Total Costs would be. Let us assume an acceptable yield is 12 percent. Finally, we know that Total Costs equals C plus P. Therefore, we can use the simple algebraic equation Total Costs × 12 percent = NOI or C + P × 12 percent = NOI. Dividing each side by 12 percent results in C + P = NOI/12 percent. We can now solve for the purchase price. The final step is to take the derived Total Cost number and back out all known costs, which results in a plug number: the purchase price.

This process can be summarized in five steps as follows:

Step 1: Determine realistic, achievable income numbers.

Step 2: Determine realistic, achievable expense numbers.

Step 3: Derive NOI.

Step 4: Determine FMV at the acceptable cap rate to which you are developing the project given project risk, effort, etc.

Step 5: Back out the estimated costs to achieve the pro forma lease-up to determine the purchase price.

Applying the above to our hypothetical example, the result is as follows:

Step 1: Gross income equals the income set forth in Exhibit 9.4 plus the rent increase soon to take effect for the chiropractic office plus the vacant space at the scheduled rate per square foot. The existing owners have been unable to lease-up the vacant space, so our thinking is that to lease-up this space, a significant discount from the rent being achieved on the rented space is necessary. In reviewing rent comparables for the area, it is determined that at the scheduled rent per square foot number, the vacant space can be rented over a two-year time frame. This results in a total gross income of $1,402,623.

Step 2: For purposes of this analysis, we are going to accept the sales package's estimated total expenses of $336,023.

Step 3: Derive NOI:

Gross Income	$1,402,623
Less Expense Reimbursements	336,023
Total Gross Income	$1,738,558
Less Vacancy and Collection Loss	86,928
Effective Gross Income	$1,651,630
Less Operating Expenses	336,023
Net Operating Income	$1,315,607

Step 4: We must decide now what yield do we want to achieve when the project is complete? Again, the project subtitle says "Build to a 12 Percent Yield." The subject project is not a ground-up development project. It is already in existence, but, depending on the project's scope, we may still have to contend with many of the risks associated with constructing the project from ground up including, without limitation, the permit process, delays due to weather, neighboring homeowners' issues, material cost variations, and so on. However, let us assume the project location is a "B" to "C" area, the leasing market is very soft, and, given the occupancy of the project, any financing will most likely have to be full recourse. We therefore decide to "Build to a 11.5 Percent Yield." Hence, the fair market value at completion is estimated to be $11,440,061 ($1,315,607/.115).

Step 5: We must now back-out the cost to achieve this value. Appendix H on the companion website reflects an analysis of the estimated costs to achieve the lease up of the project. Therefore, reducing the FMV at completion by the cost to get there results in a purchase price of $9,363,672 ($11,404,607 – 2,076,389). Based upon this purchase price, the going-in cap rate would be 8.54 percent ($800,000 NOI/$9,363,672 purchase price) and the cost per square foot would be $104 ($9,363,672 purchase price/90,000 square feet).

Construction of Improvements in a Rehab Project: Decisions, Decisions, Decisions

As in a ground-up construction project, a thousand-plus decisions must be made during the course of the rehabilitation project and often the decisions are made on a daily, if not hourly, basis.

Rehab Project: Communication, Communication, Communication

Similar to the dynamics of a ground-up construction project, the success or failure of a rehabilitation project often turns on the developer's ability to communicate with the various parties involved. Usually, communication is even more important and difficult in a rehab project because additional parties are involved. It is common in a rehabilitation project to keep part of the project open for business. Therefore, the developer, in addition to the normal coordination with the general contractor, the architect, the surveyor, various subcontractors, and so on must also be concerned with tenants and guests. In a construction project, there are always safety concerns, but the concerns are amplified to the extent existing tenants and their patrons are involved.

Summary

As a general rule a ground-up construction project and a rehabilitation project is more difficult, more complicated, and more risky than a straight acquisition of an existing leased project. However, with risk there is usually more potential reward. Additional elements that you must be concerned with in a development or a rehab project include project feasibility, design, governmental approvals, and, of course, construction.

To assess a development or a rehabilitation project, start with a target yield, determine the project's estimated cost, pro forma income, and expenses at stabilized occupancy, and then work backward to find what you can afford to pay for the land in a ground-up development project or the project in a rehab transaction.

Be aware that decisions must be made constantly in a successful development or rehab project and therefore the developer's continuing involvement is crucial. Also communication is important to a successful project between the developer and the architect, the developer and the contractor, the contractor and the architect, and so on.

Wealth Opportunities in Commercial Real Estate: Management, Financing, and Marketing of Investment Properties
By Gary Grabel

CHAPTER 10

Marketing, Leasing, and Management

When I first thought about how best to present the subjects of marketing, leasing, and management, I considered writing three separate chapters. Upon reflection, I felt that these subjects were so intertwined, or *should* be so intertwined, that one chapter discussing all three subjects would be much more helpful.

Definition of Marketing, Leasing, and Management

What do I mean by "marketing, leasing, and management"? My definition of marketing is a broad one, including both the process to attract new tenants through promotion of the project as well as that of encouraging patrons to buy goods or services from existing tenants, thereby stimulating their business and making the overall project more viable. Leasing refers to the steps that must be taken that culminate in signing a contractual agreement with a potential tenant, existing or new, wherein the tenant gains the right to use and enjoy the subject premises in return for paying rent. In other words, leasing means filling vacancies with new tenants or renewing existing lease obligations. Management is the day-to-day running of a property: everything from fixing the toilet to painting the exterior of the structure to addressing tenant complaints or concerns, and monitoring the tenants' timely payment of rent.

Why are these three subjects intertwined? Effective marketing leads to increased leasing, but also should lead to consummating renewals and, hopefully, to tenant referrals that fill vacancies. A good leasing and management team reduces the need for marketing. A key element in marketing should be to show that a great property management team is in place. The objective is to communicate that the subject project is a good environment from which to run a business, since in addition to its attractive location and other benefits, there are both a property manager in particular and a property administration in general that are fair and reasonable and will work with the lessee to solve any problems that might arise.

The most expensive costs in running a property are often the costs surrounding the loss of a tenant. The consequences of losing a tenant include downtime, that is, rents that are lost while the unit is being marketed for a new occupant, as well as potential additional costs associated with legal fees, brokerage commissions, and tenant improvement dollars. The statement that "the most expensive costs in running a property are the costs surrounding loss of a tenant" is mitigated, of course, by situations when the demands of an existing tenant are unreasonable from the landlord's standpoint and when, therefore, it is better to start afresh by negotiating with a new prospective lessee. Such a circumstance, however, should be the exception, not the rule.

Rule Number 24

The most expensive costs in running a property are the costs surrounding the loss of a tenant. Unless their demands are unreasonable, keep an existing tenant happy, because, in general, it is far more expensive to replace that tenant.

Marketing

What should marketing a real estate project entail? Of course, the scope of the assignment has a direct relationship with the nature of the property and the extent of the vacant space that must be leased. A game plan must be thought out and preferably committed to paper.

Historically, marketing has been conducted by the landlord or a marketing association, or in conjunction with a marketing fund. Usually, the marketing association or the marketing fund is controlled by the landlord since it is funded by contributions from the tenants and the landlord, typically on a matching fund basis. Marketing associations are uncommon today, since the same objectives can be accomplished through a marketing fund without negative tax repercussions. Even marketing funds are rare. They are usually found in larger shopping centers where the landlord has had the bargaining power to build this obligation into all of the leases because of the desirability of the property. Retailers are usually resistant to contributing to such a fund since they are sensitive to increasing their expense line items and they argue that they already are expending monies directed at marketing their stores. For purposes of this section, it is assumed that the landlord will be the sole active player in marketing the property and conducting any and all efforts to market in an attempt to secure new or replacement tenants.

Let's assume we have just acquired Crossroads Plaza, a 120,000-square-foot shopping center with 7,800 square feet of vacancy, that is, vacancies that constitute 6.5 percent of the project. Most of the vacant space is composed of 1,300-square-foot shop spaces, some of which are contiguous and some of which are separated by leased space. Let us also assume that the 20,000-square-foot anchor space is occupied by the Giant Green Grocer, a national market with only two years to go on its lease. The anchor tenant is losing money and has indicated that, based on the store's current performance, it is not intending to renew the lease. The Center also has an undeveloped outpad upon which a building of about 5,000 square feet could be constructed. A current rent roll can be viewed on the companion website as Exhibit A.8.

Marketing Game Plan

The first step should be to lay out a written game plan, a strategy for promoting the Center and leasing-up the vacancy. The game plan can be a narrative or a series of simple bullet points hitting the main areas of focus. The game plan should be site specific. In other words, making nice statements like "We are going to work hard to fill all of the vacancy" really does not achieve the objective. Rather, specifics are needed. For example, in our hypothetical, we know that the anchor will probably not renew its lease. Therefore, an analysis should be made to determine the feasibility and cost associated with breaking up the 20,000-square-foot vacant space. Does this size space work for a traditional supermarket such as Albertson's or Von's, or should the premises, given its size, be presented to upscale "niche" specialty markets such as Trader Joe's or RJ's?

There is no single correct format for the marketing plan, and since each marketing plan is site specific, no two marketing plans will be the same. Subject matters that might be covered in the marketing plan include:

- The project's existing characteristics: It is important to understand what you have to work with.
- Demand generators: Why do shoppers come to this shopping center? Is it due to the proximity to their home or business?
- What is in the immediate area surrounding the center and how does it affect the subject property?
- General market knowledge: If a specific tenant is a good candidate for your center but already has a store across the street, you can probably eliminate this prospect; however, if this tenant's lease is expiring and your center is a superior location and tenant mix, perhaps it jumps to the top of your prospect list.
- What are the goals, short- and long-range, that the owner seeks to accomplish?
- Strategies and tactics to accomplish the goals.
- Specific action items to carry out the strategies and tactics. (See also Chapter 1, including Exhibit 1.1.)

Existing Center's Characteristics

The obvious starting point is to analyze what you have. Understand your existing center. Ask three key questions: What are the existing tenants like? What is missing from the center? What are the physical characteristics that define this center? In other words, scrutinize the type of tenants you have and this property's place in the world. Do the existing tenants sell commodities, or is the center more of a service center, providing professional advice to the community, or a combination of the two? To illustrate, a discount store and a supermarket sell goods; in contrast, a dance or karate studio, an income tax consultant, an insurance agent, a chiropractor, and a dentist sell services.

Make a list of what services or stores the center may be missing. For example, if the center is a service-oriented center, does it have a hair or nail salon or dry cleaners? Is there a type of tenant that is missing that is normally associated with the anchor tenant? For example, a movie theater often has in close proximity a coffee shop, a food court, or an ice-cream store. Is there food service in close proximity to the theater? Can the food service be expanded?

Last, concentrate on the nature of the vacant space and how the center is physically laid out. For ease of reference, its best to generate a vacancy chart. The center's site plan might be used to reflect vacant units and the corresponding square footage. Can the vacant space be split up? If it can be divided, where is the logical division line and what usable spaces result? What is the depth of the shop space? Is this depth practicable? Are the shops rectangular or cut into odd shapes? What is the parking situation in relationship to the businesses? Is there a standard configuration, with parking in the front of the street and shop space in the back facing the street? Is there adequate parking? Is the parking convenient surface parking or must some of the customers valet park or park in a subterranean garage? How many stories does the center have? Is there an issue with second-story accessibility? Is signage clear or is it hard to locate certain tenants? Is there a visibility issue? Do some of the buildings on the out-pads block in-line store signage?

Demand Generators

What are the demand generators for the project? What drives this center? Why do people shop there? Where do the existing tenants derive their business from? Do people come to this center because of its convenience or is it a "destination" center? Is it a neighborhood center or does it draw from a greater geographic area? Does the center have mostly national tenants, local businesses, or a combination thereof? What is the profile of the "typical" customer who frequents the center in terms of age, sex, ethnic background, income, and wealth? Is the typical customer a professional or a blue-collar worker? Doctors tend to locate in close proximity to hospitals. Supermarkets that focus on specific ethnic groups will be located in an area that has a high concentration of people of that ethnicity. At times, there is a synergistic relationship between tenants. If this exists, it should be identified and capitalized upon. For example, Walmart and Home Depot are anchors that generate huge amounts of traffic. Are there certain types of retailers, or better yet specific companies, that desire to be located in close proximity to these demand generators and are not objectionable to the demand generator? For example, as previously mentioned, food courts often work well in conjunction with entertainment facilities such as movie theaters. An imaging center complements orthopedic and neurological doctors' offices.

The Surrounding Area

It is also important to understand what is going on around the center. If the vacant lot across from the center will soon be a Super Walmart, how does that affect your marketing program? What if a shopping center is being demolished or renovated in close proximity to the subject property and the tenants from this center must find a new home? The soon-to-be-displaced tenants are a great source of leads.

> **Rule Number 25**
>
> Be aware of your surroundings and what is going on in the local market since that can have a dramatic impact on your marketing strategy and business success.

Practical Concerns: Temper the Marketing Plan with Market Knowledge

Let us assume that you have done your homework, and have analyzed the center's physical characteristics and its demand generators. Based upon these factors, you conclude that Trader Joe's would be an ideal tenant. The problem is that Trader Joe's already has a store across the street from the subject property! Your analysis must be tempered with market knowledge. The most important practical question often becomes: Based upon the size of the available space, what company is currently looking to rent space in this marketplace? The space might be ideal for Trader Joe's, but if Trader Joe's already has a presence in close proximity to the center in question, it is not likely to be a viable candidate for the vacancy, unless, of course, the prospect's lease is expiring and your location is far superior and would amount to an upgrade for this tenant. In contrast, let us say Smart and Final is attempting to get a foothold in this marketplace, yet does not currently have a store located nearby. It would jump to the front of your line. Smart and Final has an unfulfilled need that can be filled by your 20,000-square-feet anchor space. However, there are practical concerns, for example, there are two years to go on the Giant Green Grocer's lease. If Smart and Final is ready to go now, how do you deal with the lease expiration date? Will the Giant Green Grocer consider a payment by the landlord in return for terminating the lease? Given that the Giant Green Grocer is losing money, might not the tenant consider this course of action?

Leasing

In general, landlords seek long-term leases and tenants tend to want shorter terms with options to extend. Landlords want stability, which translates into a long-term commitment from the tenant, while tenants are not sure what will happen tomorrow and therefore usually attempt to limit their commitment while, if possible, keeping their future choices open-ended.

Strategy

The options to extend are a one-way street in the sense that they only benefit the tenant. If the option is favorable or at market, the tenant may extend. If the option is not favorable, the tenant is in no worse a position. He simply ignores the option and commences to negotiate an extension with the landlord. Options to extend are not bilateral, that is, they do not contain a provision that allows the landlord to require the tenant to extend the term of the lease. If the landlord commits significant monies toward improving the premises for the tenant then, logically, the landlord will insist on a term at least sufficient to recover the dollars spent—and probably significantly longer.

When leasing, a forward-thinking landlord will attempt to stagger lease maturities. A concentration of leases maturing in the same year can severely affect cash flow as well as impact capital outlays needed to retain the tenants. Also, an eye should be kept on the loan maturity. Lenders underwrite based upon leases in place. Therefore, a problem may arise if lease maturities and loan maturity converge. Similarly, lease negotiations should consider economic cycles. Landlords should attempt to anticipate down-cycles and set the lease maturity, if possible, past the projected weak market periods. In contrast, tenants, if possible, should attempt to renegotiate during a high-vacancy period. Obviously, it is difficult to predict the peaks and the valleys, but in a strong market, landlords can approach their tenants to renegotiate leases early and conversely, if the economy and specifically the subject building are suffering from a high vacancy rate, a tenant can then seek to extend the term of its lease.

Leasing In-House versus Employing an Outside Broker

How you intend to market the property should be addressed. Will you market in-house or through a leasing broker? Does the owner have the time, ability, and inclination to attempt to lease-up the property? Does the owner have in-house personnel or specific leasing personnel that can take on this task? Does the owner want to control the beginning leasing effort, pick the "low-hanging fruit," and then turn the leasing efforts over to a professional? The problems with this policy are, first, that there usually is *no* low-hanging fruit and, second, the owner has to be careful that he does not take all of the juice out of whatever fruit there is, leaving nothing for the broker. In other words, the project can be whittled down to a size that makes it less than attractive, from an economic standpoint, to a quality leasing broker.

If you elect to hire a leasing broker, interview more than one company. Always ask who specifically is going to do what. Understand who ultimately is going to be in charge of the leasing assignment. At times, especially with large brokerage companies, you might meet with a senior leasing specialist who sells you on the company's capabilities but then you never see the same person again. The "grunts," that is, individuals with less experience, are assigned to do the tedious labor of working the market, making cold calls by knocking on doors and doing telephone solicitation. This might be an acceptable division of work, but you should at least understand what you are signing up for. An acceptable compromise might be to allow the less-experienced agents to do lead generation, but then require the more experienced broker to step in to coordinate the lease offer, lease negotiation, and lease closing. It is crucial to understand what you are getting for your money.

Exclusive versus Nonexclusive Authorization

An *exclusive authorization* says in effect that if, during an agreed time period, regardless of who procures the tenant, a lease is executed for the property, a commission is owed to the broker in whose favor the exclusive authorization runs. The language governing when a commission has been earned must be carefully scrutinized. Care must be taken to avoid a dispute with the listing broker. If the contract indicates a commission is owed when a willing and able tenant is found, a commission might be owed even if a lease is not consummated. Prudence might dictate that the contract indicate "no ticket, no laundry." In other words, only if a lease is entered into is a commission earned.

In contrast to an exclusive listing agreement, a *nonexclusive agreement* provides that if the broker brings in a tenant and a lease is consummated with that tenant, a commission is earned, but if another broker procures a tenant and a lease is finalized with the other broker's client, a commission is owed only to the procuring broker.

Most brokers require an exclusive authorization to induce them to work on a leasing assignment. They argue that they do not want to compete with the owner or expend efforts marketing a property when a potential prospect might learn about the project through their marketing efforts and then attempt to cut the broker out by going directly to the owner or using another agent.

Of course, parties can enter into variations and hybrid arrangements. For example, the broker might be paid a monthly fee and no additional commission upon lease consummation, or a monthly fee plus a reduced commission schedule on an exclusive or nonexclusive basis.

The Commission Amount

The commission schedule is always subject to negotiation. Typically, the leasing commission will be based on a standard within the local market. In some parts of the country, a fee based upon the square footage of the leased space, such as $6.00 per square foot, is typical. In other areas, a flat fee or a declining percentage such as the following might be the norm:

- 7 percent of the Base Rent for the first 12 months
- 6 percent of the Base Rent for the second 12 months
- 5 percent of the Base Rent for the third 12 months
- 4 percent of the Base Rent for the fourth 12 months
- 4 percent of the Base Rent for the fifth 12 months
- 3 percent of the Base Rent for the next 60 months
- 2 percent of the Base Rent for the balance of the term

The reasoning behind the declining percentage is threefold: (1) As the lease term is lengthened, the expectancy of collecting the rent is reduced and hence the brokerage fee should be reduced; (2) the absolute amount of the fee becomes sufficient to induce a broker to work the project and hence it need not increase further; and (3) the schedule reflects the market for this type of service.

When confronted with this type of a commission schedule, I will usually ask that the percentage be switched in the early years of the lease term. My argument is that I want to discourage short-term leases. My typical five-year leasing schedule reflects annual charges of 4 percent, 4 percent, 5 percent, 6 percent, and 7 percent in years one to five, respectively.

Another, and simpler, approach is to set the leasing commission at 4 to 6 percent flat for the first five years and then one-half of the agreed percentage thereafter.

If the commission is based upon a percentage of Base Rent, then defining what comprises Base Rent becomes important. By definition, Base Rent does not usually include any expense recovery by the landlord. Should there be a different leasing percentage for a gross lease as opposed to a net lease or a net, net lease, or a triple net lease? If you are calculating the commission using the Base Rent, then theoretically an adjustment should be made since, comparing apples to apples, the Base Rent in a gross lease will be higher than in a lease where the tenant is obligated to pay a portion of the operating expenses in addition to the Base Rent. An alternative way to adjust the commission between lease types would be to include all or a portion of the operating expenses within the definition of Base Rent for purposes of calculating the fee owed. Despite the potential disparity in the commission calculation between the lease types, usually the percentage is simply based upon the Base Rent with no adjustment for contractually charged and recoverable operating expenses.

Another issue that should be considered when entering into a leasing contract is the effect of free rent, or a tenant improvement allowance, or any other concession on the commission. If extensive concessions must be made, should the broker participate? Without adjustments, disparities may result. For example, if a tenant must be given a free build-out period and a free ramp-up period, and if the commission is based upon a percentage of the income generated, the commission is affected by the concessions. However, if the commission is based upon a dollar figure per square foot, the commission amount is unaffected by the concessions.

Should there be any adjustment in the commission schedule due to tenant improvement dollars above a certain standard level? The answer to this question depends both upon how the Base Rent was determined and on how the commission is calculated.

The broker may argue that the commission should not be adjusted since the owner is receiving increased rent, that is, the "excess" tenant improvement allowance was factored into the rental rate. Therefore, if the compensation is based upon a flat fee or a rate per square foot, the owner should have no complaint since he is not paying more because of the enhanced rent. On the other hand, a commission based on a percentage of gross rent would increase the fee due to the overstandard tenant improvements. Usually the commission agreement is not adjusted to factor in build-out costs. It is usually considered just part of the deal.

Cobrokerage Arrangements

An area that is often not covered in a standard leasing authorization and one that should be clarified is how a commission will be shared, if at all, with a broker who is not related to the listing broker but who nevertheless procures a tenant. A typical arrangement is to increase the commission schedule by 1 percent for each category and agree to a 50/50 split of the fee. Usually, the broker representing the tenant seeks to achieve at least 4 percent for the first five years and 2 percent thereafter.

When Is the Commission Payable?

The agreement should also cover when the commission is payable. Brokers usually angle to receive payment in full when a lease is signed. The tenant has been identified, the lease has been drafted and negotiated, the lease has been executed, the job is done: Pay me. Owners, especially when the commission is large and/or when it is anticipated that the tenant will not be in place paying rent for a protracted period of time, usually seek to defer at least part of the fee. A fairly typical arrangement specifies that one-half of the commission is due and payable when the lease is executed and the other half is due and payable when the tenant moves into the suite and is paying rent. If an extensive free-rent period or a protracted build-out period is built into the lease, a compromise might be to set the payment for the second half of the commission at the earlier to occur of (1) a specified period such as three months from lease execution or (2) when the tenant is in place paying rent. In other words, set an outside date for the second half to be paid regardless of other delays. In an area that is experiencing high tenant delinquencies, the owner might attempt to have the commission schedule split into three payments with the last payment due after a seasoning period, that is, the tenant is current and in place for six months.

Exclusions from the Listing Agreement

Often, leasing efforts have been expended on projects before an authorization is agreed upon. The efforts might have been expended by the owner and/or by a broker that is different from the listing broker. This leads to the concept of "exclusions." The authorization to lease might exclude or carve out certain potential tenants from the listing agreement. Alternatively, as a compromise position, the agreement may provide that as to certain named prospects, the listing broker will be compensated at a reduced fee if a lease is consummated with these named parties.

The most common exclusion is for existing tenants. The owner reasons, "Why do I need a broker to negotiate with the tenants I already know? I am paying a broker a commission to find new prospects." This argument has some validity, provided the owner is active in the management of the project and has the ability to understand and negotiate the lease terms and conditions. The broker's counter, if applicable, might be that his potential fees are too small unless he can also work on renewals.

Lease Renewals and Extensions

A lease can be renewed on the same terms and conditions as it presently exists, or it can be renewed on different terms and conditions. Usually, at a minimum, when a lease is renewed, the base rent is altered. Similarly, the lease term can be extended without changing other provisions in the lease or, concurrent with the extension, the lease terms and conditions may be modified. For purposes of this section, a lease renewal shall be treated the same as a lease extension. A renewal or an extension shall be referred to interchangeably as a "renewal" or as an "extension."

If you elect to enter into an authorization to lease with a broker, it is important to specifically cover lease renewals. Lease renewals by definition relate to existing tenants and therefore, as previously stated, existing tenants may be excluded from the listing.

A distinction is sometimes made between renewals associated with tenants' leases procured during the authorization period versus renewals for tenants' leases entered into prior to the brokerage contract. The broker's argument is "I understand, Mr. Owner, your reasoning for excluding existing tenants since I did not bring them to the table; however, as to tenants I procured during the listing period, I should be covered for the lease they sign and paid on any renewal if those tenants renew their lease."

No distinction is usually made as to the documentation surrounding the renewal, that is, whether the tenant exercises an option to renew the lease or modifies an existing lease or negotiates a new lease. However, if the "renewal" is for other space within the project, it is probably technically not a renewal. The language in the contract controls.

- Management must decide whether or not it wants an outside leasing broker to negotiate with existing tenants. If the leasing assignment covers renewals, should the commission schedule be reduced given that identification of the prospect, arguably the most difficult aspect of the assignment, has been eliminated?
- Lease renewals include situations when a leasing broker procures a tenant during the authorization period, a lease is entered into, and when the lease expires the tenant extends the term of the lease by exercising an option to extend or possibly by entering into a new lease for the premises or entering into a new lease for another space within the project. Has a commission been earned? The contract controls. There is no right answer. The broker has an argument that he procured the tenant. The owner may be concerned that the renewal probably will occur several years after the original lease was signed. When the lease is renewed, the owner may not have a relationship with the broker. In fact, the broker may no longer be in the leasing brokerage business!

Are Commissions Due upon Suite Expansions?

A similar issue to extensions revolves around expansions. Should the procuring broker be paid an additional fee if the tenant increases the suite size at a future date? What if the lease, when signed, posited that the suite would possibly be enlarged at a future date? There is no right answer to this question, but the important point is that this issue should be covered in the listing agreement.

Treatment of Commissions for the Month-to-Month Tenant

What if the tenant that is procured will not sign a long-term lease, but rather will only agree to a trial month-to-month tenancy until his business shows profitability. If the landlord is willing to give this tenant a try, how should the commission be structured? The problem is that the tenant, on 30-days' notice, may terminate the lease. On what basis do you set the commission amount? Usually, for month-to-month tenancies the payment is based upon a percentage of rent actually received. The commission is paid monthly as long as the tenant remains in occupancy paying rent.

Right of Offset

At times, the listing agreement may contain a provision that says, in essence, that if the landlord fails to pay the brokerage commission on or before its due date, then the broker may send a written notice to the landlord and the tenant of such failure, and if the landlord fails to pay the amount owing within 30 days after the notice, then the tenant shall be entitled to pay the broker directly the fee due and offset the amount paid to the broker against the tenant's next rental obligations coming due under the lease. The commission agreement language usually goes on to say that any amounts so offset from the tenant's rental obligations under the lease shall no longer be owed from the landlord to the broker and that this right of offset shall be set forth, in writing, within the lease document between landlord and the tenant.

In most cases, the landlord will strike this type of "self-help" provision, arguing that the broker has remedies built into the commission agreement if the landlord fails to pay its obligations, but that involving his tenants is not an appropriate remedy.

Implementation

Okay, you have analyzed the Center's characteristics, its existing tenant base, and its physical layout. You have determined what, if anything, is missing from the Center. You have developed a marketing game plan and hired a leasing broker. What is the next step?

What does the authorization say your broker is obligated to do? There may be a vague statement obligating the broker to use his best efforts to lease the property, but usually that is about it. The exclusive authorization is all about the broker getting paid; how much and when. The owner should include specific action items that the broker is mandated to perform, including preparing a leasing brochure, having weekly face-to-face or telephonic meetings, delivering monthly written reports, and generally following up on the marketing game plan.

Now we have analyzed the project and identified the potential type of tenants that would be a good fit. We may have actually identified specific tenants that would be good candidates for the vacant slots. We have also designed and produced a leasing brochure that highlights the project and provides potential tenant candidates with contact information. We have also created a written marketing game plan, part of which addresses implementation. It is now time to get out there and make the necessary contacts to implement the game plan.

What implementation boils down to is contacting the potential leasing candidates and following up with them. Contacting potential tenants should include all of the following:

- Making telephone calls.
- Sending mailers, including mailing out the leasing brochure.
- Knocking on the doors of the potential candidates.
- Canvassing the local area where the property is located.
- Contacting brokers, especially brokers that represent tenants.
- Creating a referral incentive program within your existing tenant base.
- Advertising.
- Making local community contacts, such as the local Chamber of Commerce.
- Placing "For Lease" signage on the project itself.

Rule Number 26

When attempting to lease-up your project, leave no stone unturned!

Leasing Brochure

Regardless of whether the property is to be marketed internally or through an outside broker, after a marketing game plan is generated, a leasing brochure should be produced. The objective of the brochure is to capture potential clients' attention without bogging them down with details at this point in time. Ideally, the brochure should be on an 8 ½" × 11" sheet of high-gloss paper. On the front, there might be a picture of the property and a listing of its salient features such as:

- Four-Story Medical Office Building
- Located on Campus of XYZ Hospital
- Convenient Freeway Accessibility
- Abundant parking—5 spaces per 1,000 net rentable square feet
- Suites ranging in size from 1,000 sq. feet to 20,000 sq. feet available
- Tenant Improvement package available

The reverse side of the brochure might feature a location map and contact information.

Leasing as an Art

Leasing is an art, not a science. It is crucial to be able to screen a potential tenant not only for financial strength and credit, but also with regard to their moral fiber and potential strengths. Are they likely capable of making a go of it in the face of obstacles? Since there are always trials and tribulations when running a business, the tenant's commitment to the business is an important ingredient. It is also important to have a vision of what works for your property. Often tenant compatibility and, ideally, synergy is a key to the long-term viability of a property.

Before you turn your broker loose to find prospects to fill the vacancies, note that there are several traps and pitfalls that should be avoided. A few of them are outlined next.

Exclusivity Provisions

How do you react if the shopping center has a beauty salon and your leasing agent calls saying he has another beauty salon prospect?

What issues does this raise? The question arises: Does the lease with an existing tenant contain an exclusivity provision barring other tenants from this type of competing usage? In other words, has the existing tenant been given the exclusive right to sell this type of product or render this type of service? This issue is a threshold question and must be examined at the outset, not only in conjunction with a specific potential tenant but also with the leasing agent, who should be informed from the get-go what kinds of vendors may not be solicited because an existing tenant has the sole right to sell certain products or render certain services.

Even if there is no contractual prohibition from renting to another tenant who intends to sell or render a similar product or service, it is still wise to ask if it is a good business policy to have two or more competing firms in the same center selling similar goods and services. The answer to this question revolves around several factors, including the size of the center, the size of the general market, and whether or not the tenants are direct competitors or, essentially, serve different market niches. It is important to have a vision as to how the tenants might work together for the overall benefit of the property and, ideally, this concept should be conveyed to the leasing broker.

Restrictive Covenants

Exclusive-use provisions may be found in existing leases as mentioned above. In addition, a lease may contain a restrictive covenant that prohibits other tenants from coming into the center and doing business in a manner barred by the provision, whether or not the existing tenant is selling the prohibited commodity or service. Restrictions may be found in existing tenant leases, such as when a supermarket or other major tenant negotiates a provision blocking other tenants from selling similar or competitive goods in the center. The covenant might also restrict a type of usage that it deems harmful to its business. For example, an investment firm might desire to prohibit a bar or pub from being located within a short distance from their site. They might want this restriction because they feel a bar or pub will detract from the professional nature of their business.

Restrictive covenants may also be located in other documents affecting the project. As previously mentioned, the most common additional place the lease restrictions may be found are in CC&Rs or in ground-lease provisions. For example, assume a medical office building is located on ground-leased property on a hospital campus. The lessor of the land is the hospital. Wanting to control the competitive usage in the immediate area that surrounds its premises, the hospital uses the ground-lease to bar physical therapy, out-patient surgery, and radiology including X-ray, CAT scan, and MRI services in the medical office building.

Rule Number 27

Make sure you understand what types of tenants are permitted tenants before you start the search for new tenants and certainly before you execute a lease.

Interference with Tenant's Business

Let us assume you own a shopping center. One of the tenants is a beauty salon, La Salon, owned by Jacques LeBeau. The beauty salon is having financial difficulties. It is three months delinquent in its rental obligation. The owner has been trying to sell his business for several months and advises you that he is in negotiations with a potential buyer, Joe Purchaser. LeBeau introduces you to Joe Purchaser during a conference call. The sale falls through and you evict La Salon due to its failure to pay the rental obligations. One month later, Joe Purchaser approaches you to rent the space formerly occupied by La Salon. You enter into a new five-year lease with Joe Purchaser, who renovates the space and opens a new beauty salon. The next day, La Salon's owner serves you with a complaint claiming, among other things, that you conspired with Joe Purchaser to deprive him from the profit from the sale of his business to Joe and interfered with his business relationships.

The facts are that you had empty space, the LeBeau sale to Joe Purchaser had fallen through, the Purchaser approached you, and in fact you have a duty to mitigate damages and lease the beauty salon space to reduce LeBeau's damages. To avoid an interference with contractual relations and/or a conspiracy type of a claim, you might obtain an authorization from LeBeau that allows you to enter into a new lease with Purchaser and/or obtain an indemnity from Purchaser protecting you from claims by LeBeau. Additionally, after the LeBeau/Purchaser sale falls apart and when Purchaser approaches you about a new lease, you might send a letter to LeBeau advising him that you are attempting to mitigate damages and that Joe Purchaser has approached you and you are therefore entering into negotiations with Purchaser for a new lease. This is a gray area and, therefore, prudence and caution are advised.

Rule Number 28

When considering entering into a lease, be cautious when dealing with parties who were previously under contract to purchase a business within the center.

The Screening Process

Okay, we have our written marketing plan, we have hired a broker, and, through the broker's marketing efforts, a prospective tenant has appeared. What is the next step?

It must be determined if the applicant meets the owner's financial and credit standards to warrant entering into a lease. To some extent, this test becomes a market issue. If the economy and the center are doing great and the owner has choices, he can be selective and discriminating. However, if times are tough and the center is experiencing significant vacancy, the owner's options are less abundant. It is nonetheless important to have a minimum standard, especially if the owner must spend money to put the tenant in place.

What documentation should the owner seek in order to qualify the prospect? Typical materials include a rental application, which should contain an authorization to run a credit report, a resume or a short narrative biographical sketch, financial data such as annual income and expenses, a balance sheet, and tax returns. As previously noted, leasing is an art, not a science. Therefore, it is essential that the landlord and/or the landlord's representative have a face-to-face meeting with the prospective tenant.

What is your reaction if your broker advises that he has found a well-qualified prospective tenant and when you call the prospect the first thing he says is "What rent per square foot are you charging?" Potential lease candidates also often go through a screening process of the prospective premises and possibly the landlord. Usually, what the prospective tenant is saying really is, "Tell me what your lease rate is so I can eliminate you from my list of potential space candidates." The tenant is trying to screen the landlord's space and narrow his search for a deal.

When asked this question, I invariably answer the question with a question. How long a lease are you willing to commit to? I often do not get an unequivocal response and therefore can easily say, "How can I quote you a definitive rent per square foot number when you can not tell me how long you will lease the space for? The rate for a 10-year lease is different from the rate for a five-year lease." At times the response is, "Okay, let's assume the lease term is five years." My next question stops them cold. I ask, "What kind of a tenant improvement allowance do you want?" The response usually is "How do I know? I haven't seen the space yet so I don't know what is needed." I respond, "Exactly. You don't even know if you like the suite and I certainly do not know what, if any, remodeling you will require or the cost associated with it . . . so how can I quote a rate per square foot?" The point is that if you truly have a potential lease candidate, in order to move the process forward, you must get him involved in the process and excited about the suite. You must at a minimum show him the space. Answering the question "What do you charge per square foot?" usually results in a lost prospect.

Rule Number 29

If the first question a prospective tenant asks is how much you charge—What is the rent per square foot?—don't answer the question.

If the owner feels comfortable with the prospect, the terms and conditions of the lease must be negotiated. This process can be done verbally and thereafter a lease can be drawn, but it is more common to present a written letter of intent to the prospect, from which the discussions may commence.

Letter of Intent

In order to properly draft a letter of intent (LOI), it is important to be familiar with the property and, more specifically, with what market rent is and what you have been able to achieve at the Center. A review of the current rent roll is helpful. Please refer to the Crossroads Plaza Rent Roll found in Exhibit A.8 on the companion website. A perusal of Exhibit A.8 reveals that the lease rates are very erratic, with the range going from $.49 per square foot per month for the large 205,000-square-foot supermarket to $1.70 per square foot for the 5,000-square-foot restaurant/tavern. The most recent lease for 1,200 square feet was cut at $1.08 per square foot per month on a triple net basis. The vacant space is shown at a scheduled rent of $1.17 per square foot per month. Before the LOI is issued, you should be familiar with any usage or other restrictions applicable to the project. A review of the Project Summary Sheet, discussed below, might clarify these concerns. To speed up the process, you might also have prepared a standard letter of intent and a standard lease. Of course, the standard form must be tailored for the specific lease transaction, but the standard form is a good starting point. A letter of intent is often used as an expedient way to "cut a deal," that is, to get directly to the salient business points without the clutter of all of the other lease provisions.

A sample letter of intent covering the key business might look as follows:

Landlord	EC California Gold, LLC.
Tenant	The Hobby Shop, Inc.
Guarantor	Peter Smith and Mary Smith.
Premises	Suite 101 consisting of approximately 2,600 net rentable square feet.
Building	A 120,000 net rentable square foot Shopping Center plus all associated common areas including the surface parking.
Term	Five years commencing January 1, 2009.
Rent	The monthly Base Rent to be Three Thousand Five Hundred Ten Dollars ($3,510.00).
Rent Adjustments	The Base Rent to increase annually by four percent (4%).
Lease Type	Triple Net. Tenant to pay its pro rata share of operating expenses.
Tenant's Maintenance Obligations	Tenant shall be responsible to maintain in good condition the interior of the Premises and shall be obligated for the maintenance, repair, and upkeep of the HVAC unit solely serving the Premises. Tenant shall also be responsible to keep in full force and effect a full service contract for the HVAC unit from a HVAC company approved by Landlord, approval not to be unreasonably withheld, delayed, or conditioned.
Tenant Improvement Allowance	Landlord to disburse Twenty-Five Thousand Dollars ($25,000.00) to Tenant for use on approved Tenant Improvements upon receipt of:
	1. Description of the work done and/or materials installed.
	2. Copy of applicable invoices.

(Continued)

	3. Copy of payment check to vendor or contractor.
	4. Unconditional notarized lien release.
Security Deposit	One month's Base Rent.
Building Hours	Tenant shall have access to the Premises 24/7.
Confidentiality	Tenant shall not disclose the Lease terms contained herein to any third party, except Tenant's accountant or attorney-at-law or as otherwise approved by Landlord.

This Letter of Intent shall not be binding upon the parties and is merely an expression of interest. Only if Landlord and Tenant execute a lease shall there be a binding contractual relationship between the parties.

The following is a brief commentary on the above letter of intent combined with a hypothetical negotiation between the landlord, Miles Mission, and the prospective tenant, Peter Smith. The emphasis is placed upon shedding additional light on the leasing issues and especially on business areas and deal points that should be reflected upon as the transaction is negotiated.

An accurate recitation of the parties is important. The landlord should understand clearly who the obligor on the lease will be. If the obligor is a married man or woman, consideration should be had on whether both parties should sign the lease. This avoids a finger-pointing argument in the event of a default. If the husband is obligated on the lease and the landlord seeks to collect delinquent rent, the landlord wants to avoid the husband's argument that "I own nothing; everything is in my wife's name."

If multiple tenants comprise the obligor, the LOI should recite that they shall be jointly and severally liable. Joint and several liability results in all of the signors responsible for the rent ("joint") and each signor individually responsible for the entire rent ("severally"). When the landlord requires joint and several liability, one obligor cannot say, "Here is my one-eighth of the rent, collect the balance of the rent from the other seven obligors." Of course, the tenants should have an agreement between themselves allocating, among other things, the monthly rent obligation.

Often, a tenant will request the ability to sign the lease in the name of his business entity. They usually argue that by doing so the rent will be an expense within the partnership, corporation, limited liability company, and so forth. Of course, if the prospective tenant is Microsoft, no problem. The reality is that 99 percent of prospective tenants are not "credit" tenants and the desire to move to an entity obligor insulates their liability. The landlord's counter to this proposal, although not without its own set of risks, is to require a personal guaranty. If a guaranty is required, it is prudent to include such language in the LOI and, again, if the guarantor is married, both the husband and wife should execute the guaranty.

A letter of intent is a lease proposal. The letter of intent is usually stated as nonbinding as stated earlier; however, alternative language might indicate "This Letter of Intent shall be binding upon the parties and confirmed in a lease to be executed by Landlord and Tenant." Although this provision suggests that the LOI is binding and enforceable against both landlord and tenant, in actuality it probably is not binding due to its lack of definiteness. There are too many areas not covered in the LOI, and even the covered areas usually are set forth in general terms.

In our hypothetical scenario, Peter Smith, after reviewing the LOI, admits to Mission that his business is a start-up, but he argues that he has a lot of experience in the hobby field, having worked for several other hobby shops over the past 15 years. He also indicates that he is not willing to guaranty the lease. He argues that he is putting all the money he has, not to mention his heart and soul, into this business. He also states that, given the economic climate, a severe recession, with businesses going under left and right and unemployment approaching 10 percent, that the proposed $1.35 per square foot per month rent is too high, that the annual escalation of four percent makes no sense in a deflationary economy, and that the tenant improvement allowance of $25,000, which equates to $10 per square foot, does not work since the build-out will cost approximately $87,500, which equates to $35 per square foot.

Miles reasons that he needs tenants, given his occupancy, and after meeting with Peter he feels confident that Peter will give the business his total commitment. However, Miles is firm that the $1.35 per square foot per month is at or below market price and that he wants Peter to have his own money in the transaction to assure his attention. Miles proposes to give up the guaranty by significantly increasing the security deposit. He also decides to ameliorate the rent issue by offering some free rent. Miles understands

Peter's concern about the build-out cost and agrees to increase the tenant improvement allowance, yet feels the increased allowance should come at a cost. He therefore agrees to increase the tenant improvement allowance by $25,000, with the stipulation that a cost to the funds be attributed and amortized into the rent. Miles asserts that his cost of capital is 8 percent, so using his financial calculator he figures that the additional charge should be $387 per month if spread over a seven-year lease. Miles realizes that this modification might run counter to ameliorating the rent, but he feels that that is a fair trade-off if Peter desires that Miles fund additional tenant improvement costs. Again, Miles' biggest concern is having Peter financially committed in terms of hard cash invested. Miles figures that under this structure, Peter will have, at the least, approximately $60,900 of cash at stake going into the transaction: $37,500 in tenant improvement money and a $23,400 security deposit. Miles wants to cover the potential inflation factor and he is not set on the fixed annual bump, so he decides to give Peter options. Miles modifies the LOI as follows:

Landlord	EC California Gold, LLC.
Tenant	The Hobby Shop, Inc.
Premises	Suite 101 consisting of approximately 2,500 net rentable square feet
Building	A 120,000 net rentable square foot Shopping Center plus all associated common areas including the surface parking.
Term	Seven years commencing January 1, 2009.
Rent	The monthly Base Rent to be Three Thousand Nine Hundred Dollars ($3,900.00).
Free Rent	Tenant shall pay one-half of the Base Rent for months one through six of the Term.
Rent Adjustments	The Base Rent to increase annually by (1) Four Percent (4%) or (2) CPI with a floor of 3% and a ceiling of 5% or (3) CPI. Tenant to select choice 1, 2, or 3 prior to lease execution. Choice selected shall be for entire Lease Term.
Lease Type	Triple Net. Tenant to pay its pro rata share of operating expenses.
Tenant's Maintenance Obligations	Tenant shall be responsible to maintain in good condition the interior of the Premises and shall be obligated for the maintenance, repair, and upkeep of the HVAC unit solely serving the Premises. Tenant shall also be responsible to keep in full force and effect a full service contract for the HVAC unit from a HVAC company approved by Landlord, approval not to be unreasonably withheld, or conditioned, or delayed.

Tenant Improvement Allowance	Landlord to disburse Fifty Thousand Dollars ($50,000.00) to Tenant for use on approved Tenant Improvements upon receipt of: 1. Description of the work done and/or materials installed. 2. Copy of applicable invoices. 3. Copy of payment check to vendor or contractor. 4. Unconditional notarized lien release.
Security Deposit	Six month's Base Rent, that is, $23,400.00
Building Hours	Tenant shall have access to the Premises 24/7.
Confidentiality	Tenant shall not disclose the Lease terms contained herein to any third party, except Tenant's accountant or attorney-at-law or as otherwise approved by Landlord.

After Peter reviews the LOI, he calls Miles and indicates that the parties are getting closer to a deal, but he is concerned about five issues:

1. Miles had set the lease commencement as of January 1, 2009. Peter points out that it is now November 20, 2008. Peter argues that there is no way he can have the tenant improvements built-out prior to year-end with the holidays coming up and, in fact, he has not even applied for a permit.
2. Peter expresses his concern that he does not have a handle on the triple net expenses. He requests that Miles cap this cost and that increases in real estate taxes due to a sale be excluded from the triple net charges.
3. Peter is willing to take on the repair and maintenance obligation of the HVAC unit, but he questions its current condition. He wants to make sure, going in, that it is in good working condition, and if it needs to be replaced that that would be a capital expense, an obligation of the Landlord.
4. Peter says he is unclear how the tenant improvement allowance works. Does he have to spend money and then get reimbursed, or can he just give Miles a copy of the invoice for services or materials?
5. Peter indicates that his goal is to build up a business and, that if it is successful, the location will be crucial since his customers will be used to going to this location. He therefore asks for two five-year options to renew.

Addressing some of Peter's concerns, Miles revises the LOI as follows:

Landlord	EC California Gold, LLC.
Tenant	The Hobby Shop, Inc.
Premises	Suite 101 consisting of approximately 2,500 net rentable square feet.
Building	A 120,000 net rentable square foot Shopping Center plus all associated common areas including the surface parking.
Term	Seven years commencing upon Lease execution ("Commencement Date").
Rent	The monthly Base Rent to be Three Thousand Seven Hundred Sixty-Two Dollars ($3,762.00).
Rent Commencement Date	Tenant's obligation to pay the Base Rent shall commence upon the earlier to occur of substantial completion of the tenant improvements or April 1, 2009. Tenant shall pay only one-half of the Base Rent for the first six months after the Rent Commencement Date.
Rent Adjustments	The Base Rent to increase annually by (1) Four Percent (4%) or (2) CPI with a floor of 3% and a ceiling of 5% or (3) CPI. Tenant to select choice 1, 2, or 3 prior to lease execution. Choice selected shall be for entire Lease Term.
Lease Type	Triple Net. Tenant to pay its pro rata share of operating expenses. However, Tenant's pro rata share of operating expenses for the first two years of the Lease Term will not exceed $.40 per square foot per month.
HVAC and Maintenance of the Premises	Landlord agrees to have the HVAC unit for the Premises serviced and in good working condition prior to the Rent Commencement Date. Tenant shall be responsible to maintain in good condition the interior of the Premises and shall be obligated for the maintenance, repair, and upkeep of the HVAC unit solely serving the Premises. Tenant shall also be responsible to keep in full force and effect a full-service contract for the HVAC unit from a HVAC company approved by Landlord, approval not to be unreasonably withheld, or conditioned, or delayed. Landlord agrees, at Landlord's sole cost and expense, to replace the HVAC unit in the event the HVAC unit's condition, at any time during the Term, requires replacement.
Tenant Improvement Allowance	Tenant to pay for the first Thirty-Seven Thousand Five Hundred Dollars ($37,500) of tenant improvements. Payments to be verified by a copy of the applicable contract, cancelled checks, and appropriate releases. Landlord to disburse the next Fifty Thousand Dollars ($50,000.00) to Tenant for use on approved tenant improvements upon receipt of: 1. Description of the work done and/or materials installed. 2. Copy of applicable invoices. 3. Unconditional notarized lien release. Tenant shall bear the cost of any tenant improvement expense in excess of $87,500.

Security Deposit	Six month's Base Rent, i.e., $22,572.00
Building Hours	Tenant shall have access to the Premises 24/7.
Options to Renew	Provided there is no default under the Lease, Tenant shall have two five-year options to renew the Lease on the same terms and conditions, except this option provision, the tenant improvement allowance, and the free rent shall not apply and the Base Rent and annual escalations shall equal the fair rental value and annual increases as determined by Landlord, in Landlord's sole discretion.
Confidentiality	Tenant shall not disclose the Lease terms contained herein to any third party, except Tenant's accountant or attorney-at-law or as otherwise approved by Landlord.

Miles has agreed to give Peter sufficient time to build-out the improvements, but wants to ensure that his feet are to the fire, so he inserts an outside date when Base Rent starts in any event. Miles makes a distinction between the Commencement Date and the Rent Commencement Date. His intention is to make sure the lease starts when Peter is given possession. He wants to make sure all of the lease provisions, including the insurance requirements, are in full force and effect during the tenant improvement build-out period. This is accomplished by having the lease effective at execution.

Although Miles is willing to compromise on the triple net charges and put a cap on the charges for the first two years, he is unwilling to eliminate real property tax increases due to a sale. Miles reasons that he knows the cost of running the center now and that that cost has been fairly stable at $.35 to $.40 per square foot per month. Therefore, he feels that that cost will not get away from him if he caps it at $.40 per square foot per month. He reasons that going out more than two years is too risky, and that although he currently has no intention of selling the property, "you never know"; if he eliminates the increase in real property taxes that could directly affect the sales price. In California, the buyer might correctly argue that real property taxes on sale will adjust to market, that given this exception, the increase in taxes could not, to the extent of the tenant's share, be passed on; the NOI would decrease and therefore the value would be reduced.

Miles considers Peter's comments regarding the HVAC unit valid. He knows the unit is in working condition because the prior tenant who just moved out had no complaints, but having the unit serviced, the filters changed, and so on is probably a good idea. Miles does not mind putting in the LOI his obligation to replace the unit as necessary. This provision was going to be documented in the lease in any event.

Miles attempts to clarify how the tenant improvement allowance will work. He wants to make sure that there are sufficient monies to complete the build-out, so he requires that Peter put his contribution in first. Once that is done, he feels that he is willing to put in the next $50,000, his obligation, not as a reimbursement but rather as a direct payment. He keeps the payments going to Peter, not a contractor, since he wants Peter to be satisfied with the work and responsible for monitoring the improvements.

The options to renew only inure to the benefit of the tenant. Nonetheless, Miles is willing to grant the options because he reasons he wants a tenant in place and, as long as Peter is current, not in default, he may as well work with Peter as opposed to a new party. Miles also proposed an option in which he feels he has all of the control. The rent is to be set at market in his discretion, and there are no other concessions such as free rent or tenant improvement monies.

After reviewing the revised LOI, Peter tells Miles he is in agreement with the overall concepts, but he feels the option language should be more balanced, so that if he does not agree with the Landlord's estimate of the fair rental amount there should be a procedure to set the rate. Also, he mentions that one of the key reasons he is going into this shopping center is because of the potential traffic from the supermarket. He has heard that the anchor tenant is not doing well and has only a short time on its lease. He therefore proposes a cotenancy clause that will provide that if the Giant Green Grocer or a comparable supermarket does not occupy the main anchor space for a six-month period, that The Hobby Shop may terminate its lease.

Miles' response is that he is willing to insert an objective standard to set the rate for the options if the tenant feels that the rate the landlord comes up with exceeds market, but he declines to include a cotenancy provision. Miles indicates to Peter that The Hobby Shop must stand on its own two feet; he cannot control what another tenant will or will not do. Also, if the Giant Green Grocer does not renew, he might put in a discount store that could be as beneficial to The Hobby Store as the super-market. Finally, he states that this type of an issue is a business risk that The Hobby Store must bear, especially in light of Miles' investment of $50,000 into The Hobby Store's tenant improvements and the free rent granted. Miles reissues the LOI as shown below, which is signed by both Landlord and Tenant.

Landlord	EC California Gold, LLC.
Tenant	The Hobby Shop, Inc.
Premises	Suite 101 consisting of approximately 2,500 net rentable square feet.
Building	A 120,000 net rentable square foot Shopping Center plus all associated common areas including the surface parking.
Term	Seven years commencing upon Lease execution ("Commencement Date")
Base Rent	The monthly Base Rent to be Three Thousand Seven Hundred Sixty-Two Dollars ($3,762.00).
Rent Commencement Date	Tenant's obligation to pay the Base Rent shall commence upon the earlier to occur of substantial completion of the tenant improvements or April 1, 2009. Tenant shall pay only one-half of the Base Rent for the first six months after the Rent Commencement Date.
Rent Adjustments	The Base Rent to increase annually by (1) Four Percent (4%) or (2) CPI with a floor of 3% and a ceiling of 5% or (3) CPI. Tenant to select choice 1, 2, or 3 prior to lease execution. Choice selected shall be for entire Lease Term.
Lease Type	Triple Net. Tenant to pay its pro rata share of operating expenses. However, Tenant's pro rata share of operating expenses for the first two years of the Lease Term will not exceed $.40 per square foot per month.
HVAC and Maintenance of the Premises	Landlord agrees to have the HVAC unit for the Premises serviced and in good working condition prior to the Rent Commencement Date. Tenant shall be responsible to maintain in good condition the interior of the Premises and shall be obligated for the maintenance, repair, and upkeep of the HVAC unit solely serving the Premises. Tenant shall also be responsible to keep in full force and affect a full-service contract for the HVAC unit from a HVAC company approved by Landlord, approval not to be unreasonably withheld, or conditioned, or delayed. Landlord agrees, at Landlord's sole cost and expense, to replace the HVAC unit in the event the HVAC unit's condition, at any time during the Term, requires replacement.
Tenant Improvement Allowance	Tenant to pay for the first Thirty-Seven Thousand Five Hundred Dollars ($37,500) of tenant improvements. Payments to be verified by a copy of the applicable contract, cancelled checks, and appropriate lien releases. Landlord to disburse the next Fifty Thousand Dollars ($50,000.00) to Tenant for use on approved tenant improvements upon receipt of: 1. Description of the work done and/or materials installed. 2. Copy of applicable invoices. 3. Unconditional notarized lien release.

	Tenant shall bear the cost of any tenant improvement expense in excess of $87,500.
Security Deposit	Six month's Base Rent, that is, $22,572.00
Building Hours	Tenant shall have access to the Premises 24/7.
Options to Renew	Provided there is no default under the Lease, Tenant shall have two five-year options to renew the Lease on the same terms and conditions, except this option provision, the tenant improvement allowance, and the free rent shall not apply and the Base Rent and annual escalations shall equal the fair rental value and annual increase as determined by Landlord, in Landlord's sole discretion. In the event Tenant disagrees with Landlord's determination of fair rental value, an arbitration procedure to determine Base Rent and annual escalations shall be set forth in the Lease.
Confidentiality	Tenant shall not disclose the Lease terms contained herein to any third party, except Tenant's accountant or attorney-at-law or as otherwise approved by Landlord.

Comparison of Lease Terms

The prior discussion about the LOI is illustrative of the give-and-take negotiation that results in the final lease. The problem is that it lacks a method to quantitatively compare alternative lease proposals. Yes, some of the negotiated terms do not involve the purely economic provisions, but to the extent the monetary deal points are being traded, it is important to set up a model so that the give-and-take is better understood.

In grade school we are given problems such as, Is $\frac{3}{5}$ less than, equal to, or greater than $\frac{14}{25}$? In order to make this determination a common denominator is found and both fractions are converted to a fraction with the same denominator. In our example, 25 is the lowest common denominator. Converting both fractions to a denominator of 25 results in $\frac{3}{5} = \frac{15}{25}$ and $\frac{14}{25}$. Clearly therefore $\frac{3}{5}$ is greater than $\frac{14}{25}$.

How does a landlord determine if the lease terms are a reasonable package to offer? How can a tenant assess the options? Why not build in six months of free rent rather than three months? If you increase the tenant improvement allowance and reduce the free rent on a quantitative basis, how does that affect the landlord's return? Is there a methodology to compare variations in offered terms to assess the relative value of an offer?

Let us assume that you have just acquired a project. Let us also assume that during the process of the acquisition you made certain assumptions on what you felt were achievable goals in terms of lease-up parameters and eventual sale. Your assumptions were that during a five-year holding period, your initial rent would $3.00 per square foot per month, escalating 3 percent per year. Furthermore, you assumed that it would take nine months to lease-up the vacant space with a concession package of a 3 percent paid for leasing commissions and a $35 per square foot tenant improvement allowance. Also, you assumed that at the end of five years you would sell the building at a 7.75 percent cap rate with a cost of sale of 4 percent.

Along comes a prospect who says he wants minimal fix-up costs and as low a rent as possible. You think of offering $2.75 per square foot per month, increasing 3 percent per year, with a concession package of half Base Rents for one year and a tenant improvement allowance of $2.50 per square foot, which is what you have estimated will be the cost to paint the premises.

From a present value standpoint, is the proposal you are thinking of offering less than, equal to, or greater than the standard you set up when purchasing the property? Exhibit 10.1 is a simple Argus

Exhibit 10.1 Lease Terms Comparison Analysis

	Year				
	1	2	3	4	5
Projected income	$36.00	$37.08	$38.19	$39.34	$40.52
Sale value of income @ 7.75 cap with 4 percent cost of sale					$501.90
Leasing commission (3%)	(27.00)				
Downtime 9 months	(35.00)				
Tenant improvements	(35.00)				
Cost analysis	$(61.00)	$37.08	$38.19	$39.34	$542.42
Return					
Present value at 8.77%	$389.32				
Leasing Proposal					
Rent	33.00	33.99	35.01	36.06	37.14
Sale value of income @ 7.75 cap with 4% cost of sale					$460.08
Free rent (6 months)	(16.50)				
Tenant improvements	(4.00)				
Cost analysis	$12.50	$33.99	$35.01	$36.06	$497.22
Present value at 8.77%	$419.78				

analysis showing that the proposal is better than the standard set-up during due diligence. The upper portion of the chart shows target or standard lease terms and conditions. In this case, it assumes an initial annual rent of $36 per square foot, increasing 3 percent per year. A value is calculated in the fifth year based upon reasonable assumptions. The rent concessions reduce income. The result is a cash-flow stream that can be reduced to a present value at an assumed discount rate. The bottom portion of the chart inserts proposed lease terms. The present value is again determined. The present value of the standard can then be compared to the present value of the proposed lease terms to derive a comparison of how the proposal stacks up to the target illustration. If the present value of the proposed lease terms exceeds the standard, then perhaps the landlord should move forward with the transaction. If the present value of the proposed lease terms is less than the standard, then perhaps the offer should be modified.

This type of analysis is a rational method to compare alternative deal structures. All too often, real estate professionals make economic decisions based on emotional factors rather than based upon a reasoned, economic model.

Lease Administration

A system should be created to move from lease execution through monthly rental billing.

In our organization, the office manager, within a short time frame after a lease is consummated, scans the lease into the computer and creates a permanent lease file. As an additional precautionary measure, it is prudent to store a copy of the scanned file offsite, for example, with counsel. The property manager for the applicable property then completes a lease abstract. A copy of the lease and the lease abstract is then given to accounting, which inputs the basic rental terms into the computer so that monthly invoices can be generated and a rent history established.

Lease Abstract

As mentioned above, a lease abstract should be created shortly after the lease has been entered into. The lease abstract attempts to summarize the key terms and conditions of the lease. Obvious items such as the base rent schedule should be outlined. In addition, it is helpful to highlight unusual provisions such as rights of first refusal, any termination rights, or the right to reduce the size of the suite upon the occurrence of certain events, and so on. Like the Lease Summary Binder, the lease abstract should be a document that is a useful living tool so that as other information about the tenant is learned, the abstract can be annotated with additional information. For example, often at the outset of the lease relationship, it may not be clear who the main tenant contact will be. However, as time passes, a working relationship develops and the contact person then can be listed in the abstract with his or her office number, a cell-phone number, and an e-mail address. As another example, let us assume the tenant goes into occupancy and six months later installs a security system. The lease abstract might be a convenient place to document the security code to be used in emergencies or to otherwise gain access to the tenant's premises.

Management

Organization, execution, and follow-up are the key factors in property management. Each property should be viewed as an independent business, as its own profit center.

The management of a project is the overall running of the asset. It can be divided into four segments: planning, implementing, monitoring, and reporting.

Planning

Planning is also discussed in Chapter 1. A written business plan as well as goals, property-by-property action items, and priority lists should be composed. Please refer back to Chapter 1 (including Exhibit 1.1).

An annual budget for each property is essential. The process of budgeting forces you to review your cash flow, your capital reserves, and problem areas in each property. Part of the budgeting process is to compare what was spent last year with what was spent during the current year and what is anticipated will be spent next year on each line item. By doing this, those items that are out of line, the variances, are highlighted and can be discussed.

Additionally, if your portfolio contains several similar properties, comparisons can be made between the properties to attempt to discern standout variances. The comparison is facilitated by translating the income and expenses into a per-square-foot number. Care must be taken to compare apples to apples since different geographic areas can have significantly differing factors that might affect the analysis. For example, the extremely hot summer temperature in Palm Springs, Las Vegas, and Phoenix increase the cost of roof replacement, parking lot repaving, and HVAC repairs as compared to those structures in a more temperate climate such as Los Angeles.

The budgeting process is geared to focusing on where the funds for the project will be spent during the coming year. Therefore, important areas to discuss include what leases are maturing and the present condition of those suites as well as what capital improvements, such as painting, paving, or roof replacement, will be needed over the next calendar year. Given the nature of capital improvements, major cash outlays, the budgeting process for these items may extend over several years. Ideally, bids for the needed capital improvements should be secured prior to budget discussions. Without knowing the associated cost, it is difficult to make informed decisions about where to spend limited resources.

Rule Number 30

Pricing is needed in order to make informed management decisions.

Implementing

To some extent, implementing is a function of the size of one's organization. If you have a small shop with one or two individuals, guess who takes out the garbage? Small to medium-size real estate companies outsource more functions than larger companies, which have the internal staff to take care of a greater range of matters.

Once a new property is acquired, the first step is an accounting function to set up the books. A balance sheet, income and expense analysis, and bank account information must be input into the computer. Computer programs such as Yardi and QuickBooks Pro have software designed to assist this process. The key data relating to each lease must also be inputed. The lease abstract can assist as a double-check, but the actual signed lease should be used for the data assembly. The computer program will pick up changes in monthly rent, so for billing purposes this aspect of the process becomes automated.

The computer facilitates issuance of monthly bills and receipts. When the rent checks come in for payment, the payment must be posted and a rent history is thereby created.

When a rent check is received, should it be posted to the most delinquent item or the current month's outstanding debt? The general accounting rule is last in, first out. Meaning that the last payment you receive gets applied to the most delinquent item. Notwithstanding this accounting rule, the lease controls. Most leases state: "All payments received by Landlord from Tenant shall be applied to the oldest payment obligation owed by Tenant to Landlord."

In California, by Code, you may go back only one year to determine the delinquent amount for purposes of the three-day notice to pay or quit and the unlawful detainer, that is, the lawsuit to evict a tenant. If the tenant cures the delinquency within the three-day period for the amount owed, then he may not be evicted. Nonetheless, the tenant still owes the outstanding balance beyond the one-year period and the landlord may file a lawsuit to collect the amount owed.

The manager's role vis-à-vis the property, as stated earlier, is a function of the size of the company as well as the type of leases involved. In other words, management should take the time to understand what responsibilities rest with the tenant and what responsibilities must be borne by the landlord. Full-service gross leases place more burdens on the landlord while, in contrast, bond leases pass the obligations for the care of the premises and the project to the tenant. Management personnel should take the time and effort to read the applicable leases, so a clear understanding of the delineation of responsibilities is made.

Notwithstanding the general rule that the language in the lease controls, there are gray areas that must be dealt with on a fairness basis. For example, if a plumbing backup occurs in the tenant's bathroom, is the cost the tenant's expense or the landlord's expense? The determining factor is usually where the blockage occurred. If it is localized in the bathroom toilet, the expense should be covered by the tenant. However, if the stoppage is in a main sewer line far removed from the tenant's shop, it is the landlord's expense. As a practical matter, it is often difficult to determine where the blockage occurred and for sake of tenant relations the landlord usually picks up the repair cost.

A light goes out in the tenant's suite. Who is responsible for replacing the bulb? What if the ballast must be fixed: Is that a landlord expense? What if the light fixture burns out in the common hallway? Who tends to that? The building air-conditioning is malfunctioning. Who is responsible for fixing it? Does it matter if the HVAC unit services multiple tenants, or just one tenant? A leak occurs during a rainstorm. Is the landlord required to repair the leak? Is the landlord liable for damage to the tenant's equipment caused by the water that leaked in? Is this damage covered by insurance? If yes, does the landlord's or the tenant's policy apply? What if the leak was due to a tenant's equipment breakage on the floor above where the damage occurred? Where is the delineation of responsibility? If the lease contains a waiver of subrogation clause, how does that affect the parties and their respective insurance carriers? If the leakage was due to a malfunction in the tenant's equipment and assuming the tenant's insurance carrier covers any loss within the tenant's premises and the landlord's insurance carrier covers any loss to the common area, what if the landlord's insurance policy has a huge deductible? The damage was caused by the tenant's equipment; can the landlord at least recover the deductible from the tenant? Does the answer change if the waiver of subrogation paragraph states "Notwithstanding the foregoing provision, Tenant shall be responsible for any deductible incurred by Landlord in connection with the loss or damage?" If a guest is injured in one of the common areas such as the parking lot, is that the landlord's problem? If the injury occurs in the tenant's premises, then, is it a tenant concern? Again, is this an insurance issue? Problems of this nature are commonplace and it is management's job to address these matters.

Management concerns are varied and it is helpful to develop procedures to address at least some of the recurring issues. A few of the issues that management must deal with include:

- Security concerns.
- Hazardous waste.
- Trash removal.
- Violations of exclusivity rights.
- Parking matters such as the need for valet parking at peak times.
- Annual testing for fire, life, and safety.

- Storage issues.
- Americans with Disabilities Act (ADA) compliance.
- Public access issues.
- Real estate taxes and related appeals.
- Emergency issues such as preparations in the event of fire and/or earthquakes.

The point is that there are many different issues and concerns that come up on a daily basis that must be addressed.

The more properties one has, the more difficult it is to keep track of the various nuisances that exist within each property. Important matters can be forgotten. By creating a booklet or binder for each property, the salient items that pertain to that property may be captured and reviewed when needed, so that decisions and finalizing documentation can be expedited.

Project Summary Binder

The Project Summary Binder for each property might contain the following:

1. Current rent roll reflecting the date prepared as well as the tenant's name, square footage, base rent, rent per square foot, commencement and expiration dates, what if any operating expenses are paid by the tenant, security deposit, options, and any special provisions such as guaranties.
2. "Cheat Sheet" summarizing what, as landlord, you are trying to achieve, as well as special or unique provisions that apply to the subject project. The Cheat Sheet should cover the type of leases in the project, that is, a triple net, modified gross, or gross lease, the scheduled rent per square foot, and the load factor.
3. Individual Lease Summaries for each lease.
4. Vacancy Chart.
5. Delinquency Report.
6. Annual Budget.
7. Leasing Flyer.
8. A narrative highlighting special lease features, such as exclusives, rights of first refusal, death and disability clauses, options to purchase and/or extend, and so forth.

9. Loan information, which should include:
   a. Loan servicer's contact information.
      - Loan number
      - Account representative's name, telephone number, email address, and mailing address.
   b. Outstanding balance.
   c. Monthly payment.
   d. Amortization.
   e. Due date.
   f. Interest rate.
   g. Right to place secondary financing.
   h. When debt is open for prepayment.
   i. Prepayment penalty/defeasance fee.
   j. Holdback provisions, if applicable.
   k. Reserves.
      - Type of baskets.
      - Amount held by lender per basket.
      - Amount deposited per month per basket.
      - Cap per basket.
   l. Special features.
10. If there are percentage rent clauses in any of the leases, the breakpoint sales and the breakpoint percentage.
11. Depending on the type of project, a site plan and/or schematic plans for each floor and each suite.
12. "As-builts" for each suite and especially for any vacant space.
13. Bank account information including the depository, type of account, and balances.
14. A narrative list of specific problems that must be addressed.
15. Ownership information. If the project is syndicated, a list of the investors and their percentage ownership should be drafted.
16. How documents should be executed to bind the owner. Having a ready reference to the signature block is helpful so that every time a document is signed, there is a quick guide available.
17. A recitation of what the management fee is for the property and how it is calculated.

Assembling this type of handy reminder in a single source assists not only the property manager, but also will assist in leasing and, if kept current, as a reference guide for individuals that might be less informed than the manager about a specific property.

The Project Summary Binder should be reviewed on a monthly basis, with a focus on expiring leases, the budget (with emphasis on any income or expense line item that is outside a normal variance), delinquencies, and major and minor problems. The binder should be used as an active tool for managing the property.

Be Proactive, Not Reactive

Well-executed property management means anticipating problems and attempting to take corrective action before a major crisis arises. Being proactive can mean eschewing the path of least resistance. It is relatively easy to call the plumber when the bathroom toilet is backed up; it is a lot more difficult to ensure that the plumbing lines in a mid-rise office building have the proper slope so that potential clogs are avoided. In most areas of the country there is a rainy season. A proactive approach schedules the gutters and drains to be serviced well in advance of the rains. When it is raining and leaks are occurring due to clogged gutters, if the gutters are serviced at that point, the manager has been reactive rather than proactive. In the long run, a proactive approach is more efficient and cost-effective than a reactive approach. How many times do you want to call the roofer or the plumber, after all? Try to get a roofer out to your property when it is raining. Getting the roofer or a handyman to check out potential problems before they become a problem is usually a wiser approach and less costly in the long run.

There is no easy way to avoid problems, which usually are property specific. The key is to take the time to view the subject property from top to bottom, identifying potential areas of concern: Is there any area where the grade of the floor is so steep so that a trip hazard may arise? Do the elevators have a motion sensor to avoid closing prematurely? Is the surface of the lobby too slick, which may lead to someone falling down? Is the external lighting adequate for visitors? Have reasonable security measures been taken to prevent theft? Are the trees routinely trimmed so as to avoid damage to parked cars in the event of a severe storm? The list, of course, goes on. A proactive approach attempts to anticipate and address potential concerns well in advance of the problem occurring.

Monitoring

Monitoring is a review process to oversee that employees are properly carrying out their assigned tasks and also making sure tenants are honoring their lease obligations.

Monitoring employee performance should not necessarily have a negative connotation. The objective is to be encouraging and render constructive, positive feedback. For example, let us say the onsite manager is attempting to lease a vacant space in the Center. A discussion with the manager might reveal that he has not approached the other tenants in the Center with an incentive program to encourage them to bring potential tenant leads to the manager. Now the situation can be swiftly corrected, to the mutual benefit of all.

Mundane matters must also be monitored. Is every lease being abstracted? Are the leases being scanned? Are errors being made in imputing the lease data into the computer?

The project delinquency report should be reviewed monthly. Are the tenants paying their rent in a timely manner? If there are significant delinquencies, a discussion should be had with the property manager to determine a proper course of action. Is the delinquency an ongoing problem, or a rough spot for a tenant who is making a sincere effort to honor his obligations? Is a rent deferment program appropriate, or should a three-day notice to pay or quit be issued? These issues are crucial to the economic viability of the project and therefore should be monitored closely.

At times there are also nonmonetary lease obligations that must be consistently reviewed. An example of this type of obligation is the tenant's obligation to maintain insurance. The landlord wants to make sure that the tenant carries the required insurance to protect against loss within the premises as well as the economic viability of that tenant in the event of a casualty. For example, if a fire occurs at the center, the landlord's obligation to carry fire insurance ensures that the structures will be rebuilt, and the loss of rents provision pays the tenant's rent during the 12- or 18-month period covered by the policy. What if the tenant fails to maintain adequate contents coverage? Its loss in terms of damaged goods and equipment might be so substantial that the tenant cannot afford to reopen.

In conjunction with shopping centers, the tenant's sales volume is often a good barometer of the financial health of that tenant. Tenants required to pay percentage rent must disclose sales results. Also, large tenants, such as the anchor, are often required to supply this information. In contrast, for small or medium-sized centers retail sales, volumes are normally not readily forwarded to the landlord.

If a store's sales volume is obtained, translating that dollar figure into monthly and annual sales per square foot is very helpful for evaluating performance. Different industries have different profit margins, but usually industry statistics will show what price per square foot represents breakeven and what are, in general, the reasonable sales per square foot needed to have a successful business.

Reporting

Everyone reports to someone. Day porters report to managers. Managers report to owners. Owners report to investors and lenders. Lenders report to shareholders, and so on.

If the project is syndicated and there are third-party investors, it is important to keep them advised as to the status of the project. A status report should, at a minimum, go out yearly, and preferably at least quarterly. The report should comment on the overall health of the project: occupancy levels, cash flow, and cash reserves. Also, new developments, such as leasing that has been recently entered into, should be mentioned. Lastly, problem areas and major issues, such as how a maturing loan is being dealt with, should be covered.

With the advent of the computer and especially the Internet, consideration should be given to posting project financial results, that is, rent roll, balance sheet, and income and expense numbers, on a monthly basis. Investors could access this information on the Web through the use of a password so that the financial data remains confidential.

Management as a Business

Viewing one property, the fee for managing the asset is fairly simple. The fee is usually a percentage of the gross income collected: typically 3 to 5 percent. The management may be internal or conducted by an outside management firm. If it is done internally, there is usually not an exact identity of interest between the property ownership and management. A typical ownership structure might involve investors that are passive, not involved in the day-to-day affairs of the property. The equation becomes more complicated when multiple properties are owned and the same key entrepreneurs are involved as partners and as the owners of the management entity.

The management fee should be monitored and reviewed on an annual basis. Given the inherent conflict of interest between the managers and the owners, any modification of the management fee should be approved by the partnership.

In the beginning of this chapter, I mention that each property should be viewed as a stand-alone asset, a separate profit center. The same holds true for the management income. The analysis becomes much more complicated when multiple properties are involved and overhead is incurred, including salaries and office expenses to run the property management business. A distinction must be made between a property expense and an expense attributable to the management company. Should any or all of the property manager's income be borne by the asset, or is it 100 percent attributable to the operating company? The profitability of the management company must be monitored and controlled as a stand-alone business similar to each individual property.

Conclusion

Rule Number 31

Marketing, leasing, and management are interconnected and interdependent. Care should be taken to integrate all three of these areas cohesively.

The next chapter discusses the area about how to structure your venture. You are in the process of acquiring a real estate investment. You have analyzed it thoroughly, you have gone through the leases and composed a detailed income and expense analysis, and you have arranged appropriate financing and considered the tax implications. You have also put on paper a marketing game plan. Your leasing and management team is in place, but how do you structure the acquisition in terms of your relationship with your potential partners? The next chapter addresses this issue.

Wealth Opportunities in Commercial Real Estate: Management, Financing, and Marketing of Investment Properties
By Gary Grabel

CHAPTER 11

Partnership Structuring and Deal Restructuring

The purchase of real property is capital intensive. Although historically, 75 to 80 percent of the acquisition price consists of third-party debt, the balance of the purchase price is equity, the down payment, and other monies invested by the buyer. Therefore, when you are purchasing a property for $10,000,000, you still must come up with $2,000,000 to $2,500,000 in cash. Complicating this picture is the fact that, in times of credit tightening, lenders become more conservative. The loan-to-value ratio is reduced significantly: typically to the 50 to 60 percent range. The result is that now the buyer must write a check for $4,000,000 to $5,000,000. Of course, individuals or entities might have sufficient resources to front the entire equity portion themselves. However, if the acquiring party lacks the necessary funds, or desires to conserve its cash—perhaps to facilitate multiple projects or simply to spread the risk—a partner or partners might be taken into the venture.

Partnership Structuring

There are numerous ways to structure a partnership. Some of the more common forms are:

- A joint venture agreement, which usually takes the form of a general partnership for a specific purpose.
- A limited partnership, where the equity contribution is usually represented by the limited partner's share. Very often, the

general partner in the limited partnership (LP) is insulated from liability by being a limited liability company (LLC) or a corporation. Today, the same net result can often be accomplished by using the LLC as the owner rather than a limited partnership. This avoids the need for a general partner. This type of entity affords limited liability to all of its members. Tax issues often dictate which structure to use.
- The parties may execute a trust deed with a "kicker," commonly referred to as a participating mortgage. Often, the equity piece is in the form of a junior mortgage.
- The financial partner may own the project and enter into a participating management agreement with the active partner or a participating ground lease.
- The passive partner may fund 100 percent of the acquisition costs and fix-up expenses with the borrower/active partner posting a satisfactory letter of credit for an equity cushion.

In each of these structures, the goal is for the active player to obtain the needed capital while rewarding the passive partner with a profit split of cash flow and/or profits on sale or refinance. Nonetheless, the form of the structure could have a significant impact on such concerns as project control, the monetary commitments of the parties, the tax benefits, and rights of enforcement in the event of a breach or if the project performance is lower than anticipated.

As mentioned above, there is no single right way to structure a profit participation or profit-sharing arrangement. However, in the "typical" or standard transaction, the deal is divided into two parts: the capital side and the entrepreneurial side. In other words, 50 percent of the "cookies" go to the money partner(s) and 50 percent to the promoter(s). The percentages are often a function of the potential upside in the real estate transaction. The more the property to be acquired has a "value-added" element, the more the entrepreneurial side can command. In contrast, if the property is stabilized at 95 to 100 percent leased, then often the entrepreneurial side will command less of a cut, typically 30 to 35 percent.

In addition to a percentage of the project ownership, often a promoter will charge an upfront fee for putting the real estate transaction together. This fee may be labeled an acquisition fee or syndication fee. Also, a financing fee may be charged if the promoter coordinates the arranging of acquisition debt or of a refinance.

If the project involves construction, whether ground-up or rehab, there may be a development fee. A disposition fee may also be built into the structure upon sale.

Usually, there is a trade-off between taking an ownership position versus earning fees. In other words, if the syndicator is taking an equity position for putting the deal together and creating value, then the fees charged, if any, will be de-emphasized. In contrast, if the promoter is not taking an equity interest, the project usually will be more heavily fee-loaded. In any event, care must be taken not to overload the project with too many fees, so as to make the yield unattractive.

Securities Issues

Any type of arrangement wherein one party is relying on the skill and effort of another party to generate a return on capital invested may be considered a security under federal and state laws. The result is that the syndicator must make the proper disclosures, or the transaction must fall within an exemption, or the active partner runs the risk that he will, in essence, become a guarantor of the investor's investment.

Licensing

The general rule is that if you are putting together a real estate venture and not receiving compensation for the sale of the applicable units, then no license is required. In contrast, in California, if you are getting paid to raise money for a LLC or a LP, then licensing is required and the type of license depends on the number of investors involved. If there are fewer than one hundred investors, you need a real-estate broker's license, which is issued by the Department of Real Estate. If there are more than a hundred investors, a broker-dealer license issued by the Department of Corporations is mandated. Even if there are more than a hundred investors, a limited broker-dealer's license may be available provided your activity is confined only to the sale of interests in entities that concern real estate projects.

Federal and State Laws

Securities offerings must comply with both federal and state laws. Federal security law is governed by the Securities Act of 1933.

Each state has its own securities laws, which are often referred to as "Blue Sky Laws." The origin of the state's reference to its securities laws as Blue Sky Laws stems from the statute's intent of protecting the naive and vulnerable from an evil promoter selling promises of real estate that are in fact fraudulent and no more based on reality than "the blue sky."

Registration

The general rule is that registration is required unless the offering falls within the scope of an exemption. If registration is required on the federal level, the registration is with the Securities and Exchange Commission (SEC). If registration is required on the state level, in California the registration is with the Department of Corporations.

Exemptions from Registration

There are certain basic rules that must be understood regarding registration exemptions:

- The applicability of the exemption is judged by applying the test to the entire offering rather than to the sale to one particular purchaser.
- The entire offering must comply with the exemption. It is not sufficient if part of the offering complies with one exemption and the other part complies with a different exemption.
- If the offering does not qualify for the exemption, any investor may sue to recover his investment even if, as to that party, the exemption was complied with.

Federal Exemptions

The two most commonly applicable exemptions are the private offering exemption and the intrastate offering.

Private Offering Exemption

The *private offering exemption* is usually defined by what it is not: namely, a public offering. A public offering is a solicitation to the general public, while a private offering is an offering involving friends, family, and business associates. The test is not who actually invests in the offering, but rather to whom the membership interests were offered. The offering is more likely to be found to be a private offering if the offering is made directly to the offerees rather than through the facilities of a public distribution. Also, if the offerees have a close relationship to the issuer so as to have access to, among other things, accurate financial information, the offering is more likely to be deemed a private offering. The underlying concept of this exemption is that registration is not needed if the issuer has reasonable grounds to believe that the offerees are capable of evaluating the prospective investment or are able to bear the economic risk.

The SEC adopted Regulation D, in which Rule 506 sets forth a safe harbor for this exemption. Rule 506 "imposes a suitability requirement," which boils down to each investor qualifying as an "accredited investor." An accredited investor must have a net worth greater that $1,000,000 and an annual income greater than $200,000 or annual joint spousal income of $300,000.

Intrastate Offering Exemption

The *intrastate offering exemption* is designed to cover only those security distributions that are essentially local in character. This exemption requires that the entire issue be confined to a single state in which the issuer, the offerees, and the purchasers are residents. If all of the contacts involving the project, that is, if its location, the address for the syndicator, its members' residences or places of business, the sales activity in connection with the units, and so on are solely connected within one state, then the offering qualifies as an intrastate offering and registration with the SEC is not required.

SEC's Regulation D, Rule 147, defines what the SEC considers an intrastate offering. The concept underlying Rule 147 is to allow localized operations to sell securities as part of a plan to raise money locally. To satisfy the exemption, the entire issue must be offered and sold exclusively to residents of the state in which the issuer is resident and doing business. An offer or sale of part of the issue to a single nonresident will destroy the exemption for the entire issue.

Blue Sky Laws

As previously mentioned, in addition to complying with the Securities Act, a security issuance must also, to the extent applicable, comply with state laws governing the distribution of securities. The problem is that state statutes and regulations vary significantly from minimal rules and regulations to a very sophisticated system of regulations. In general, if you fall within a federal exemption, you will also not be required to file a registration on the state level.

Disclosures

Assuming your offering falls within the purview of an exemption, a private offering, or an intrastate offering, prudence would dictate that certain steps should still be taken to protect the issuer against any claim that the offering violates the Securities Act or any applicable Blue Sky Law. The following steps might be taken:

1. Have each investor execute an accredited investor letter.
2. Indicate that "The interests referenced herein have not been registered under the Securities Act of 1933, as amended, nor pursuant to the provisions of any state securities act."
3. Additional disclosures accompanied with an explanation might include statements that:
   - **a.** There is a risk that the acquisition does not occur.
   - **b.** There are general risks associated with real-estate ownership.
   - **c.** Leveraging and other factors relating to financing increase the risk of loss of investors' equity investments.
   - **d.** There is no assurance that the Property will increase in value.
   - **e.** Certain risks associated with the Property are either uninsurable or not insurable at commercially reasonable rates, and certain events or conditions could have a detrimental effect on the profitability of the Project.
   - **f.** There are environmental risks related to investing in real property.
   - **g.** An investment in the Project involves certain tax risks.
   - **h.** There is limited transferability of the investment.
   - **i.** There is only a limited right to participate in the management of the Company.
   - **j.** There is a potential conflict of interest between the Manager and the investors.
   - **k.** The financial projections provided are estimates only, based on assumptions that may be incorrect, and therefore the projections may not prove to be accurate.

- **l.** The investment is illiquid and may not be readily sold or pledged as collateral for a loan.
- **m.** Investors may be liable for return of distributions in certain circumstances.
- **n.** The Operating Agreement provides for limitations on the liability of the Manager.
- **o.** No independent counsel has been retained to represent the interest of the investors.
- **p.** There are substantial risks incident to the ownership of an interest in the Company.
- **q.** The investment is speculative and involves a high degree of risk of loss.

Where the disclosures are made depends on the documentation the promoter prepares. In other words, when putting together real estate syndications, there is always going to be an agreement between the partners, an agreement of limited partnership (if a limited partnership is formed), an operating agreement (if a limited liability company is established), and so forth. Therefore, it is common to build disclosures into these agreements. Typically, the face of the agreement will indicate that the offering has not been registered. If the syndicator has drafted and presented to investors an offering memorandum or an offering circular or a subscription agreement, then disclosures can also be made in those documents. Offering memorandums and/or subscription agreements usually come into play in development projects when there is a large time gap between raising the money for the investment and the time when the project will be in operation.

Fifteen Key Structuring Issues

There are several key issues that must be addressed in formulating the venture's structure. These issues include:

1. **Capital Contribution.** Historically, the money partner puts up 75 to 90 percent of the capital needed and, conversely, the entrepreneurial side invests 25 to 10 percent of the needed cash. This is a negotiated item. The money partner wants to ensure that the entrepreneurial players have enough at stake so that not only are their hearts and souls committed to the success of the project, but also that their pocketbooks are at

risk. A point of discussion might center around whether or not the entrepreneurial partners may syndicate their cash investment; or to restate this issue: is there a minimum dollar amount that the active partners must invest from their own funds? There is no right answer to this question. Some money partners do not care; money is money. However, other investors block any other party from investing under the theory that they only want to work with a small group of people whom they know and trust.

2. **Management Fee.** The day-to-day running of the real estate should be conducted by an experienced property manager. This function can and is usually performed by the individual or group that puts the transaction together. A standard management fee is 3 to 5 percent of the gross income, or 15 percent of operating expenses. If the promoter delegates the management function, a smaller asset management fee is often charged.
3. **Preferential Return, Look-Back Return, and a "Clawback."** A preferential return relates to monies paid to the money partners as a return on their invested cash. An issue that often arises is whether or not the money partners should receive a priority return on their investment on a regular basis prior to monies going to the promoter. The issue becomes: How is the cash flow distributed from the property? The cash flow distribution from the property is often referred to as "the waterfall."

   The operating expenses and reserves of the venture must be paid from rents received. The operating expenses, as discussed in Chapter 3, include all of the ordinary expenses of running the real estate, such as utilities, janitorial, repairs and maintenance, landscaping, and trash removal. After the operating expenses have been paid, then lender required reserves must be paid. Typical reserves include tax and insurance impounds and monies set aside for capital improvements, tenant improvements, and leasing commissions. Next, monies to pay any debt service on loans secured against the property must be disbursed. The remaining cash flow, less any reasonable reserves created voluntarily by the borrower, may be distributed to the partners. Usually, the next dollars distributed will go to the investors as a return on their investment. The percentage return is typically spelled out in the partnership agreement. The percentage is a function of the market rates of return when the property is acquired as well as the projected cash flow from the subject investment. For example, the money partners might receive a 10 percent return on their money paid monthly if the property is being purchased at a 12 percent leveraged return, yet the percentage might drop to 7 percent if on acquisition the leveraged return is 9 percent.

In almost all ventures, if there is a preferential return, it is not guaranteed. The return kicks in if the monies are available, and usually there is no adverse consequence if the project generates insufficient cash to pay the "pref." The concept of a look-back return, although not a guaranty, was developed to attempt to ensure the financial partner an acceptable return prior to the active partner's participation. In essence, a look-back return creates another level of payments in favor of the money partner. Usually, the cash flow goes to pay operating expenses, then debt service, then reserves. After these expenses are paid, then the capital invested receives a return and, finally, any remaining funds are split according to each party's percentage ownership. If there is a look-back return, another layer of payments is inserted. After capital obtains a return, then possibly the active partner might receive a payment; then again the capital partner gets a return on its invested monies before any further split.

The concept of a "clawback" is designed to balance profits over several transactions. If a financial partner is doing multiple deals with an entrepreneur, is it appropriate for the entrepreneur to have only an upside while all of the downside rests with the money partner? Let us assume that the parties do four projects together and each of these projects is very successful in generating oodles of profits. On the fifth transaction, the project runs into delays resulting in severe cost overruns and, ultimately, the partners lose money on the project's sale. Let us further assume that 100 percent of the equity on the fifth project was funded by the financial partner and, therefore, 100 percent of the cash loss is borne by the financial partner. Under a "clawback," the active partner would have to give up some of its prior profit to cover the losses incurred in the fifth development.

4. **Cumulative or Noncumulative Returns.** If the project pays a preferential return, is the return cumulative or noncumulative? In other words, if a payment is not made when agreed upon, must that payment be made up before other distributions to partners may be made? If yes, the preferential return is cumulative. If the missed payment need never be made up prior to other partnership distributions, the preferential return is noncumulative. Most partnership agreements make the distribution cumulative.
5. **Profit Split and the Promote.** After operating expenses, reserves, loan payments, and preferential return are paid, the remaining funds are usually distributed to the partners in accordance with their partnership ownership percentages. In our "typical" venture based on a 50/50 profit split, if $1,000,000 was raised, then for each $100,000 invested the capital partner would receive 5 percent of the ownership interest. The $100,000 cash invested is 10 percent of the total monies raised, but the money partner's interest is diluted to account for the promote of the entrepreneurial side, that is, the $100,000 investor receives an interest equal to 10 percent of 50 percent, not 10 percent of 100 percent.

   An issue that should be addressed is, when does the promote kick in? If it kicks in at the outset, then after the money partners receive their preferential return, the distributions would be split in accordance with each party's ownership percentage. To clarify, if there is a 50/50 profit split between the money partners and the entrepreneurial partners and if $1,000,000 was raised with a preferential return of 7 percent, then on a $10,000 monthly distribution, assuming all reserves, operating expenses, and the mortgage have been paid, the next $5,833.33 ($1,000,000 × .07/12) goes to the investors and the balance $4,166.67 ($10,000 – $5,833.33) is distributed 50 percent to the investors and 50 percent to the promoters. This seems like a fair way to structure an agreement giving a return to the investors and an incentive to the promoter.

However, there is no single right way to set the waterfall. The partnership agreement might indicate that all of the cash flow after reserves and expenses including the mortgage expense might go to the money partners. It might be agreed that after the money partners receive an agreed return, the excess distribution might be documented as a return of capital. If value is not created at the outset on acquisition, then possibly distributions should be made solely to the money side until a triggering event, such as return of the investor's capital through a refinance or sale. The money partner might argue that his cash should yield whatever is generated from the property and the promoter should be satisfied with a management fee and possibly leasing commissions until he gets his money back. If the money partner can block a sale or a refinance effectively, he could unfairly be blocking the active partner from getting his promote even though the active partner has done a tremendous job of leasing up the project and creating value. Even if the money partner does not block a sale or a refinance, the economic climate and the capital markets might be such that a beneficial sale is not timely and a refinance at an acceptable dollar amount is not reasonably achievable. An alternative might be to tie receipt of the promote to a future event, such as lease-up to 90 percent or the attainment of a certain gross or net income. By tying the promote to a definable standard, a degree of objectivity can be achieved and the promoter is not subject to the whims of an unreasonable capital partner.

One way to structure the partnership to create incentives for the entrepreneurs is to step up the preference to the money partners over time, so possibly it goes from 7 percent to 12 or 14 percent over a three- to five-year period. This gives the promoter the incentive to lease-up the property or otherwise create value so the increased preference can be paid or a refinance accomplished, as discussed in item 7. If the promoter is successful in creating value on a refinance, most, if not all, of the original equity might be returned to the money partners so that the higher preference rate never need be paid.

6. **Control.** Here the issue is, who makes the key decisions for the partnership? Typically, the agreement will provide that the active partner makes the day-to-day decisions of the partnership such as hiring vendors, entering into leases, dealing with problems and, in general, managing the property. Usually, extraordinary matters—those outside the normal course of business—require the consent of at least a majority of the

money partners. Extraordinary matters include a sale, a refinance, investing partnership monies in other than partnership business, admitting additional partners, changing the ownership structure, and so on.

In a typical syndication, when a promoter who raises capital syndicates a project, money is raised from several individuals. Due to the diverse nature of these capital sources, the entrepreneur in most cases, and for the most part, retains the decision-making authority for the group. In contrast, if the money partner is one individual or one entity, then usually the balance of power shifts and that party can often dictate partnership terms and often welds the majority control on key issues.

If there are numerous investors, ownership is usually taken in a partnership or a limited liability form. If one individual or one entity is the money partner, then again the ownership might be a partnership or a limited liability company, but often then the money partner exercises more control by taking ownership in its name and entering into a participating management agreement or by granting the active partner some other form of incentive compensation. By structuring the ownership in this manner, if the active partner's performance is not acceptable then the money partner's taking over the project is simplified—since the money partner already owns the property.

7. **Refinance.** If the documentation is drafted to give the money partners a preferential return, especially if the preferential return increases over time, then the incentive is placed on the entrepreneur to return the investors cash investment as quickly as possible. Once the investor's money is returned, the preferential return ceases, since there is no dollar amount outstanding upon which to base the preference. To illustrate, if the property was purchased for $5,000,000 with $1,000,000 down and a $4,000,000 interest-only first trust deed, then if, when the property is refinanced and a new $5,000,000 loan is placed against the security, then $4,000,000 of the funds go to pay off the existing loan and the balance of $1,000,000 goes back to the investors to repay their capital investment. Subsequently, if $10,000 is distributed to the partners, $5,000 goes to the money partners and $5,000 goes to the entrepreneurs.

The funds are distributed according to each partner's percentage ownership. The preferential return ends since the investors have received back all of their initial investment.

8. **Sale.** Typically, on a sale, the proceeds will first be disbursed to pay any third-party debt and all closing costs, such as title and escrow fees as well as any brokerage costs. Any net proceeds would then repay any outstanding loans within the partnership. Next, any unpaid cumulative preferential return must be paid, then the partners would receive back their invested capital and, finally, any remaining funds would be split according to each partner's ownership percentage. Although this is the typical distribution formula, the partners may agree to vary this standard treatment.
9. **Pare-Down.** The issue arises, what happens if the project does not live up to expectations, that is, what happens if the actual economics fall far short of projections? Usually, a syndicator does not guaranty operating results. However, at times, the money partner can extract a minimum return, and if the minimum return is not met, the result might be a dilution of the promoter's interest. Alternatively, if the financial results are very negative, the money partner may have the right to replace the promoter altogether.

   A pare-down can also occur in other contexts. For example, what if a project is syndicated, money is raised from several individuals, and for whatever reason the project runs into financial problems that require additional capital. Assume further that most of the owners are willing to advance their pro rata share of the needed additional money into the company; however, a few of the partners decline to fund their obligation. How do you handle the shortfall and the unfairness created by the unwillingness or inability of some partners to pony up their additional capital contribution? Usually, the noncontributing partner's share is funded by the other partners and these monies usually receive a return in excess of the preferred return. If the preferred return is paying 8 percent, funds might be paid at a 12 percent rate. In addition or alternatively, the noncontributing party's interest may be decreased or, in extreme cases, eliminated entirely in favor of a party or parties who have contributed more than their required share.

The key point is that the partnership agreement should address this potential problem. Underperformance and cash calls do occur and must be planned for. It is a lot easier to agree on a formula to resolve these possibilities up front rather than after they occur.

10. **Fees and Other Charges.** A distinction might be made between fees charged by the promoter for organizing the venture and other charges that are associated with functions related to the project. The problem is that the fees tend to be blended and the distinction blurry. If you are putting together a venture and as part of the venture you are acquiring a real estate project, is it appropriate to act as a broker and charge a brokerage fee? Typical fees and charges in real estate syndication include: an acquisition fee, a property management fee, a disposition fee, an organizational fee, a financing fee, a developer fee, a construction management fee, a contractor fee, and leasing fees. The bottom line is that the fees charged must be reasonable in light of the overall deal structure. The syndicator is usually receiving a promote. What is reasonable as additional compensation depends on the nature of the project, projected yield, and the market acceptance for the fees charged.

    In addition to the fees charged, the timing of receipt of any fee is of utmost importance. If a fee is to be charged, backing ending the charge is much more palatable than charging an upfront fee. At least if the syndication is set up so that the investors receive back their investment plus a return, then incurring the fee is much more reasonable from the money partner's perspective.

    Although uncommon, fees might also be charged by the money partner. The same issues arise. Is the size of the fee reasonable? When is the fee to be incurred? When is the fee earned and payable?

11. **Under Budget.** If certain line items come under budget, the excess is usually used to increase the contingency line item. If the project as a whole comes in under budget, most of the time, the venture benefits as a whole and no monetary incentive is given to the developer. Nonetheless, it is possible to structure a venture in which the promoter is encouraged to get the money partner out within a projected profitability

range by receiving a larger slice of the pie the sooner that objective is accomplished.

12. **Over Budget.** This area is the converse of the situation raised in item 11 and, obviously, is much more troublesome. The threshold question is, will the developer agree to be tied to a budget? Most partnerships do not penalize the active partner if he exceeds the projected project costs. This is viewed as part of the risks associated with the investment. However, in some projects, when the promoter has presented a budget to fix up the property or develop the land from ground up, and especially when there is only one major investment partner, the passive partner may insist that if the budget is exceeded that the active partner take responsibility for cost overruns over a contingency amount. To the extent that the active partner covers the cost is excess of budget, those funds, instead of being considered a capital contribution, may be characterized as a loan to the partnership. If you are over budget and the active partner covers the overage, okay. Nothing is perfect; the "responsible" party has solved the problem. What if, however, the developer breaches the agreement and fails to fund the shortfall? The language in the partnership agreement controls. A pare-down, as discussed in item 9, may result or, worse, the passive partner may have the right to—and actually choose to—replace the active partner.
13. **Liability.** To understand the liability concept, it is helpful to identify where liability in a project might be found.

    What if a guest is injured at the project? Comprehensive liability insurance affords a degree of protection. What if there is a fire? Does the owner have the responsibility (liability) to rebuild? The lease and/or the mortgage documents control but, again, extended insurance coverage is a safety net.

    In partnership structuring, the key liability issues usually revolve around the project financing. Is the debt a nonrecourse or a recourse loan? If the debt is recourse, the promoter usually will bear the personal liability risk. Arguably, it is one of his responsibilities to justify the promote. However, again there is no right answer to this issue. Possibly the contribution from the capital partner is to guarantee the construction loan. If the debt is nonrecourse, someone must still step up and sign the nonrecourse carve-outs, which place liability on the signer for fraud, waste, toxic issues, running off with security deposits, and the like. Usually, the promoter steps up for these types of liabilities, however, lender's carve-outs should be carefully scrutinized. At times the carve-outs result in at least partial de facto recourse debt. For example, if the loan documents require the project to be rebuilt even for hazards not covered by insurance, for example, earthquake, hurricane, or civil unrest, and the promoter personally agrees in the carve-outs to honor the covenant to rebuild regardless of the cause of the damage, he may be inadvertently taking on more liability than intended.

14. **Cap on Investment.** Often, the partnership documents will limit the money partner's dollar commitment to the initial capital investment. This area usually ties into our prior discussion on pare-downs. If additional money is needed, for example, to support the mortgage due to a vacancy factor as the result of tenants not renewing or defaulting, although no partner may be required to fund his share of the needed funds, often there is a partnership debt created to the extent a partner does contribute additional capital. Additionally, the partnership debt that is created at some point may convert to an increased share of the partnership in favor of the contributing partner and a reduction in the noncontributing partners' interest.
15. **Dead Costs.** Due to the nature of acquisitions, one does not buy every property one looks at. A seasoned purchaser knows his acquisition criteria and will quickly reject transactions that do not meet his standards. Unfortunately, however, at times a promoter will enter into escrow to purchase a property and during due diligence expend a considerable amount of time and money investigating it only to determine, for any number of reasons, that he does not want to move forward. It is a given that the promoter cannot recover his time and effort, but should there be a sharing of his due diligence costs? Often, the promoter has not even identified all of his eventual financial partners at this point. Usually, therefore, the active partner bears the up-front due diligence cost if the transaction does not go forward. It is part of his cost of doing business. On the other hand, if the entrepreneur is working

with one financial partner, then the parties typically arrange for a sharing of the due diligence loss. The percentage of loss incurred by the parties is a negotiated matter.

The critical factor in structuring a joint venture is to recognize what each party brings to the partnership and to build in appropriate compensation. I refer to this concept as "partnership structuring a la carte." In the foregoing discussion, the assumption is that the only element that the money partner is bringing to the party is cash. If they are providing additional needed elements, a revised structure may be warranted. A good example of this is when the money partner is an institutional lender and it provides a construction loan or end loans or a take-out commitment to third-party buyers. Yes, standard compensation should flow to the lender for funding the loan, however additional compensation might be merited if the type of loan funded was not readily available in the marketplace. The theory behind this analysis similarly applies if one of the partners is also bringing occupancy to the project, that is, if a partner is also going to be a key tenant or the sole tenant.

Debt Restructuring

If everything goes smoothly, the project leases up, performs as projected, and a healthy profit is realized. All of the participants are happy campers. Unfortunately, everything does not always go as planned. Unanticipated costs can undermine the projected yield, a slower than hoped-for lease-up can reduce return, tenant defaults can severely impact cash flow, and so on. Coupled with these types of problems, an overall economic slowdown can aggravate whatever the situation might be.

Let us assume that you purchase a shopping center on a syndicated basis when it is 95 percent leased and occupied. You secure a nonrecourse loan for 70 percent of the purchase price. Unfortunately, the anchor tenant, a major furniture store, files for bankruptcy and several of the other tenants disappear at midnight. The center is now 50 percent leased. The monthly debt service is $35,000. The income from the property is sufficient to cover operating expenses, but not also the principal and interest on the loan. What should you do?

You have the following options:

1. You can continue to pay the contractual debt, working the project to fill the vacancies, and get the project back on its feet. Consistent with this option, you could attempt to raise additional funds from existing partners through a capital call. (The rights and liabilities of the partners in relation to the capital call should be spelled out in the partnership agreement. If a partner fails to pony up his share and other partners cover his share, a loan to the partnership or a pare-down may result). This project is severely underwater; the negative cash flow is huge. Unless you have a strong cash flow from other sources, or significant liquid reserves, it will be difficult to keep the mortgage current. Of course you must also consider: Are you throwing good money after bad? Your equity is gone. Does it make economic sense to continue to support this asset? Unless you have a substantial potential replacement tenant or tenants, this project is in jeopardy of default.

   Another possibility is to continue to pay the mortgage and resyndicate the project by buying out the existing partners. Given the severe economic stress associated with the project, you might be able to buy out partners at a discount. When resyndicating the project, you might be able to build in enough reserves to carry the project through the down economic cycle.
2. Another alternative would be for you to contact the loan-servicing department of the lender in order to seek a loan modification. If the loan is being serviced by the financial institution that originated it, then you might be able to enter into a dialogue concerning the restructuring of the loan. However, if the loan is being serviced by a third party, which includes all conduit loans, then unfortunately, in the real world, a meaningful dialogue will probably not occur until the loan is in default and you stop making the monthly mortgage payment. If you do not pay the contractual $35,000, the loan-servicing function is usually forwarded to the "Special Servicer." Discussions with the Special Servicer typically revolve around three options: (1) a loan modification, (2) a discounted payoff (DPO), or (3) a note purchase.

Usually, the quid pro quo used to induce the Servicer to enter into a loan modification is an agreement by the borrower to inject additional cash into the project. In return, the lender might agree to enact a period in which the loan is interest-only, or to reduce or eliminate certain reserves, or to create an A/B structure. The key to a loan modification is that usually the debt remains intact so that there is no forgiveness of debt, no negative tax consequences. In an A/B structure, the parties agree to reset the debt priority. Borrower and lender agree that part of the loan will be of first priority in terms of cash flow and priority on sale or refinance. Usually, then, the borrower's new cash contribution comes into play, again in terms of cash flow and priority on sale or refinance. Finally, the lender's B piece receives cash flow and repayment treatment.

Usually, in a note purchase, an entity other than the borrower purchases the note. This separate entity steps into the shoes of the lender, with all of the rights and liabilities of the lender. Therefore, if there are any reserves held by the lender, this entity should be entitled to those reserves. Again, at this point in time, there has not been a forgiveness of debt. The loan merely has a new owner. This is true even if the lender sells the loan at a steep discount, because between the new lender and the borrower the loan balance remains unaffected. It is important to maintain a separation between the new entity and the borrower or the Servicer could argue that there has been a merger and that the borrower has, in fact, received a benefit in the form of forgiveness of debt. Loan purchases are more difficult to accomplish than a discounted pay-off, as discussed below, since most lenders take the position that if a loan purchase is to occur at a discount, the sale must first be widely exposed to the market. The time factor and the uncertainty surrounding this process usually push the borrower to alternative solutions.

With a *discounted pay-off* (DPO), the borrower repays the loan at a reduced price. Unfortunately, the borrower is faced with negative tax consequences due to the forgiveness of debt. However, under the American Recovery and Reinvestment Act of 2009 (the Stimulus Bill), the income taxes otherwise due

> may be deferred for four years and then spread ratably over the five taxable years after the deferral period ends. Your tax attorney and/or your CPA should be consulted to determine the applicability of the Stimulus Bill to any specific transaction. Also, IRC Section 1082 might be applicable. This section allows a basis adjustment to another property owned by the taxpayer based on the discharge of indebtedness. In other words, instead of paying immediate tax on the forgiveness of debt, the borrower can reduce his basis on another property so the tax is deferred until a future event, such as a sale of the other asset. Section 1082 must be reviewed carefully because it only applies if the borrower is insolvent. If the borrower is a single member limited liability company, the limited liability company is a disregarded entity, and therefore only if the taxpayer is insolvent would the section apply.

To make the subject matter of this chapter on partnership structuring and debt restructuring more concrete, let us apply some of the foregoing discussion points to a hypothetical example. In the hypothetical example, when applicable, the 15 key structuring issues previously outlined as well as some of the points mentioned in the debt restructuring section are highlighted in parenthesis.

Let us assume that Metro Plaza, Ltd., a California limited partnership, is under contract to purchase, for $9,363,672, the Metro Plaza outlined in Chapter 9 in the "Rehabilitation Project" section. Our analysis in that section determined that the NOI at stabilized occupancy would be approximately $1,315,607, Exhibit 9.4, and that at an 11.5 percent cap rate, the project would be then worth approximately $11.4 million. Appendix H in the companion website sets forth additional assumptions, including that the lease-up would take two years to achieve at a cost of $2,076,389. The "costs" included about $900,000 of expenses that did not require a cash outlay, such as downtime, free rent, and unreimbursed CAM charges. Footnote number 6 in Appendix H assumes that 30 percent of the acquisition price, $2,809,102, would be paid up-front as a down payment and that an acquisition and development loan (A&D Loan) for approximately $7.7 million would be secured. Milton Metro is the syndicator and active partner.

Metro commences his due diligence by examining the rent roll. He is immediately concerned that there are several leases over market. Amazing Comics' lease is particularly troublesome since its lease rate is arguably twice the market rate and the tenancy is month to month, which allows Amazing to move out on 30 days notice. Even if Amazing does not terminate its lease, certainly it has an opening to renegotiate the lease terms. Given Metro's lease concerns, he decides to interview all of the tenants before spending significant monies on reports and attorney's fees. Metro realizes that as the entrepreneur he will bear the loss if the project aborts prior to closing (Dead Costs).

Under a "traditional" joint venture structure, the money partner(s) would contribute 80 percent to 100 percent of the down payment. Let us assume they fund 90 percent of the $2,809,102 down payment or $2,528,192. Hence, the syndicator and active partner, Milton Metro, would be required to put into the partnership 10 percent of the $2,809,102 down payment or $280,910 (Capital Contributions). Please refer to Appendix I for a breakdown of the partnership capital contributions and ownership. The capital contributions, including Milton's investment, are to be paid interest monthly at an agreed rate of 9 percent (Preferential Return). The return is not guaranteed, but if it is not paid, it must be made up before other distributions may be made (Cumulative). The parties decide to form a limited partnership, rather than a limited liability company, because the property is located in state where the law provides for a tax on a limited liability company's gross receipts but not if ownership is held in a limited partnership. The partners agree that the active partner, Milton Metro, will make the day-to-day decisions concerning leasing and running the property (Management). The partnership agreement indicates that Metro will be paid a management fee on a monthly basis equal to 5 percent of the gross revenue collected. The gross revenue is specifically defined to include any operating expenses paid by the tenants (Management Fee). The partnership agreement also indicates that the manager may not charge for leasing activities, arranging financing, legal work, accounting, or construction management (Fees and Other Charges), but it does permit the manager to charge a fee of 1 percent as an acquisition cost and 1 percent as a disposition expense (Fees). Major decisions such as selling, refinancing, adding additional partners, and so on will require an affirmative vote of at least 75 percent of the ownership to approve (Control). The parties also agree that the property ownership shall be 90 percent to the money partner and 10 percent to the entrepreneur (Profit Split) until the money partner gets his capital back—at which time the ownership shifts to 60 percent to the money partner and 40 percent to the entrepreneur (Promote).

Let us further assume that one of the limited partners, Fred Muscle, is the owner of All Night and Day Gym and Fitness Center, a California corporation, the key tenant in the center occupying about 40 percent of the Center's gross square footage. The Gym's lease runs until February of 2022. However, the lease contains a termination right, without cost, in February of 2015. The lease is guaranteed by Muscle, but the guaranty has a maximum liability of $100,000. Let us also assume that the Gym is having financial problems and is two months delinquent in rent, that is, $118,266 in arrears.

Muscle approaches Milton Metro and indicates that he cannot afford to pay $59,133 per month in the current depressed economic environment. He adds that one of his problems is that the air-conditioning system keeps breaking down. He has lost a significant amount of members, which is affecting his bottom line. Muscle points out that a health club in close proximity just vacated its space. It is comparable in size with a brand new build-out gym and all new equipment. The landlord is offering to rent this facility to Muscle with all of the equipment in place at $8 per square feet. Muscle argues that, based on this health club and other comparables, he is paying over twice the current fair rental value. Muscle tells Metro that if he cannot get some relief on the rent, he will be forced to place the gym corporation into bankruptcy. Muscle proposes to Metro the following: (1) the Base Rent be reset at $10 per square feet, (2) the delinquent rent be forgiven, (3) the Base Rent for the next three months be waived, and (4) Muscle agrees to delete the cancellation provision.

Metro has several concerns. First, if he agrees to this lease modification, the project's gross income will be reduced by approximately $29,000 per month, or $348,000 per year. This is a huge income loss. From a value perspective, Metro figures at an 8.5 percent cap rate, the project would be losing over $4 million ($348,000/.085) in value. Additionally, if Metro waives three months of Base Rent, he would be giving up an additional $177,400 ($59,133.17 × 3). Metro also questions whether he must obtain the lender's consent for this type of a waiver. Finally, Metro realizes that Muscle is a major partner on the ownership side. Muscle has invested $855,195 into the venture. Metro mulls over in his mind how this factor should effect the overall equation.

Metro examines the partnership agreement and learns that it really does not cover a situation wherein a partner is also a defaulting tenant. He attempts to balance the need to keep the project alive and have the tenant meet his responsibilities with a partner's rights and liabilities. He suggests the following:

- The Base Rent to be reduced to $17 per square foot from the contractual rate of $19.75. Metro reasons that if he accepted Muscle's proposal of $10 per square foot, there would not be sufficient monies to pay the monthly mortgage, so that does not work. He notes that the partnership agreement does not require limited partners to fund any additional capital into the venture, so if the NOI is insufficient to cover the monthly mortgage, the shortfall would be 100 percent Metro's obligation (Cap on Investment). He reasons that if he lowers the Base Rent to $17 per square foot per year, he is giving Muscle a monthly break of $8,233 dollars, an annual rent reduction of almost $100,000. The NOI will then be $701,195, an amount sufficient to service the existing loan debt of $614,747 even if he loses the month-to-month tenant, Amazing Comics.
- The project has built up reserves of $200,000. He is unwilling to use all of these reserves to give Muscle a free-rent period. He decides that the project can survive if one month's Base Rent is deferred to give Muscle a chance to get back on his feet.
- Metro is concerned that he is making a huge concession over the lease term. He worries what happens if Muscle defaults on the modified lease terms. He reasons it would then be unfair to be forced to attempt to collect on the reduced lease terms. Metro therefore agrees to the rent reduction and a one-month Base Rent deferral only if Muscle puts up additional collateral and agrees that the new Base Rent is conditional on his faithful timely payment of the new Base Rent. If he defaults on the payment of the new Base Rent, all of the "forgiven" rent and any deferred rent would be due and payable. Metro attempts to build in a "hammer" to ensure Muscle's performance under the revised lease terms.

- Metro requires that Muscle relinquish his interest in the partnership (pare-down). Arguably, he is costing the partnership over $4 million in value. Asking Muscle to relinquish his cash contribution of $855,195 does not seem out of line. If Metro is successful and is able to lease-up the balance of the project in a reasonable time frame at a reasonable rental rate, the profit potential is significant, but there are a lot of "ifs" in that equation.

Muscle accepts Metro's counterproposal with the exception that he retain his interest in the partnership with all of its rights and liabilities including any right to receive his share of distributions. However, he offers that, in the event of a refinance or sale, then $1,000,000 shall be deducted from his share of any distributions. Muscle reasons that his tenancy is still contributing a huge amount to the potential success of the venture. Also, he suggests that the loss in value is theoretical. Muscle reasons that any potential buyer and/or lender very likely will evaluate the project based upon market rents rather than contractual rents, so they will discount the value of Night and Day Fitness Center's lease in any event. Also, the $1,000,000 hit to his return on a sale or refinance covers over 10 years of lost income ($1,000,000/$8,233 = 121.5 months). Given that Muscle's lease permits him to unilaterally terminate, without penalty, in six years, he feels he is being generous in offering a $1,000,000 reduction to his distributable share.

Under Muscle's counterproposal, on a refinance, the loan proceeds would first go to pay closing expenses, that is, mortgage brokerage fees, attorney fees and costs, title, escrow, interest on the existing loan and any short interest on the new loan, any defeasance or prepayment penalty, and so forth. Next, the existing loan balance would be paid off. Any net loan proceeds would pay any unpaid preferential returns. The funds would then go to the partners to repay their capital accounts. In our hypothetical, Muscle would then not receive his $855,195 capital contribution back, but rather this amount would be credited against his $1,000,000 obligation. Any remaining funds would be distributed to the partners in accordance with their percentage ownership except, again, Muscle must account for his remaining $144,805 obligation ($1,000,000 less $855,195) prior to his receiving any additional funds (Refinance). A sale transaction would be similar to a refinance. After costs of the sale are paid, the outstanding debt must be retired; then any unpaid preferential return is caught up. Next, the partners receive back their capital contribution. In this case, Muscle's share would be offset against his $1,000,000 obligation. Any remaining funds would be distributed in accordance with partnership ownership. Muscle's share of any additional distributions, again, would first be subject to being reduced by the remaining $144,805 obligation (Sale).

Metro accepts Muscle's counterproposal, except he argues that it is unfair for Muscle to reduce his lease obligation by $8,233 per month and also continue to get any monthly distribution from the property. Metro suggests that any distribution that Muscle is entitled to should not be distributed to Muscle, but rather applied against the $1,000,000 obligation until satisfied. Muscle agrees to this modification.

One of the hotly discussed issues under this structure would probably be the liability under the A&D Loan. Most likely, due to the project's initial occupancy of 51.5 percent as set forth in Appendix A.7 on the companion website, and given the lender's agreement to fund the Center's fix-up, tenant improvement, and leasing expenses, the loan will be recourse. An issue then arises as to who will be the obligor under the encumbrance (Liability)? The lender will probably require joint and several liability, but as between the partners, a logical allocation would follow the ownership percentage so that the initial liability would be 90/10—and when and if the ownership percentages shifts to 60/40, so would the recourse liability. Given Muscle's right to income and profits under the partnership agreement might disappear or be altered under a lease modification, his liability for the recourse debt to the lender and his allocated liability in relation to his partners very likely would be a discussion item.

Let's now assume Metro fixes up the property, since his marketing program is based on a center that has a bright and shiny curb appeal rather than its existing tired look. Metro enters into a contract to paint the entire center and finds that the roof and the heating and air conditioning system are in much better condition than he had anticipated. The fix-up costs come in at $105,000 rather than the budgeted $205,000. Does Metro get a bonus or some other type of compensation for bringing in the costs under budget (Under Budget)? The partnership agreement controls. Usually, as in this case, the cost savings becomes part of the deal, as they would if Metro were able to arrange financing below the anticipated financing cost. Metro is not given any additional compensation.

What if the fix-up costs came in over the budgeted $205,000? Would Metro be penalized (Over Budget)? Again, the partnership agreement controls, but typically the active partner would not be penalized for this misstep. Again, it would merely be part of the deal. At times, events and performance lead to better results than the pro forma schedules suggest, and at other times the end result is worse than expected.

Now let us fast-forward two years. Unfortunately, the lease-up has not gone as planned. Not only did Metro fail to achieve stabilized lease-up in two years, but rather he lost tenants. A portion of $200,000 of the development portion of the loan was used to fix up the center. The outstanding loan balance is therefore $6,754,570 (footnote 6 of Appendix H sets forth an analysis of how the outstanding loan balance is calculated). Nonetheless, being the eternal optimist, Metro feels that success is right around the corner since he is in negotiations with several potential tenants. If he is able to finalize leases with these tenants, the center would be fully leased and occupied. After negotiations with Fred Muscle, based on current occupancy and adjustments to the income due to contractual lease terms and the passage of two years, the NOI is $750,000, which is sufficient to service the debt—especially since interest rates have decreased from 7.5 to 6 percent. The annual interest charge is therefore $405,274, which leaves an annual net cash flow of $344,726. The A&D Loan, however, has matured, and the lender is requiring a loan pay-down of $500,000 to extend the loan term for two years.

The active partner does not have cash reserves of $500,000 and, given the project's dismal performance to date, none of the existing partners wants to put in additional funds. In fact, both the Grosses and Metro Plaza 1, LLC, would like to be bought out of the partnership and would sell their partnership interest at a discount. Metro approaches Big Bucks, a wealthy individual Metro has used as a money source in the past. Big Bucks agrees to put up the $500,000 in return for 50 percent of the project ownership, which includes cash flow, appreciation, and all other ownership benefits, but no personal liability on the loan (Profit Split).

Metro starts to write a letter to all of the partners indicating that if they do not fund their pro rata share of the capital requirement, that their interest will be pared down accordingly (pare-down).

However, before Metro sends the letter, he spends time analyzing the transaction and concludes that the partnership is giving up too much to Big Bucks under this structure. He reasons that the partnership has already invested $2.8 million into the property, he is already personally liable on the outstanding debt of $6,754,570, and he is being given no credit for his leasing efforts, which he feels are about to pay off thanks to his recent endeavors. He further reasons that the project is worth at least $8,823,529, based on an NOI of $750,000 at an 8.5 percent cap rate. This would result in his current equity being worth at least $2,068,959 ($8,823,529 − $6,754,570). On a simple ratio basis, he should have to give up no more than 25 percent of the project's ownership, not half. The proposed capital infusion divided by the existing equity would be 24 percent ($500,000/$2,068,959), not 50 percent.

With the majority of the partners' consent, the active partner decides to take on more risk, yet he hopes to give up less of the ownership pie. He approaches a different venture partner and seeks a two-year $500,000 second mortgage. He agrees to pay 12 percent on the second, 8 percent current and 4 percent deferred, plus a 20 percent profit participation on cash flow and the net proceeds from a sale or refinance.

A complicating factor under this structure is that the first trust deed documents must be reviewed in order to determine if a junior encumbrance is permissible without the consent of the holder of the first mortgage. Most likely, the first trust deed holder's consent is needed. Therefore, the existing first trust deed lender would either have to approve the second trust deed, or the second would have to take an assignment of the partnership interest as collateral—assuming that doing so is not prohibited under the loan documents for the first trust deed.

Metro reasons that a participating mortgage is a better partnership structure for the group if he is able to execute and lease-up the vacant space in a timely manner. He understands the trade-off, which he perceives as less patient money since the second trust deed will come due in two years. However, if Metro leases up the project quickly, the carry on the second mortgage is only $45,000 per year and then, under the participating mortgage structure, he need give up only a 20 percent interest in the project.

What happens if, as in this factual setting, a passive partner, such as the Grosses or Metro Plaza 1, LLC, wants its money back?

Real-estate syndications are illiquid investments. Unlike stocks and bonds, there is no established market in which to sell your interest. It should be noted, however, that although alternative investments in such instruments as stocks and bonds are often actively traded and are therefore "liquid," often there is a psychological inhibition to selling these investments at a loss. The limited partnership interests or an ownership interest in an LLC does not trade. (This point was mentioned as a suggested disclosure, item 12). The result, therefore, is that if a money partner must exit at what is perceived to be an importune time, usually the promoter/active partner, if willing to buy out the passive partner's investment, will purchase it at a steep discount.

Let us assume that even with the lease modification lowering Night and Day Fitness Center's rent and despite Fred Muscle's valiant efforts, he still cannot make ends meet and Night and Day files bankruptcy and rejects the lease at the Metro Plaza. The NOI is now approximately $139,207 per year ($11,583 per month). The annual debt service is $405,274 ($33,773 per month). At an 8.25 percent cap rate, the project is currently worth approximately $3 million, that is, the current NOI of $139,207 divided by a market cap rate of .0825 plus a reasonable value for the vacant space. The loan balance is $6,754,570. Metro's partners are unwilling to come up with additional funds to support the first mortgage so that loan goes into default and the holder of the first mortgage files a notice of default, which starts the running of the foreclosure process. The holder of the second mortgage understands that a default under the first mortgage is also a default under his loan documents so he considers advancing funds to cure the first and then starting his own foreclosure procedure.

Metro has some good luck. He finds a thrift store tenant with excellent credit that is willing to take over Night and Day Fitness Center's space at a higher rent, $24 per square feet per year. However, to put the thrift store in place will cost $1,000,000, between brokerage fees and tenant improvement costs. Metro reasons that once the thrift store is in occupancy paying rent, the project's NOI will be approximately $1,000,000 (current NOI of $139,000 plus thrift store rent of $862,296). At an 8.25 percent cap rate, the FMV is approximately $12 million. Metro debates with himself. Does he have a duty to tell the lender about the potential thrift store tenant? There is no signed lease. He is, at this stage, only in negotiations with this tenant. Metro decides that ethically he must disclose the potential tenant to the lender. Metro approaches the Special Servicer for the first trust deed, discloses that he is in negotiations with a replacement tenant that will cost $1,000,000 to put in place, and proposes a loan modification (A/B structure). The proposal is as follows.

Borrower's Proposed Terms

- Bifurcate the loan into A1 and A2 pieces.
- The A1 piece would be $4,000,000 and earn interest at the Note rate of 6 percent.
- The A2 piece would be $2,754,570 plus any past due interest at the Note rate of 6 percent.
- Borrower would put up $1,000,000 (New Equity) into an account to be held by the lender for any tenant improvements, leasing commissions, capital expenses, or any repairs needed to the building including the thrift store build-out. The New Equity to be paid a return of 15 percent.
- Lender to waive all default interest and penalties.
- A reserve for taxes and insurance to remain in place, but lender to waive all other reserves for tenant improvements, capital costs, and leasing expenses.
- Lender to charge interest on an interest-only basis.

Cash Flow

Monies from the project to go first to pay the approved operating expenses, then reserves for taxes and insurance, then—commencing when the thrift store is in place paying rent—to pay the A1 interest on an interest-only basis, that is, $20,000 per month ($4,000,000 × 6%/12), then to pay a 15 percent return on the New Equity. If there is any additional cash flow, the funds would go 50/50 to the borrower and to the lender.

Sale

The net sale proceeds would go to closing costs, then to pay off the A1 piece plus any accrued and unpaid interest, then the New Equity plus any accrued and unpaid interest at 15 percent, then 50/50 to the borrower and the lender.

Refinance

The net refinance proceeds would go first to pay the cost of the refinance, then the A1 piece plus any accrued and unpaid interest, next to pay the New Equity plus any accrued and unpaid interest at 15 percent, then 50/50 to the borrower and the lender.

In making this proposal, Metro reasons that it puts both borrower and lender on the same page. It attempts to align their interests and work to increase the value of the property to their mutual benefit. Metro recognizes that to induce the lender to do a loan modification, he has to give the lender benefits. Hence, he reasons the A1 piece is greater than the current fair market value of the property: $4,000,000 versus $3,000,000. In addition, he asserts that he is putting new capital into the venture and that, based on this structure, the lender not only might get all of its money back, but also the venture actually might return to the lender more than its loan balance.

The lender, surprisingly, responds that it is a lender. It does not want to be Metro's partner. It wants only to recoup its loan plus all interest due. The lender indicates that it would like to make as few changes to the existing loan agreement as possible, and counters with the following deal structure.

Lender's Counterproposal

- Bifurcate the loan into A1 and A2 pieces.
- The A1 piece would be $5,000,000 and earn interest at the Note rate of 6 percent.
- The A2 piece would be $1,754,570 plus any past due interest at the Note rate of 6 percent.
- Borrower to put up $1,000,000 (New Equity) into an account to be held by the lender for the thrift store build-out.
- The existing reserves to be keep in place, for example, for taxes and insurance, leasing commissions, and capital expenses.
- Lender to waive all default interest and penalties.
- The loan shall not be assumable, but the existing prepayment penalty shall remain in full force and effect.
- Lender to charge interest on an interest-only basis.
- Borrower to put up an additional $100,000 as a debt service reserve to be used to keep the A1 piece current during the

build-out of the thrift store (estimated at four months) as well as to support the loan service, as needed.
- Borrower to agree to a receiver if there is a future default.
- Borrower to pay for all attorney fees documenting the loan modification and a 1 percent loan modification fee.
- Lender to impose a “hard lock box.” All income goes to the lender and it would take out reserves, forward to the borrower monies to pay the approved operating expenses, retain funds—if available to pay the A1 and A2 pieces—and place any remaining funds into the debt service reserve account.

Cash Flow

Monies from the project to go first to pay the reserves for taxes and insurance, leasing commissions, and capital expenses, then the approved operating expenses, then, commencing at loan modification, to pay the A1 interest on an interest-only basis, that is, \$20,000 per month (\$4,000,000 × 6%/12), then to the A2 piece at the note rate, with any remaining cash flowing into the debt service reserve account.

Sale

The net sale proceeds would go to closing costs, then to pay off the A1 piece plus any accrued and unpaid interest, then the New Equity, then 50 percent to the A2 piece up to its loan balance plus any accrued and unpaid interest and 50 percent to the borrower.

Refinance

The net refinance proceeds would go first to pay the cost of the refinance, then the A1 piece plus any accrued and unpaid interest, next to pay the A2 piece plus any accrued and unpaid interest up to the fair market value of the property, and the balance, if any, to the borrower. Lender shall appraise the property. Borrower shall pay lender the greater of the net refinance proceeds or the fair market value of the property.

After reviewing the lender’s counterproposal, Metro had a few questions. What happens if the project needs money in excess of the reserves? The lender responded that this is the responsibility of the owner. If additional capital is required it will not be counted as New Equity. Will the lender cap the legal fee cost? The lender responded "no." Is the loan modification fee of 1 percent on the A1 piece or the A1 and A2 piece? The lender indicated that it was on the total outstanding loan balance.

Metro thought this proposal over and was very concerned about several issues. First, he felt the prepayment penalty was too restrictive. His objective was to put the thrift store in place and sell the building, but given that the lender would be taking away the assumption feature, keeping the prepayment penalty in place is very onerous. It gives him only a short window, three months at the end of the loan term, to sell the property without a penalty. Second, if he is going to put up an additional $1,000,000, it is unfair for the investors to receive no return on their money. They would be better off investing in another transaction. Third, Metro knows that more than $1,000,000 will be needed to lease-up and create value for this property. Any money that the borrower injects greater than the New Equity does not gain priority over the A2 piece. He could give potential tenants free rent instead of a tenant improvement allowance, but often tenant prospects do not have the funds to build-out their suites. It would be very detrimental to the project to lose a potential tenant because he did not want to spend additional money since it would not be counted as New Equity. Metro's fourth concern is that he feels that the loan modification fee should be only on the A1 piece, since that is the real new loan, while the A2 piece is a "hope note."

Metro discusses his concerns with the lender and the lender agrees to delete the prepayment penalty. The lender also agrees that the owner can earn 10 percent on its New Equity. The cash flow would therefore go to reserves, the A1 piece, a 10 percent return on the New Equity, and the A2 piece, with the balance into the debt service reserve account. Regarding Metro's desire to count additional capital contributions as New Equity, the parties agree that Metro will initially put in $1,500,000, which will be considered New Equity. Given the amount of the New Equity, the lender waives the requirement for any reserve for tenant improvements or leasing commissions. As to the loan modification fee, the lender indicates that the charge will be on the full outstanding loan balance. The lender further adds that, as a requirement of the loan modification, the holder of the second trust deed must consent to this arrangement and specifically agree that its loan priority is junior to the A1 and A2 pieces as modified.

After again reflecting on what the lender is willing to do on a loan modification, Metro decides that the structure is too complicated and has too many negative aspects. He approaches the lender and asks if the lender is willing to sell him the loan and, if so, at what price. The lender responds that it would consider a note sale. Metro offers to buy the loan for $4,000,000, which is $1,000,000 in excess of the lender's appraised value for the property. The lender counters at $5,000,000 and Metro agrees. The issue then arises of whether or not the reserves are included in the sale. Metro argues that of course they are included that is part of the loan. The lender says it thought a DPO was what they were going to do and usually when a borrower pays off the loan, the lender simply gets a net price and retains all of the reserves. Metro explains that his offer clearly indicated a loan purchase not a loan payoff. The lender reviews the correspondence and agrees to a loan sale. The parties agree to split the reserves of $200,000 so that the purchase price is reduced to $4,900,000.

Metro consults with his CPA and learns that a DPO and a loan purchase result in different tax treatments. In the event of a DPO, under current legislation, you may lower your basis in the property rather than recognizing a current gain. With a loan sale, the loan remains in place and therefore at that point in time, no taxable event has occurred.

Partnership structuring is one of the more difficult areas of real estate to master since it is typically learned by experience rather than through a textbook. There are myriad ways to structure transactions, each variation with advantages or pitfalls. The 15 key structural issues outlined in this chapter should be considered when evaluating any proposed deal structure—not only for how they will be addressed but also to make sure that these key points are clearly covered.

In the current economic environment, debt restructuring is becoming a more and more vital part of the real-estate game. It is important to have a handle on what concessions lenders will seek, as well what terms and conditions a lender is typically willing to modify in terms of the loan restructure, in order to induce them to cut deals.

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CHAPTER 12

Keeping the Money

Okay, we mapped out a game plan to make the dough (value-added real estate), we harvested it (refinance), and then we repeated the cycle. Our problem then becomes keeping the money we made. The reality is that your silent partners, the state and federal governments, have their hands out. Planning is the key to minimizing your tax bite. We have all heard the expression that the only two things that are certain are death and taxes. This statement is a truism; however, through forethought and proper representation one can at least keep Uncle Sam's share to a minimum.

Planning

There are five types of taxes that we, as real estate investors, must attempt to minimize: the real property tax, the estate or inheritance tax, the gift tax, the income tax, and the capital gains tax. It is important to be aware, in general, of the rules relating to when these taxes occur, of the percentage of tax applicable when they do occur, and of methods to avoid or at least minimize these various taxes.

It is not my intention in this chapter to make you an estate planning expert, but rather to sensitize you to the importance of this area and to, in general terms, set forth the steps that could be taken to minimize your ultimate tax bite. Of course, the steps you take should be tailored to fit your particular situation and, of course, you should consult with your estate-planning attorney and/or your CPA. However, in this chapter, I outline an overview with a general step-by-step checklist covering procedures you might consider in order to lower your tax bite and preserve your assets.

Secure Proper Representation

Your first and most important step should be to secure proper representation. Hire an attorney who specializes in estate planning. This is a specialized field. The money you spend in this area will come back many times over. Do not try to save on second-rate representation. This is not the place to scrimp. Obtain referrals from your CPA, insurance agent, and/or your general counsel. Interview the estate-planning attorney, ask for references, and determine if he has a specialization certification in estate planning. Ask if he has written any articles or books on the subject, how long he has been practicing law in general, and how long specifically he has been focused on estate planning. In addition, find out about the overall quality of his law firm. What is its reputation? Finding the right representation in the estate-planning field also means hiring an insurance agent and a certified public accountant, if you do not currently have such representation.

Wills for Both Husband and Wife

The next step is to have counsel draft a will. If you are married, both you and your spouse should have a will. If you die without a will, you die intestate. If you die intestate, three main problems are created: (1) your assets will be distributed according to the state's succession rules, which might not correspond to your desired intentions; (2) you will have lost a significant and powerful tool in estate planning; and (3) your heirs will then be forced to go through probate, a long and costly process.

Inter Vivos Trust

To work with the will, counsel usually drafts an *inter vivos* trust, also known as a living trust. The grantor, during his lifetime, has full power and control over the terms of the trust and, accordingly, has full power and control over its assets, including the income that is generated from the trust. The living trust is a powerful estate planning tool since it allows you to take full advantage of the marital deduction, utilize generation-skipping concepts to shift the tax burden to the future, and so on. Usually, the living trust is initially the vehicle wherein real property assets are placed. As discussed further on, as the taxpayer accumulates more and more wealth, consideration must be taken to place future acquisitions into a family limited liability company.

Insurance

Insurance is a crucial component for any estate plan. Death is a certain event, but its timing is uncertain. It is important to financially cushion against this event given its inevitability and the fact that it can occur at any time—even in financially inconvenient times.

Life insurance should be secured on the primary breadwinner. It is obvious that if the primary breadwinner dies, the family's income will usually be severely impaired. Often overlooked is the financial burden that results if the homemaker passes away. It can certainly put an economic strain on a family with young children if the homemaker's functions must be assumed by a third party. The insurance should be designed to provide supplemental income and liquidity to the surviving family members. Also, especially as your estate increases in size, insurance should be purchased with the intent to use all or part of the death benefit to settle estate taxes. Having the insurance avoids heirs being forced to liquidate real property assets under unfavorable conditions, or at all. Usually, this type of insurance is contained in a *second-to-die policy*. A second-to-die policy, as its name suggests, pays its death benefit when both of the named insured parties, usually husband and wife, pass away.

Additionally, also often overlooked is the concept of obtaining insurance on young children. Financially, securing insurance at an early stage in an individual life can be an intelligent estate-planning move for several reasons: (1) the cost of the coverage is usually relatively inexpensive (it is when the children are young that the best financial policy can be obtained, since the insurance company's risk is low given the low mortality risk and therefore the premium is low); (2) by starting the policy when the children are young, you can build up the cash surrender value; (3) by starting the policy when the children are young, depending on the policy, most likely at some time the policy will sunset, that is, if desired, no further premium need be paid and the coverage remains in full force and effect; (4) the insurance can be used by your children as a financial vehicle to borrow money for a real-estate investment or any other needed expenditure; and last and most important, (5) obtaining insurance for your children begins the process of estate planning for them and their families.

Consider building into the policies a feature that allows you to increase the death benefit on a periodic basis without the need to prove insurability. Similarly, since many of the insurance companies pay dividends to their policyholders, consider taking advantage of a contractual provision that allows you to reinvest the dividends to buy additional insurance coverage.

Irrevocable Insurance Trusts

It is wise to form an insurance trust to receive the death proceeds of any insurance policies. The insurance trust should be irrevocable. Once it is set up, the trustor may not cancel it and may not change the beneficiaries, although he may collapse the policy through failure to fund its premiums. Even though you, the trustor, cannot change the beneficiaries, you can build in flexibility by, for example, wording the trust so that children born after the creation of the trust are included as equal beneficiaries. The idea is that the trust is outside of the control of the trustor and therefore the proceeds from any insurance policy held in trust should not be included in the trustor's estate. The main objective of insurance trusts is to remove the death benefit from the taxpayer's estate. Since the death benefit is not counted as an asset of the decedent's estate, inheritance tax is not applicable to the insurance proceeds. When an insurance trust is formed, it is a legal entity with its own tax identification number.

Usually, at least three insurance trusts are formed: one to hold the death benefit on the primary breadwinner's life, one for the spouse's policy, and the other to hold the second-to-die policy. The proceeds from the first insurance trust, that is, on the primary breadwinner's life usually are designed to supplement the income of the surviving spouse and children. The spouse's policy, as mentioned above, usually is intended to assist the family during the difficult time of grieving and to take care of tasks usually done by the deceased spouse. The second-to-die policy is typically targeted to cover any estate tax liability.

Sole and Separate Bank Account

An additional cautionary step you should take is to create a sole and separate bank account. As noted previously, one of the main reasons that insurance trusts are formed is to keep the death benefit from being attributed back to the estate of the deceased. An argument that the IRS can postulate is that if funds from a community asset, such as a joint checking account, are used to pay the premiums on life insurance, then at least part of the death benefit should go back into the estate for tax purposes since it was monies from "the estate" that created the asset. In order to avoid this argument, an additional layer is created. A sole and separate bank account is formed. It is from this account that monies are funded into the insurance trust's banking account from which the insurance premiums are paid.

Gift Tax Problems and the "Crummey" Solution

There are other issues surrounding insurance trusts that should be addressed. One such issue centers on the potential liability for a gift tax. As previously stated, insurance trusts are set up to avoid attributing any death benefit back to the taxpayer's estate, but the trusts usually are not an operating entity. They do not generate any income and have no assets apart from a life insurance policy. The problem then becomes, how are the life insurance premiums paid? Typically, the trustor funds monies into his sole and separate account, which then deposits monies into the trust sufficient to pay the insurance premiums. The trustee then pays the insurance premiums from the trust when they are due. The problem is that when the trustor makes a payment into the insurance trust, he is making a gift to the beneficiaries—not a present gift, but a future gift. The future gift occurs because the funds are to be used to pay insurance premiums that eventually will result in a benefit to the various beneficiaries, that is, each beneficiary shares in the death benefit, which does not occur until the death of the taxpayer, a future event. The annual gift tax exclusion, currently $13,000 per donee, only applies to present gifts, not future gifts. Therefore, the entire amount of the trustor's contribution to the trust must be reported as a taxable gift. Enter Dr. Clifford Crummey, and his significant 1968 gift law court case, *Crummey v. Commissioner.* Dr. Crummey created an irrevocable trust for the benefit of his four children, which he and his wife funded each year with cash transfers. Their four children each held a power, exercisable until December 31 in the year of the transfer, to withdraw an amount up to $4,000, or the amount contributed to the trust, whichever was greater. The 9th Circuit Court held that the withdrawal right was sufficient to convert the interest into a present interest that qualified for the annual exclusion under the IRC.

The Crummey case centered around the issue of whether the trustor's payments into the trust were a present gift and therefore the per donee exemption applies or whether the payments were future gifts, in which case the amount must be reported as a taxable gift. The court focused on the concept of a "withdrawal rights" also known as "Crummey powers." If beneficiaries are given a limited period of time, such as 30 to 60 days from the date the contribution is made to the trust, in which they have the technical right to withdraw their share of monies placed in the trust, the court took the position that the gift is a present gift. If the beneficiaries do not exercise their power of withdrawal, it is irrelevant. The important point is that they were given this power. If the beneficiaries do not exercise their withdrawal power, the power will normally lapse or expire so that the beneficiary will be prevented from requesting a distribution of the amounts accumulated in the trust.

What Dr. Crummy did was to give his beneficiaries the right to withdraw their share of his deposit within a short period of time so that the deposits are a present gift, not a future gift, and therefore the annual gift-tax exclusion is applicable.

Crummey Notices

Based upon the Crummey case, in order for contributions of money to the insurance trust to qualify for the annual gift-tax exclusion, the trustee must provide a notice to the beneficiaries informing them that a specific dollar amount has been contributed to the trust and that they have the right to withdraw their share of the deposited funds. Typically the beneficiaries, understanding that the funds, in reality, are to be used to pay the insurance premiums, relinquish their right to withdraw funds. Then the annual gift-tax exclusion applies, and the trustee pays the premiums. The notices that are sent out to the beneficiaries are called "Crummey Notices."

Gift Taxation

The taxpayer must keep track of his contributions to the trust and any other gifts, since the gifts are aggregated. Currently, a husband

and wife can give each beneficiary an annual gift of $26,000 before a gift tax return must be filed.

Umbrella or Excess Liability Coverage

Unfortunately, we live in a litigious world. Individuals with a high net worth and/or large liquid accounts are targets for lawsuits. Accidents can happen at your place of residence or while you are driving your car. Homeowners and automobile insurance covers the owner's liability up to defined policy limits. It is the function of excess liability policy to cover the owner for potential problems in excess of any coverage granted by the primary insurance carriers. Individuals with significant personal wealth should seriously consider excess liability coverage, given its cost versus its benefit of increased liability coverage. A typical schedule for excess liability coverage might be as follows:

Annual Premium	Excess Coverage
$400	$1,000,000
$500	$2,000,000
$600	$3,000,000
$900	$5,000,000

Often the excess carrier will require that the primary coverage limits be at a certain specified level prior to the excess policy taking effect. Typically, the primary car insurance policy must have at least $150,000 per occurrence, $250,000 aggregate, and property damage coverage of $100,000. This coverage is double that required by the State of California.

Protecting Your Personal Valuables

Homeowner's insurance policies provide a degree of protection from loss from fire or theft. Usually the fire policy includes a generous coverage for personal property. The problem often becomes one of proof. If there is a fire and valuable items are destroyed, their existence and their value may be difficult to establish after the fact. It is prudent to document your possessions and their value. Take the time to photograph each item and attribute a value to it. If the item has a significant value, an appraisal should validate its worth. In this age of digital photography, it is a relatively easy step to photograph your belongings, yet most people do not take the time and make the effort to do so.

Another problem revolves around theft. Usually, a standard extended homeowner's insurance policy contains modest coverage for the theft of valuables. You can buy a policy that schedules specific items, such as jewelry, and that covers those specific items for an agreed dollar amount. Unfortunately, this type of coverage is very expensive in relationship to the coverage it provides. Typical premiums are $100 per year for each $1,000 of coverage. It is understandable why this type of coverage is so expensive, given the potential for fraud and the ease with which a small item may be lost.

A much more cost-effective way to "insure" against loss is to purchase a safe deposit box. A safe deposit box in a bank, depending on its size, will cost between $30 to $300 per year, yet the box can contain, if desired, a significant amount of valuables. For a fraction of the cost of insurance, a safe deposit box is a secure way to protect your valuable possessions. The negative, the inconvenience of having to go to the bank when you want an item, does not seem to outweigh the expense of insurance on scheduled items.

Fractional Interests

A *fractional interest* is the term for owning a portion of a real-estate asset. The concept behind creating a fractional interest is that, if a commercial property is worth $1,000,000 while owned by an individual as a leased fee estate, then if that individual conveys to his son or daughter a 20 percent interest, the retained 80 percent interest would be worth less than $800,000, its pro rata percentage of the assumed value. The reasoning for the reduction in value is that now each party owns a part of the whole, a fractional interest. The problem in owning a part interest in a property is that you must coordinate and interface with another party or parties as to various issues relating to the property. You must agree on matters from the day-to-day management of the property, which includes a myriad of decisions that must be made on a daily basis, to extraordinary events, such as the sale or refinance of the asset.

The basic idea is to lower the value of the estate and, hence, the estate tax. By transferring out 20 percent of the ownership in the estate property, the size of the estate has been reduced, and the value is further reduced since now the title is held by multiple parties (with the associated consequential issues). When the transfer is accomplished, there may be a gift-tax assessment depending on the amount of the gift and whether or not it falls within the gift-tax exemption. A key issue when executing the transfer is how the transfer will be accomplished. The parent could transfer to the children, creating a tenant-in-common ownership, or they might transfer to a family limited liability company. Alternatively, they might arrange for a step transfer, first to a tenant-in-common ownership and then to a family limited liability company.

Key Issues in Fractional Interests

Some of the key issues when a fractional interest is created include:

- Who is going to pay for the appraisal (property and business) and the legal costs associated with the transfer?
- What effect does the transfer have on real property taxes?
- What happens to the tax basis on the transfer?
- Is there a capital gains tax due?
- After the transfer, who pays what income tax on monies earned from the property?
- Who controls the property management decisions after the conveyance?
- What is the inheritance tax effect?
- Is a gift tax due and payable?

Family Limited Liability Company or Tenant in Common Ownership

A family limited liability company and a family limited partnership are essentially the same thing. Both terms refer to a company or partnership made up of family members. In essence, this is a partnership for a specific purpose. For purposes of the discussion in this section, I refer to the entity as a "partnership" and the participants as "partners," since in essence the form does not differ legally from any other type of partnership. The issues that arise in a family limited partnership are no different from the issues that arise in any partnership; that is, control, buy/sell language, the decision-making process, compensation, functions, and the like.

A family limited partnership is a vehicle that can be used to reduce estate taxes. The same effect can be accomplished through a tenant-in-common arrangement with a tenant-in-common agreement, although it is more cumbersome to work with. The process usually involves the taxpayer deeding real property assets into the partnership and then, subsequently or concurrently, making gifts of partnership interests to his heirs. Alternatively, he could make gifts to heirs who subsequently transfer their interest into the LP, but the effect is the same. Since now the taxpayer owns a fractional interest, from a valuation viewpoint, usually a 25 to 35 percent discount in value has occurred when compared to his prior 100 percent fee ownership.

In order to avoid issues with the IRS, it is crucial to support the valuation with an appraisal and the filing of a gift tax return. Issues that must be addressed include: who will pay for the appraisals, the gift taxes associated with granting fractional shares to family members, control of the decision-making process, and, in California, the consequences of increased property taxes resulting from the transfer. The appraisal cost can be significant if the estate involves multiple properties but, similar to the gift-tax issue, it can be quantified and dealt with. Control can be a more difficult issue, especially when the party owning the properties has been the sole decision maker for many years. In California, real property taxes are established based on fair market value at time of sale. The result is that usually the fair market value is set at the sales price. If the parents have owned specific real estate for many years, then the valuation for real-estate tax purposes is probably very low. However, when a transfer is completed, the result is a reappraisal for property tax purposes. You bring the value to current market. This can have a disastrous effect on the economics of transaction. One way to avoid this result is to contain the transfer to less than 50 percent of the ownership. Hence, a transfer for real property tax purposes has not occurred.

The key issue with family limited partnerships, from the viewpoint of the IRS, is whether or not the partnership is a viable business entity. If the partners act like partners, running the day-to-day business activities, having real functions, and being involved in the decision making process, then the Service will treat the partnership for estate tax valuation purposes as a real entity and recognize the discount. However, the converse is also true. If the partners give lip service to the partnership and the taxpayer remains the sole decision maker and active partner then, for estate tax valuation purposes, the IRS will have a strong case that the discount should not be granted.

Nonrecourse Debt

With recourse debt, the obligor is personally liable for the loan. He is betting the farm. All of the debtor's assets are subject to being taken to satisfy the obligation. In contrast, with nonrecourse debt, the lender must look only to the property to satisfy the obligation in the event of a default. At times, if you desire to move forward with a real estate project, it is necessary to sign personally. The classic example is a construction or rehabilitation loan wherein there are insufficient leases and occupancy in place to support the debt service. The underwriting does not support the monies requested until, and if, the developer is successful in leasing-up vacant space. Notwithstanding these exceptions, as a general rule, it is important to secure nonrecourse debt, so on each project you are risking your equity investment at most and not all of the other assets that you have accumulated.

In practice, depending on the loan-to-value percentage, nonrecourse debt to a large extent shifts the risk of loss to the lender. If the property experiences significant tenant defaults, when the loan exceeds 100 percent of the value of the property, who is in a better bargaining position: the lender or the borrower? The risk of loss is shifted even more to the lender if the borrower has pulled out all or most of its equity through a refinance or through cash flow. In this type of a situation, if problems arise, the lender will be more inclined to work with the borrower through a loan modification, a sale of the loan at a discount, or a discounted pay-off of the loan (DPO).

Do Not Get a Divorce!

In community property states like California and Arizona, a divorce costs 50 percent of your net worth. This is a costly mistake. Choose your partner wisely. Prenuptial agreements seem appropriate when an individual has had children from a prior marriage, a sizable estate has been created, and a second marriage is contemplated. Apart from the emotional issues, a thoughtful analysis of how existing assets should be distributed if the subsequent marriage fails may be crucial for the offspring of the first union.

Estate Planning Checklist

A checklist of the steps outlined above is as follows:

- ❑ Step 1: Hire the right representation, that is, an estate planning attorney, an insurance agent, and a CPA.
- ❑ Step 2: Set up wills for both husband and wife.
- ❑ Step 3: Create an inter vivos trust (Trust No. 1).
- ❑ Step 4: Transfer your real-estate holdings and other assets into Trust No.1.
- ❑ Step 5: Create an irrevocable insurance trust (Trust No. 2) to hold the life insurance policy on the primary breadwinner.
- ❑ Step 6: Create an irrevocable insurance trust (Trust No. 3) to hold the life insurance policy on the primary breadwinner's spouse.
- ❑ Step 7: Set up a sole and separate property account.
- ❑ Step 8: Fund Trust No. 2, that is, secure adequate life insurance on the primary breadwinner, which is held by the trust.
- ❑ Step 9: Fund Trust No. 3, that is, secure adequate life insurance on the primary breadwinner's spouse, which is held by the trust.
- ❑ Step 10: Create an irrevocable insurance trust (Trust No. 4) to hold a second-to-die policy.
- ❑ Step 11: Fund Trust No. 4, that is, secure adequate life insurance payable on the death of both husband and wife. This policy is held by the trust.
- ❑ Step 12: Consider obtaining life insurance on your children.
- ❑ Step 13: Complete "Crummey" letters and have them executed whenever money is deposited into the irrevocable trusts.
- ❑ Step 14: Make gifts annually to each child, at least up to the per donee exemption. Monitor your total annual gifting, especially since funding into an irrevocable trust is a gift. A gift-tax return may have to be filed.
- ❑ Step 15: Annually review with your insurance agent your insurance policies, with an emphasis on the amount of the death benefit in relation to your assets and your cash flow.
- ❑ Step 16: Purchase an umbrella insurance policy, a.k.a., an excess liability policy.

- ❑ Step 17: Open a safe deposit box for personal valuables such as jewelry.
- ❑ Step 18: Create a tenant-in-common ownership or family limited liability company or a family limited partnership to hold title to at least part of your real estate.
- ❑ Step 19: At least every third year, review with your estate planning attorney your overall estate plan, and especially the living trust and the life insurance trusts. The estate plan and the living trust should also be reviewed if special events occur, for example, the birth of a child, a marriage, or a divorce.
- ❑ Step 20: Borrow only on a nonrecourse basis, if possible.
- ❑ Step 21: If applicable, enter into a prenuptial agreement. In any event, do not get divorced!

Rule Number 32

It is not how much money you make that matters, it is how much money you keep!

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My concentration has been in the legal and practical aspects of real estate, so it was very helpful to gain insight and comments from several highly qualified CPAs, including Steve Barlevi, Phil Demico, Paul Joseph, Dennis Nelson, and Gary Soltys.

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About the Website

The appendixes referred to in the book can be found on the Internet at www.wiley.com/go/wealthopportunities. This website is intended to supplement and enhance *Wealth Opportunities in Commercial Real Estate.*

Please note, first of all, the schedules contained in the appendixes in the website tie directly into the illustrations contained in the book. For example, Appendix A sets forth all of the Rent Rolls referred to in the text. A Rent Roll is often the initial starting point when reviewing a real estate project. It is important to understand what percentage the project is leased and what percentage is vacant. When do the leases mature? Are the rents similar for the various tenants or do they vary widely from tenant to tenant? What operating expenses are the tenants required to pay versus what expenses is the landlord obligated to cover? When reading the book to obtain a full understanding of the analysis, it is important to refer to the applicable Rent Roll to understand these and other crucial questions.

Secondly, several of the appendixes are intended as reference material rather than a readable text. For example, Appendix D contains a Due Diligence Checklist. It is a handy guide that can be referred to when purchasing a commercial property to make sure that a buyer does not overlook an important matter that should be explored prior to committing to purchase, but it is not intended to be read as text. Other examples of the checklist approach are found in Appendix C, a List of Potential Exclusions to Operating Expenses, Appendix F, the Feasibility Questionnaire, and Appendix G, Construction Decisions and Issues.

Lastly, the appendix contains certain material that is more suited to a computer presentation rather than contained within the four corners of a textbook. The Argus spreadsheets contained in

Appendix B are examples of this type of material. By placing the analysis in the website, it can be viewed or printed out for further review, but does not bog down the readability of the text with multiple pages or spread sheet analysis. I encourage the reader to study the spreadsheets to better understand the conclusions brought out in the illustrations.

Wealth Opportunities in Commercial Real Estate: Management, Financing, and Marketing of Investment Properties
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About the Author

Gary Grabel brings to this text his extensive practical experience as an owner/operator of retail centers, medical office buildings, and apartment complexes. Mr. Grabel is a principal in the real estate firm Ethan Christopher, LLC, along with his long-time partners Mark Hamermesh and Aric Browne.

Mr. Grabel received his undergraduate degree in finance and accounting from Lehigh University in 1972. He graduated from Lehigh Summa Cum Laude. In 1975 he obtained his law degree from Albany Law School. Mr. Grabel passed the New York bar exam in 1975 and the California bar exam in 1976. He is a member of the California bar association and a licensed real-estate broker.

For more than 30 years, Mr. Grabel has been involved in all aspects of commercial real estate including financing, leasing, acquisitions, and the day-to-day running of real-estate assets.

This book is Mr. Grabel's second writing endeavor. His first book was published in 1979 and was entitled *The Secrets of Mortgage Lending*.

As a frequent lecturer and a magician, Mr. Grabel seeks to create "magic in real estate."

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