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Five mistakes to avoid as a commercial real estate investor

THE REal DEAL

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Following several years of a stagnant commercial real estate market during the Great Recession, commercial real estate investment is once again popular and, if executed properly, profitable.

In commercial real estate, there is a right way and a wrong way to do most things. And in my 15 years of practice, I have had the privilege of working with hundreds of real estate investors.

From that experience, here are just a few reminders, for accomplished investors and newbies alike, of a few pitfalls to avoid in any potential commercial real estate investment.

Going it alone

Even the most seasoned commercial real estate investor will need the assistance from various professionals in order to not only locate and evaluate the appropriate property to acquire but to protect the investor's interests from a legal standpoint. The services of brokers, attorneys, accountants and other professionals are usually considered to be critical to the investor's commercial real estate success.

For example, the drafting and negotiation of the purchase and sale agreement is not a time to cut corners.

I've seen the most veteran real estate investors attempt to negotiate their own contract without legal counsel — only to find after the closing that they have increased costs and liability due to a poorly negotiated and drafted document.

Financial-analysis figures

Rewinding the process to before the contract stage of the transaction, an investor should ensure that "the numbers" meet their intended goals.

Unlike residential real estate, where a property's value is generally based on neighboring property values, or "comps," commercial real estate involves a complex financial analysis process to accurately assess its viability and potential to meet the financial goals of the investor.

In large part, what the commercial real estate investor is purchasing in a property is that property's cash flow. The same property's appreciation, loan amortization and tax shelter characteristics are also extremely important and should be carefully analyzed.

Although there are dozens of financial measures which can, if calculated properly, provide a treasure trove of information about a property to an investor, two of the most commonly utilized measures are capitalization rates (cap rates) and internal rates of return.

Cap rates express the ratio between a property's net operating income and its value. An internal rate of return is the metric of choice for savvy investors because it also takes into account the timing and size of cash flows and sale proceeds.

It is never recommended to exclusively use the seller's figures in your analysis — and certainly not pro forma figures.

A caution to an investor, however, is to be aware that in order to calculate exacting financial metrics for the complete analysis of a property, accurate figures (such as gross scheduled income, vacancy allowances, operating expenses, etc.) must be employed to avoid a "garbage in/garbage out" calculation result.

Oftentimes, a property seller will use pro forma figures in the offering package and base the asking price off of such figures rather than actual numbers.

In short, pro forma figures represent what "could" be achieved with the property if ideal conditions were met (e.g., increased rents, lower vacancies, etc.). It is never recommended to exclusively use the seller's figures in your analysis — and certainly not pro forma figures.

Do your due diligence

Another significant difference between residential and commercial transactions is that the majority of commercial transactions are on an "as is/where is basis," but will give the buyer a free "kick of the tires" during the time generally referred to as the "due diligence period."

An investor's due diligence process is extremely important, and this time should be used wisely and with the partnership of the investor's team members.

This is the time for confirming income calculations, reviewing leases and other documents provided by the seller, confirming zoning and development requirements and conducting building inspections and environmental site assessments.

There is no substitute for careful scrutiny of the financial presentation of a property and its physical characteristics.

Don't get emotional

First and foremost, an investor should never make a decision to buy, hold or sell a property based on emotional factors — it should be about the numbers.

As discussed above, due diligence is crucial, even if the investor has to renegotiate at the end of the period or, more commonly, terminates the transaction altogether based on the results.

It is difficult to walk away from a potential property after spending significant time and money in its analysis, however, it will happen — and walking away sometimes is the smartest move an investor makes.

After the deal closes

Before popping the champagne cork and celebrating a successful closing, an investor should have an exit strategy for the investment.

Perhaps the goal is to hold on for a 10-year period and to achieve a 15 percent internal rate of return. It may be the property is a value-add play to rehab and flip or convert to condos.

No matter what the strategy, there needs to at least be some strategy and a prudent investor should continually re-evaluate the property during ownership.

If there is an alternate investment opportunity that could generate higher returns than the current investment, then the original exit plan may need to be reconsidered.

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