GORDON JAMES REAL ESTATE SERVICES

- GUIDE TO -

Investing In and Managing Commercial Real Estate in Metro Washington DC

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A Guide to Investing in and Managing Commercial Real Estate in Metro Washington DC

While most casual investors begin real estate prospecting with a single-family residence, experts often advise looking to commercial property as a better investment. This ebook will address things to consider for those of you new to the commercial real estate investments.

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Benefits of Investing in Commercial Real Estate

Commercial real estate is a great way to build your investment portfolio. When the economy is strong, commercial properties can increase in value and provide an investor with a steady rate of return. With stock markets being volatile, commercial real estate can be an excellent risk/reward investment.

There are plenty of potential commercial real estate properties in and around Washington D.C. These include offices, malls and retail spaces, apartment buildings, restaurants, industrial properties, and warehouses. Commercial real estate properties are leased out to provide a workspace, as opposed to residential ones, which are leased out to provide a living space. Investors will seek out commercial real estate as a way of investing their money into an asset that offers a constant, long-term rate of return—or income.

Generally, investors team up to spread any risk, often forming a corporation. Each investor will have a pro rata share of the value of the property based on their investment and, if there is a profit, receive dividends at the end of the year proportionally based on their percentage of ownership.

There is less investor competition in commercial real estate since these properties are larger investments, so owners of commercial real estate properties are typically more flexible when looking to sell.

There are several benefits to investing in commercial real estate.

- **Lease income is higher.**
- **Commercial properties generally increase in market value.**
- **Commercial real estate investment returns have a high correlation to inflation when compared to other asset classes.**
- **You have more control than over other real estate investments.**
- **The 1031 tax-free exchange.**
- **Financial leverage.**

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Lease income is higher. One benefit is lease payments per square foot are higher than in residential real estate. Unlike the short-term leases of a residential property, commercial properties are multi-lease properties that generally have leases structured to last from 3 to 10 years that will finance a building over time. This lease structure adds the advantage of security because it minimizes the risks and costs of any vacancy. Even if one tenant vacates, you will continue to collect rental income from the other tenants.

A good strategy is to invest in commercial properties with long-term government tenants because they are stable and generally renew their leases. The end result of these benefits is a regular income stream from tenants at a high rate of return, providing equity growth over time.

Commercial properties generally increase in market value. This means your investment will appreciate. In other words, purchase the property, let it build equity, then sell it for a profit in the future.

Commercial real estate investment returns have a high correlation to inflation when compared to other asset classes. This benefit is called a hedge against inflation. Commercial real estate investments have the advantage of lease structures that can help them keep pace with inflation, as rent is usually renegotiated when a lease is up for renewal. Property values can be another factor. According to a TIAA-CREF report: "….the more net operating income generated by a property in response to inflation, the greater the likelihood that the property will also appreciate in value, even if interest rates increase."

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You have more control than over other real estate investments. As the owner, you have control over the type of tenants, the terms of the lease, upgrades to the property, and whether to change the use of the property.

Unlike residential properties, the tenant pays for maintenance, utilities, insurances, and real estate taxes. This allows returns on commercial real estate to be higher than residential properties, where the landlord pays for the property's costs. In addition, commercial tenants often invest in other improvements which help your investment and provide assurance that the lessee will stay.

The 1031 tax-free exchange. This permits investors to sell the property and move that money into another real estate investment without paying capital gains taxes.

Financial leverage. Leverage occurs when the buyer invests a portion of cash resources into multiple properties, with the balance of purchase prices contributed by a lender, typically a bank or private investor. The investor can receive long-term, fixed-rate financing to pay the debt. In this way, the investor is spreading his/her financial resources across several investments.

If you don't have the capital to invest in commercial properties, there is the option of real estate investment trusts (REITs). REITs are investments in large-scale commercial properties that are accessible to average investors. An investor can buy a share in a REIT, similar to purchasing a stock, and earn a share of the economic benefits of commercial real estate ownership. REITs are modeled after mutual funds and offer investors portfolio diversification and long-term performance. REITs can even be part of a retirement account. REIT-owned properties are located in every state.

You can build your equity by taking advantage of the benefits of investing in commercial real estate.

If you take the action and make the leap to invest in this asset class, remember to do your homework and get professional advice before making any business and financial decisions.

What kind of homework, start here:

A Primer in the Commercial Real Estate Market

After commercial real estate values plummeted with the recession in 2008, savvy investors found opportunity in the bad market news. Some financial institutions cited a decrease in values of 11 percent or more—the sharpest drop in 25 years. Now real estate on the whole is well into recovery mode, but bargains are still available. Finding prime opportunities takes a hunter mentality. With the potential of greater gain also comes greater risk. Unearthing the sweet spots in commercial real estate requires attention to market variables, due diligence, and solid partnerships.

It is better to find the motivated seller than to become the motivated seller.

Understanding risks is important:

Location, location, location – The location of any property can be "hot" or "not," making consumer interest a fleeting proposition. Residential neighborhoods are established nearly from the get-go because of proximity of schools, parks, transit access, businesses, entertainment venues and such. Commercial property isn't always as predictable. It is critical the investor knows the market. Buyers should develop neighborhood farming tactics. Network, cultivate leads, evaluate the radius of vacancies, and monitor the local news and reports for business relocations. The right time and right place can mean scoring a great opportunity.

Market Slumps – Prospectors can invest so heavily in real estate their liquidity becomes too fragile. It takes money to buy, sell and maintain commercial investments. In a soft market with abundant bargains, it can be tempting for forget the cost of turn. While property presents a sure asset to sell in the event an infusion of cash becomes necessary, successful investors will exercise caution to keep their ledger in balance. It is better to find the motivated seller than to become the motivated seller.

The Cost of Doing Business – Commercial real estate can present many of the same situations as single-family residential investments. Tenants come and go, leaving vacancies and a tenuous cash flow for owners. Litigation, and the costs that come with it, may be necessary to pursue payments or to recover damages. Repairs, improvements and other tenant demands absorb a good deal of cash and time.

In addition to the risks identified, the investor must understand the differences in the valuation of commercial property and know their limits, develop a viable exit strategy and consult experts to evaluate all the real estate metrics.

Successful commercial real estate investors will assemble a team to effectively analyze and forecast the potential of possible commercial investments. **The team might look like this:**

An accountant to provide the financial assessment of what is affordable within current business portfolios and to predict cash flow, net operating income, cap rates, cash on cash returns and tax implications.

An attorney to advise on allowable uses of property and limitations of zoning, negotiate contracts, establish leases and secure deeds.

A commercial broker to locate potential investment property, provide location analysis and negotiate deals.

A mortgage broker to sort through lending and other financial options and seek loans favorable to commercial purchases.

A property management company to provide the hands-on management of the property, recruit tenants and coordinate repairs. They will manage your taxes (and appeal them in the case of errors), and will keep a close eye on both the income and expenses for your building. A good property manager is a shrewd negotiator who will work hard to lower expenses as much as possible to keep your income high.

Assembling a trusted team, developing strategic practices and maximizing market opportunities can result in a much bigger payoff on investments in building a robust commercial property portfolio.

Performing Due Diligence on a Piece of Commercial Property

Due diligence in is an opportunity for an investor to confirm if a property is a good investment. Every commercial real estate transaction should have a due diligence period clause.

During this 45- to 60-day period, buyers would identify any physical, financial, legal, or environmental issues with a building property. The aforementioned team consisting of a lawyer, accountant, financial advisor, commercial and mortgage brokers, and a property management company can provide an investor with information and analysis and also help establish a property management plan moving forward.

A commercial broker can help an investor locate a potential investment property and provide a location analysis. Once a property is identified, the investor should consider the nearby competition for the space. How much vacancy is in the area? Will you be the only game in town?

Legal due diligence begins with a title review period reviewing all claims against the property. Next, with the attorney to conduct a survey of the property to determine any easement and right-of-way issues and restrictions, and to know whether the building is in compliance with existing zoning regulations.

The investor should know the building's age, acreage, and square feet. It also helps to get the record of all previous building owners of the property and discover the building history of the structure, e.g., whether is it built on a hazardous waste site. The investor should also know the kind of use the building is set up to accommodate and identify all present uses of the property. Is it a single-use office space? Mixed-use with retail? Can it accommodate medical offices? Restaurants? What type of construction is the building (steel, glass, brick, wood)?

Hire a professional inspection company to assist in making a general inspection of the entire property. Walk the property and inspect each unit or space if possible. Look for deferred maintenance issues. This can include determining the condition of the roof, bathrooms and plumbing, paint, finishes, and carpets, and locating any mold or asbestos. You will also want to inspect the mechanicals, such as sprinklers, HVAC, plumbing, and electrical are working to code. The purchaser might also want to check the structural condition of the building, including walls and floors. Once problems are spotted, a remediation list will be created of what will need to be fixed or replaced, and get estimates for repair costs.

Does the property have adequate access to public streets? What are the width of these streets? Are there any alleys or pavements that traverse the property? Is the property near public transportation?

For a physical inspection, inspect the property in the rain to look for roof leaks, determine if windows are leaking that will need caulking, and see if the drains work properly, i.e., is there standing water in the parking lot.

Also, count the number of regular parking spaces that the building has and make sure the number is in accordance to the square footage ratio assigned by the county.

After inspection, a thorough review of all of the seller's existing building leases is required. This includes the status of leases, the cash flow and creditworthiness and of each tenant, and the delinquency rate (there shouldn't be any delinquency if the building is being managed properly).

A thorough review of all of the seller's existing building contracts will be required.

This includes a review of:

- Verify the income of the building against its operating expenses by reviewing billing receipts.
- Copies of bills, such as water, sewer, and electric bills. Are energy-saving measures in place, such as energy-efficient light bulbs?
- Copies of property taxes, agricultural taxes, and any special taxing from the district or county where the building is located.
- Any pending lawsuits or unpaid taxes/fees.
- Inspection documents for elevator and fire, i.e., are they up to date?
- Service contracts, such as elevator, cleaning, trash removal, and pest control.
- Seller's insurance policy.
- Notices of any environmental conditions
- Handicap regulations. Make sure the property is in compliance with Americans with Disabilities Act (ADA) codes, e.g., what is the turning radius getting in and out of bathrooms? Is there an access ramp? Verify that there are clearly marked handicap spaces.
- Construction records. Are there any plans for additional building?
- Liquor, entertainment, and outdoor dining licenses.

Failure to perform an in-depth due diligence on a property can have negative financial consequences, so spend the time and resources necessary to conduct it thoroughly. It is advisable to rely on experts to help you. If problems are discovered, you might consider canceling the deal or getting the seller to renegotiate the purchase price.

What to Expect from Your Commercial Property Management Company

Tenant Relations

Commercial property management companies find tenants, negotiate lease agreements, collect rents and work with tenants that are not meeting their contractual obligations. This may include evictions, safety inspections, and a variety of other items necessary to keep the property in good working order and lower your liability.

Strong tenant relationships mean less turnover for your individual units, saving money in the long run.

Tenant selection and retention

Finding the right tenants is a crucial element of success for your commercial property. The DC area is one of the most expensive—and competitive—real estate markets in the country. A good commercial property manager has the marketing skills and industry connections necessary to get your units rented. They also know how to retain the best tenants and replace the ones that aren't working out.

Maintenance

While the majority of the interior maintenance is the responsibility of the individual tenants, there are some circumstances in which the property owner will be required to foot the bill for repairs. Commercial property managers have a deep list of contractors to pull on in order to get the job done on time and under budget.

Regulatory Compliance

Every jurisdiction has its own building codes and local rules. It's important to comply with all local laws, or else you will be liable for hefty fines.

Property management companies in DC are not required to be real estate brokers, as long as they are not negotiating the sale or purchase of real estate. Commercial property managers in the District are required to have a property manager's license.

Virginia requires all property management companies to be licensed real estate brokers as well.

Taxes and Budgeting

It's estimated that 90 percent of all commercial property owners are overpaying their taxes. A local expert on the ground who knows what exemptions and abatements are available, as well as how to ask for them will help maximize profitability. Local knowledge and market experience means they already have a relationship with a local tax assessor.

Commercial property management involves much more than just collecting rent. Between marketing, maintenance, financial management and tenant relations, you may find taking care of your building to be more burdensome than you realized.

Gordon James Realty is full service real estate services company serving commercial property owners in metro Washington, D.C. who seek investment consulting, commercial management, HOA management and real estate brokerage. Our real estate expertise, the latest technology, and superior customer service combine to maximize our clients' financial benefits of owning property while relieving the burden of handling many of the complicated and time consuming tasks that come with it. To learn more about working with us, contact us at 202-800-2610 or **online here.**

If you're interested in seeing if Gordon James Real Estate Service is a good fit for you, tell us a little about your property here and we'll be in touch.

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