ACE Introduction to:

What you need to know before going commercial

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Learning Objectives

At the end of this course, the student will be able to:

1. Describe some of the primary differences between the commercial customer and the residential customer.
2. Explain the difference in the due diligence period with commercial real estate.
3. Explain the importance of attorney involvement in the commercial transaction
4. Describe the agency/representations exception stated in Chapter 475 when referring to the commercial transaction.
5. Explain to a customer some of the basic terms they will hear during the process.
6. Describe what a typical Commercial investor/customer expects from a real estate professional.
7. Explain the importance of ascertaining the customer level of experience in commercial real estate transactions.
8. List some common differences between the commercial and residential lease that the customer should be made aware of.
9. Explain the terms GPI, Vacancy Factor, GOI to a customer.
10. Calculate the net operating income of a potential commercial property using the above given factors.
11. Demonstrate how to use the 5 main keys on the financial calculator N, I/YR, PV, PMT, FV).
12. Create a 'to do' list of due diligence when working with a commercial buyer.
13. Explain what special inspections a lender may want/require.

Timeline 3 hours

Introduction	10 min.
Chapter 1: The General Differences	30 min
Chapter 2: The Lexicon	30 min.
Chapter 3: The Customer	20 min.
Chapter 4: The Leases	20 min.
Chapter 5: The Analysis & Proforma	20 min.
Chapter 6: The Due Diligence	20 min.
Total	**150 min** **3 hrs. CE**

Introduction

Forward

<u>VISION</u>

In our extensive interaction in the real estate market both as consumers and practitioners we have had the experience of seeing both the highs and lows of service and professionalism in the real estate industry.

One common thread we have realized is that professionals close deals and closers are professionals.

We developed our courses as a means of setting a definitive road map guiding Realtors to recognize and develop the practices that are common to professional “deal closers”.

Our mission is to bring a level of professionalism into a profession that at times sorely needs it. We are the caretakers of our clients’ most valuable assets and as closers, as an ACE (Accredited Closing Expert) we hold this trust sacrosanct.

That being said, we have attempted to use a little humor throughout this book to make it a little easier to read. Some may say this is unprofessional as professionals never laugh, wear a permanent scowl, and eat nothing but a diet of rusty nails. The subject matter we go into here is often dense and we wanted to take some pity on you having to read all of this. We hope a little levity will not only make it a bit of fun but also help you to remember it.

Expectations from attendees of this program:

- To endeavor to conduct every transaction in the most professional and effective manner for, most importantly, the consumer (customer) but also extending to the other professionals with whom the transaction requires you to interact.

- To continue to educate yourselves at all times on the ever-changing aspects, both legal and market related in their industry.

- To clearly keep in mind the goal of the transaction and not get bogged down in the minutia and personalities that tend to distract from that.

- To find solutions and solve problems not to doubt and aggravate issues.

- To not be afraid to say “I don’t know” once but never twice.

- To work within the realm of your expertise.

Purpose of this Course

To give you the basic tools to determine if the commercial side of real estate is right for you and to give you the skills to service the commercial customer if you do. This information will allow you to build a strong real estate business, with exceptional customer service, and advertising that is both compelling to the customer and compliant with the ethical standards we have. We will give you the tools necessary to avoid all the distractions and superfluous activities that can get in the way of closing customers for life.

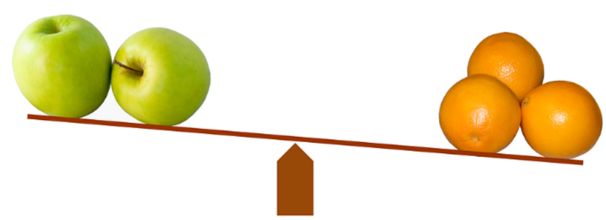
ELITE DEAL CLOSERS

Table of Contents

Chapter 1:

The General Differences

There are a lot of things with commercial real estate that differ from things done in residential. As many agents tend to work the residential side and only dabble in the commercial aspect it is probably best to take a look at some of those differences now.



Less Hand holding:

On the commercial side of real estate, the investor tends to be more knowledgeable and sophisticated. For this reason, there is less need for the agent to give them such intense oversight. The customer has usually closed multiple real estate transactions and so they are not as upset or at least surprised by the things that tend to come up in deals. They know what an inspection report looks like, also what inspections are needed, and what type of things the lender will be looking for. They also know the closing process, who they want to review their documents, and what financials they will want to see. That is a lot more than what we can reasonable expect form our normal residential customer.

There is no guarantee that all your commercial customers will be sophisticated buyers. **There is still the chance that this deal is this customer's first one ever. For that reason, we must be ready willing and able to give them all the support they need**. So, the ability to go over and discuss the commercial contract, LOI, and other forms we may need to get this deal done are important skills for any agent working with commercial customers to have. We need to be able to inform the customer and show them clearly that we know what is going on.

Longer Due Diligence Period

In residential we would call this the inspection period. If we have 15 days on the residential side it is a longer due diligence period, whereas on the ***commercial side 30-to-60-***

day due diligence periods are frequently seen. The seller does not have the same responsibility to disclose in a commercial deal for that reason for there is much more to check and inspect on a commercial property and the depth of accounting required is much more robust. That additional time is needed to check leases, order a greater range of inspections, and environmental studies, have attorneys review service contracts, and in general make sure the operations are thoroughly checked.

More Attorney Involvement

The attorney on a typical commercial deal will be much more involved. While it is still technically optional to have an attorney represent the customer… it is far less frequently viewed as anything less than mandatory by the client. The attorney may even be the one that offers are submitted to rather than the client. This also means that much of the work we routinely accept as the agent's responsibility on the residential side can be shifted to the attorney when doing a commercial transaction. For this reason, we want to find out from both sides…

Is there an Attorney Involved on the other side?

This is going to help us know with whom to talk and who to send things to. For that reason, we want to find out if there is an attorney involved and if so, what role they have. Many times, the attorney will be the one to who offers, and counteroffers may be sent. **So, we want to find out first and foremost if we are on the listing side if our seller has an attorney they want to be involved in the transaction and what role they want them to take.** There is a wide range of tasks that can be done by the attorney, or the agent and it is important to make sure the responsibilities are clearly laid out so nothing can fall between the cracks. On the buyer's side many times the attorney will prepare the offer and even sometimes want to prepare the LOI. Once again taking the time to **find out what role the customer wants their council to play** is going to be something we want to get done sooner rather than later.

Due Diligence Responsibility

The due diligence process is fraught with perils for the real estate agent. It is very easy for the agent to overstep their responsibilities and wind up doing more than they should. Agents should analyze the real estate and prepare pro formas and projections. They should not however get involved with reviewing the due diligence material to too great an extent. Checking the lease amounts to see how they compare to market rates is fine. Rendering opinions on the best way to exercise the cancelation clauses in the lease probably exceeds their expertise. When it comes time to do the due diligence process you want to be the one who makes arrangements for the materials to get to the proper people to review them. This is again where the attorney and the accountant are going to earn their money. That being said, the rule should be unless you are an expert in the thing you are thinking of reviewing don't and get it to an actual expert. There is a lot that we as agents can bring to this process, but caution must be used. We will go into a lot more detail on this when we get to the chapter dedicated to this.

Don't Bite off More than you can Chew

When driving it is always a good idea to stay in your lane and when practicing real estate it is no different. **You need to always act within your competency**. This is even more so in the case of commercial real estate as there is a lot more to know, and a lot more at risk. According to our code of ethics if you don't know how to do something you are **required** to disclose it to your customer. Trying to think how that conversation would go with your customer. "Yes, Mr. Customer I have absolutely no idea how to do what you want me to do but I'd really like to earn this commission so would you please still work with me?" If that seems less than compelling to the customer it is for a good reason. The customer would have to be out of their mind to work with that agent. The other option the code gives us is to refer the customer to someone that does know how. In commercial deals there are more things to know, but there is also a greater expectation of bringing outside specialists to help. Those experts will help to review and help with contracting and closing. If you don't know the real estate portion of the deal then you will need to select one of the two options above or the third and best option which is rather than to refer the property to another agent offer to partner with them on it and get paid to get an education in the very field in which you work. You can make yourself a more valuable agent (knowledge wise) all while making yourself a more valuable agent (bank account wise). That is what we call a win- win scenario.

Instead of inspections seller can provide warranties

In residential there is a much larger requirement to disclose. This is not the case in commercial real estate. This is one of the reasons the contracts can sometimes be shorter for a commercial deal. There are addendums that can be used that add warranties by the seller to the buyer that function to give the buyer a greater sense that the seller is not trying to hide something or pull one over on them.

Commission is not a foregone conclusion

Many of the places where commercial real estate is offered there is no promise of commission or compensation for the buyer's agent. If the property is on the MLS you are probably fine. However, for any other location, a call to the other agent and some agreement on commission should be reached prior to showing the property.

Must identify clearly what is being sold

With residential properties we know we are normally selling a house with land, a townhouse, or a condo with no land but lots of common area. With commercial there are more possibilities, so the need to be much more specific and clearer on what is being sold becomes important. If we were selling a gas station, we could be selling the land alone, the gas station business, or even just the pumps. **It is important to make sure the buyer knows what they are actually getting.**

Dual agency is allowed

For **residential** real estate, dual agency is **not** allowed in the State of Florida. However due to the fact that there are a handful of national firms that control many of the larger commercial listings, an exception exists to keep this from violating the agency requirements of Chapter 475. If the buyer is an accredited investor the law allows the same company to have their agents represent both the seller and the buyer if it is disclosed and both parties agree.

You can lien the seller for commission

This is different than placing a lien on the seller's property - you are just putting a lien on their sale proceeds. This does however allow the agents a helpful tool to make sure they get paid when the funds change hands.

NDA & Confidentiality Agreement

(Covered more in the next chapter) A way for the seller to be certain the buyer will not share information on the property the seller provides them.

The Process

- Find the property
- Sign the NDA
- Get the info on the property
- Discuss with the customer to make offer
- Create LOI
  - Purchase price
  - Commission
  - Contingencies
  - Cash or financing
  - Closing costs
  - Deposits
  - Warranties
- Fill in the state contract or have the attorney create one for the deal

Can't use an FAR or FAR/BAR contract on a commercial deal as they are not designed for it

Sometimes it's a mixed property

Sometimes it's hard to tell if it is commercial or residential. A property might be someone's primary residence and have a separate 10-unit rental property on the same lot.

Typically, we will want to get the attorney involved then to make sure the correct contract is used.

Survey is a must

A Survey tells you if there are flood zones and how much of the land was actually usable. A topography survey will show which way water flows and the lay of the ground. The buyer pays for survey typically. If any issues are found typically the seller will have a window of time to fix any defects.

Environmental inspection/Soil testing

Environmental studies are a major part of commercial real estate and are a requirement for most loans. The most basic is a phase one environmental study which is just research on the history of the property. If there are grounds to think an environmental issue exists a phase 2 environmental may be required which involves soil samples and more.

Title is a much bigger deal

In commercial, there can be many deed restrictions that can limit the use of properties. These can come from agreements from previous owners with tenants, city requirements, etc.

The Buyer will have a window to review and object to items on title.

The Seller has a window to correct the title issues

Zoning

Also, a huge deal with commercial as ***we need to make sure our buyers intended use will be allowed.*** There are a few ways to do this like:

- Pre-application meeting: meet with the city/county zoning commission to discuss the properties use
- ZVL= Zoning Verification Letter: Verifies what can be built on the site (15-20 days $300-$400)

If you want to look up the zoning for a property you can go to www.Municode.com.

Another major thing to check – make sure the parking exists for the intended use.

Fire also has final say

Another obstacle to overcome is getting permission from the fire department. They will have final say for any intended use. This can be challenging at times as there is limited ability to appeal their decisions.

DOT may be an issue

Access to the property is really important and the folks that determine how folks will have access to the property with turn ins and median cuts is DOT. Believe it or not your customers intended use and profitability is not their number one priority. For that reason, it is important to make sure they sign off on anything your customer is planning regarding entrances and exits

ADA compliance

Commercial properties are required to be compliant with ADA rules unless grandfathered in and then even so they can be sued if they are not accessible. Making sure the property is compliant with ADA requirements should be part of the research done during the due diligence process.

Buyer must repair any damage caused by inspections

Because the inspections the buyer is allowed to do are far more extensive and potentially invasive on a commercial deal the buyer is typically responsible to repair any damage done from the inspection. This is not something that you run into typically on a residential deal, so it is something you want to keep in mind.

Buyer must release all inspection reports

In the residential market the inspection report belongs to the buyer, and they are not required to provide it to the seller. Many commercial contracts make it the buyer's responsibility to provide the seller with copies of any reports they receive on the property.

That's a couple of differences huh? As it turns out there is also the minor matter of a different language the commercial folks speak. In the next chapter we will look at the different terms that are frequently used in commercial real estate as well as by investor customers to make sure you are prepared to discuss your product in a professional and intelligent way.

Chapter 2:

The Lexicon

There is a lot of terminology that crosses over between residential and commercial and some that doesn't quite make the jump. In this chapter we will try to get you up to speed on what things you need to know. It turns out there is a sperate language spoken on the commercial side and if you are not familiar with what commercial agents are talking about it will immediately identify you as an outsider or a rookie. Luckily it is not an entirely new language, but there are quite a few new terms you will need to know. First let's start with the most basic of things if we want to discuss commercial real estate and that is:

What is commercial real estate? Anything that is not residential real estate. So, if it is not a residential lot or has more than four units it is a commercial real estate deal. This means that the contract we will need to use will be dictated by that fact as will the warranties and disclosure requirements.

Platted: means the developer went to the city and said I want to develop this land as a residential or commercial site. This property will then have a lot and block number.

Unplatted: If a property has not gone through the platting process it is considered unplatted and will have a legal description more like this: NW corner of the W ½

Debt Service: This is the mortgage payment for the property. It is the amount paid to keep and maintain the debt (mortgage on the property). Another way to think of it is the rent paid on borrowed money to the person or entity that made the capital available to you.

Amortization: The amount of the loan payment that is allocated to repaying the original loan amount. This is from the Latin root word "mort" and means to kill. The amortization rate means the rate at which the loan kills itself, or in other words, how long the current payment will need to be made to fully pay the loan back and leave the borrower with a balance of zero owed. On the commercial side there are quite a few interesting things done with amortization to meet the special wants and needs of investors.

Amortization Period: The length of time, based upon the current payment, it will take for the loan balance to be fully paid back to the lender.

Loan Term: the length of time for full amortization (loan principal fully repaid) to occur

Loan Call: A time less than the loan term when the loan must be repaid (which creates a balloon payment) Many investor loans will have a different amortization period with an earlier call which will require the investor to refinance the property when the call comes due.

Index Based Rate: A variable rate mortgage will have a rate that adjusts based upon what happens to interest rates. The way they determine what the interest rate will be is based upon an index. There are a few out there. Residential mortgage rates are typically tied to the yield on the 10-year treasury bond. Many other indexes can be used. In fact, our next one is one of those.

Libor: This is a common index used to base variable rate mortgage loan interest rates upon.

Reserves for Replacement: This is money set aside (often required by the lender) to replace critical items like roofs, driveways, or paint. On commercial properties these can be major expenses and if funds are not set aside the repairs may not be made in a timely fashion. If those repairs are not made the building can suffer more extensive damage and the lender wants to protect their collateral. For this reason, it is common for them to require the owner to put aside some of the monthly income to pay for these bigger ticket repair items.

Capital gains: Tax benefits are a big reason why investors buy real estate. As a commercial agent or just one that works with investors or wants to invest themselves it is critical to be able to explain the tax benefits real estate can give to the investor. Capital gains tax is a special tax rate paid by investors on money they have already earned and paid taxes on that is then invested and makes more money. The appreciation of real estate will be taxed at this rate when a sale is made without a 1031 exchange. This rate is typically lower than the investors ordinary income rate which makes this a very good thing.

Tax Deduction: Something that removes or reduces the portion of income for consideration for taxation purposes, and thus lessens the amount of the actual tax bill.

Depreciation: This is a major tax advantage. This is a loss on the improvement portion of the real estate investment that is used to offset gains to lower the taxes paid on income. The thing that makes this so good is typically the real estate doesn't actually depreciate. It appreciates instead. That means the loss we took was 100% fictional but it reduced the amount of taxes our owner has to pay on their rent. This benefit is one that is largely limited to real estate which means our investors other investments must actually earn more to give them the same benefit as their real estate does.

Cost recovery tax: The IRS is not known for their generosity. The depreciation we just discussed and all the deductions we got to take from them, yeah they want that money back. They try to get it when we sell. Cost recovery is the tax rate charged by the IRS for the depreciation taken (during the time a property was owned) when a property is sold.

Ordinary income: This is the tax rate on income earned by the investors work. This is important to know as this is typically how rent money is taxed as well. The rent will increase the owner's ordinary income tax rate just as if they got a raise at work and they will pay taxes accordingly. This is where the benefit of the above deductions can help reduce this taxable liability. Ordinary income does not include capital gains. These are taxed at their own rate as discussed earlier.

1031 exchange: Is a way of differing the payment of capital gains and cost recovery taxes by exchanging one property for another without taking any money from the sale. It carries forward the reduced basis of the previous property plus any additional basis if the new property is more expensive than the old one.

Pro forma: The projection based on the best current market data, leases, a properties history and the anticipated market growth to create the total anticipated return for the property. This is a best estimation as to how it will perform in the future based on all the information we have today.

Projection: the process of assessing the likely performance of a property in the future based on historical data, current conditions, and any other pertinent data available

Cash flow: The income generated by real estate and any other things or operations on the real estate. Typically, this will be rents but can also come from vending machines, laundry equipment, or any premiums charged on actual costs for additional services.

LLC/S corp./C corp: The odds of dealing with a corporate structure on the commercial side are much higher. A working knowledge of the various differences is very beneficial to you and the customer. Corporate structures are a tool used to minimize investor risk, and that is always an important part of an agent's job.

Year 0: The time of acquisition. When the investor discusses year one they are always talking about the end of year one when income is recognized. The purchase of the property occurs before that. That is why we have year zero to indicate the moment when the investor trades their money for the projected cash flow and any appreciation in sale price the property gives them.

Vacancy factor: A fictious amount we reduce the GPI by to recognize the percentage of time we will project a property will be vacant each year (typically based upon market vacancy).

This is not meant to be a comprehensive list, but it will give you the most common terms you will hear when a commercial real estate conversation begins. Now we move on to the things that generate the most confusion for people attempting to learn a new language: the dreaded acronym. Acronyms are designed to do three things 1. Make complicated things to say or repeat easier to refer to in conversation. 2. Much like having its own language acronyms create a "club" of people that know what the acronyms mean and to keep the "other folks" out. Why do you think doctors still use Latin? 3. To make you angry when you try to learn the language. That being said, here are a few of the best acronyms to know:

ROR: **Rate of return**- the percentage return on invested capital. The Rate of return establishes a ratio between dollars invested and the current income of the property. This is calculated by dividing the net operating income by the purchase price.

ROI: Return on investment- the total rate of return compared to dollars invested. This includes future income and sale of the property.

DSCR: Debt service coverage ratio- A ratio lenders use that compares the net operating income to the mortgage payment amount

LTV: Loan to value- A cross over term we still use a lot in commercial. LTV is the amount borrowed versus the value of the property usually based upon an appraisal.

IRR: Internal rate of return- an analysis of all projected cash flows and future sale price which provides an amalgamated annualized rate of return for the entire investment period

GPI: Gross potential income- what a property is capable of earning based on market rents and 100% occupancy for the year

GOI: Gross operating income- the GPI with a vacancy factor removed

NOI: Net operating income- the amount of money left after all expenses have been paid but, prior to calculating taxes

NPV: Net present value- The amount of change in initial purchase capital necessary to achieve the targeted ROR based on the projection

NDA: also called confidentiality agreements. These are used prior to the seller disclosing certain information to the buyer to assure the seller that the buyer will not share that information with anyone else

Cap rate: Capitalization rate- a ratio achieved by dividing the NOI by the purchase price. Cap rates are only done based on a cash purchase.

C on C: Cash on Cash- Similar to a cap rate but taking into account the use of borrowed money. The debt service is removed from the NOI and that is divided by the down payment rather than the purchase price.

CPI- Consumer Price index- an index used to gauge inflation and also frequently in variable rate mortgages and in leases for rent increases.

TI: Tenant Improvements- Credits the property owner gives in rent to allow the tenant to make improvements to their space prior in order to make the property suitable for their intended use. (more on this in the lease section)

CAM: Common Area Maintenance- A reimbursement from the tenant to the owner for some or all of the expenses incurred by the owner for the tenant's portion of the property. (more on this in the lease section)

LOI or Letter of intent: This is a tool used to allow both parties to agree to the general terms that will go into a contract that has yet to be written. It is similar to the contract to lease we use on the residential side that basically spells out what will be in the lease. The LOI is non-binding in the sense that the parties are not required to close the deal, but there are parts of the LOI that are binding like what will and won't be in a future contract that is created.

Chapter 3:

The Customer

On the commercial side you will always be working with an investor. That is a very important thing to know, and it needs to be kept front of mind when speaking to your customer. If the customer is an investor that gives us great insight into what matters to them to start speaking with them. The first step to working with an investor would probably have to be your first interaction with them. Whether this is in person, on the phone, or via email what you say and don't say, what you ask and don't ask will be critical to how the customer perceives you.

We don't want to be seen as just another agent. **We need to realize that most of the time a customer has a certain expectation of an agent,** and that expectation is based on societies default perception of agents, what they have seen in movies and other media, and any experience they might have had working with agents in the past. This is good and it is bad. The bad news is it makes them think agents are typically not very good at what they do, they are overpaid, and easily replaceable. Sadly, many agents make the case why this thought process is accurate every single day. The really good news - the customer is coming in with exceptionally low expectations of us. It would seem we need to give a lot of thought to that initial interaction. It will be the place where we have the opportunity to show the customer we are not just like those other agents out there. We need to establish early on that this interaction is different than what they expected.

The next thing we need to do it to take the temperature of the investor. We have to figure out if there is only one series of things we should say to an investor or if our presentation needs to vary based upon the investor we are talking to. The obvious answer is it needs to vary. There are many things that will require you to alter your presentation to the customer. The first one to consider, which will make the biggest difference in how you proceed with them will be:

1. Are they a new investor?
2. Do they have investment experience?
3. Do they have previous real estate investment experience?

I know that may appear to be the same question in three different ways but the answers to those questions will not always be the same for each investor and completely different strategies are required for each one. **The strategy we employ needs to make US the best possible asset for our customer.** To figure out which of your skills would be help the customer, we need to identify the customer type, their skill level, and adjust our presentation to give them what will be most helpful to them. Here is a chart identifying the various possible experience levels and what we need:

Investor type	Our focus needs to be	What they need
New Investor	Education	To learn and know that we know the process
Experienced not in RE Investor	A case for our product	The reasons why real estate is such a great investment
Experienced RE Investor	A case for us as an agent	Why we are not just like every agent out there

Next, we need to consider what experience they have that may in some way mitigate their risk as an investor. In other words, do they have any life experience that would make them more familiar with one type of investment property over another one. The simple answer for most investors is "yes" when it comes to residential real estate. Most people have either owned or been a tenant at some point in their life. **This experience gives them insight into how that type of investment would work**. They would have an idea of:

- What owning a home is like
- What a lease looks like
- What things a landlord should be responsible for
- What things tenants should be responsible for?
- What paying rent is like
- What type of repairs are common?
- What repairs may cost

- What type of excuses tenants give
- What things a landlord can and cannot do

All of these would be things they would need to learn for a different type of property. In other words, these things wouldn't necessarily be the same if we were discussing a strip center as opposed to a residential property. So why doesn't everyone just buy residential to invest in? The answer is that many people do, and for this reason there is strong investor demand for these properties. This usually drives the prices up so that at some point only the investors that run a very "tight ship" on their properties can make a very decent return. With other investment types it would give you access to other markets that are not as inundated with investors. Many of these other types of investment can offer higher rates of return to an investor that knows how to properly run them. Once again, we are doing a risk and return analysis.

When it comes to figuring out the investor there are a few things that we need to sort out with each individual as they come:

- **What matters to them?**

It is easy to just say risk and return but that does not do this issue justice. Some investors are more risk-averse than others. Some find certain risks, which are normally not considered high, unacceptable while being willing to accept other higher risk things without batting an eye. People are different and investors are people. For this reason, we need to see what things they like and don't like in the market. If they are new, we need to see what things they think are risky and either build our purchase around those or show them how best to mitigate those risks, so they feel comfortable moving forward. If they are a seasoned investor, then we need to see what things they have done and what things they feel comfortable with. There is still room for suggestions but typically this investor will be more set in their ways and less interested in guidance.

- **What experience do they have?**

We discussed this briefly before, but we want to find out what type of real estate investment they have done in the past. Each property type of real estate has unique nuances that need to be learned to maximize a properties performance. A medical office building is different than a regular office building as medical tenants have specific things they typically want that in some ways will differ from a general office building. That office building is very different from a strip store. Not just the types of businesses but also the leases, tenant improvements and many more items. If we then compare that to buying a duplex you can see that the type of experience they have can give them a leg up on a successful venture.

- **What are they looking for?**

This ties very closely to the question above, but it also applies to risk, rate of return, as well as property class, and type. The answer to these sorts of questions gives you a good idea who you are dealing with and what you need to do to make them a happy customer. Knowing the market well and having a sense for what kind of rates of returns a buyer can expect from different property types can be a huge help in showing them you are worth talking to.

- **Does it match their experience and budget?**

Sometimes people have a caviar appetite on a Mc Donald's budget. Sometimes the middle-aged career accountant wants to become an astronaut (hey both jobs start with an "A" how hard could it be). Just because someone wants something does not make it possible, and just because someone really wants to do something does not make it a good idea. Your job is to make them aware of the risks and advise them on how best to minimize them. At times that may mean suggesting they move away from the idea they came walking in the door with and instead focusing on a better fit for the resources they bring to the table.

- **What is the investor looking for from us?**

Regardless of which type of investor you are dealing with the customer wants somebody who knows their stuff. If you know what you are talking about the customer will be interested. **In reality, the customer always wants an agent that knows more than they do about real estate and the market**. They are paying a commission for a real estate market expert and that is what we need to show them to make them feel they have gotten their monies worth out of our collaboration.

- **Do you have what it takes to earn their business???**

Based upon the above description of what the customer is looking for the question you need to ask is if you have the goods to match what the customer is after? If the answer is "no", "maybe", or "I don't know" then luckily, you're in the right place. We are going to show you exceptional market insights to share with your customers to show them you are truly worthy of their business.

Chapter 4:

The Leases

One of the largest differences in commercial real estate is the tremendous variety of property types that can be found within the realm of commercial real estate. Nowhere is that more evident than the incredible diversity in the types and terms of the leases they use. Many leases involve various methods of determining how much rent the tenant pays. Some retail leases even have a portion of the rent determined by the sales of the store that is renting the property. This means landlords make more money during high sales seasons like the holidays and less money in lower retail demand times. This is just one type of specialty lease that exists in commercial real estate. There are many others as well. Let's look now at some of the common differences from residential leases:

- Leases are usually multi year
- Built in rent increases
- Variable rent increases (percentage or based on an index)
- Tenant improvements
- Rights for tenant to renew
- Gross leases
- CAM
- Net Leases
- Double Net leases

- Triple Net leases
- Subdividing space
- Subletting

These are some of the most common differences that exist between residential and commercial leases. Let's look at these individually in more detail.

Leases are usually multi-year

In a residential lease the tenant's major financial commitment to the property they are staying in is usually largely limited to the cost of moving their furniture in and out. In a commercial deal there is far more of an investment usual for the tenant to make the space suitable for their use. There is also money that is spent to let the customers know where the tenant's property is located. If the tenant invests a bunch of money to develop a great following at their location only to have the landlord not renew their lease this is a much bigger financial hardship than exists if a residential landlord will not renew their tenant's lease. Because of the financial commitment and risk that the tenant is taking on they will want a longer-term multi-year lease typically.

Built in rent increases

If the tenant has a multi-year lease, the landlord is going to lose the ability to raise their rent on a yearly basis as market rents, go up and inflation devalues money. For this reason, multi-year leases will always have built in rent increases. This gives the landlord certainty that their income will increase to allow for increasing expenses and to allow their NOI to increase with time as well.

Variable rent increases (percentage or based on an index)

The issue with multi-year leases with fixed rent increases is that they actually benefit the tenant at the expense of the landlord. It may not seem like it on its face, but there is a risk that the landlord is accepting with a multi-year lease that has fixed increases. That is the risk of inflation. The value of money tends to go down with time. The amount it goes down is variable. If the landlord does not account for that it is possible for the tenants' rents to go up and the landlord's profits to go down. This would happen if the expenses for the property were to go up more than the amount of the rent increase due to inflation. The way landlords hedge against this is with a variable rent increase. The lease will typically say something like "the rent will increase annually at a rate of ___% or __________ (an index like CPI) whichever is greater." This protects the landlord and makes sure the lease remains flexible for market conditions.

Tenant improvements

Most spaces tenants rent are not perfectly set up for their intended use. Renovations, repairs, and construction is often needed to make a space ready to the tenant. Landlords know that when tenants improve the space it usually adds value to their property. They also know that it is typically a big expense for the tenant to shoulder the burden to do these expenses out of pocket. Landlords will give tenants a credit in the rent for tenant improvements. This will typically be in the form of rent abatement for a certain number of months. This functions almost as a reimbursement to the tenant for the work they have done to improve the landlord's property.

Rights for tenant to renew

For all the reasons mentioned above tenants often want to make sure they have the ability to stay in a property long term if they are able to build their business around the location. Landlords like longer term leases as it reduces expenses for TI and real estate commissions and also creates greater stability of cash flow. The issue for tenants is they are not certain their business will work in the space long term. Maybe they will need more space or less. Maybe the business wants to relocate based on changes in their business model. The right to renew gives the tenant certainty that their space will be there for them at the end of their lease if they still want it.

Gross leases

This is what most residential leases are. There is an amount of money the tenant pays. Tenant is usually responsible for most, if not all, of their utilities and that is it. The rent amount is not reflective of any expenses it is just the gross amount of rent the landlord charges and all other expenses the landlord pays out of this gross rent number.

CAM

Which is short for common area maintenance. When a tenant is on some version of a net lease they become responsible for some or all of the property's expenses. This includes not just the space they rent but a portion of the common area equal to their percentage of the building rentable square footage. In other words if a building is 10,000 sq.ft and it has 8,000 sq. ft. of rentable space this means there are 2,000 sq.ft. of common area. If our tenant rents 2,000 sq.ft. of the available 8,000 sq.ft they have rented 25% of the building. This means they will be responsible not just for the expenses of their 2,000 sq. ft. but also 25% of the common area (2,000 sq. ft.) which would be an additional 500 sq.ft. We will discuss what expenses we are talking about right now.

Net Leases

Net leases make the tenant responsible for their portion of the real estate taxes for their space plus their portion of the common area. A landlord will charge a lower rent typically and then charge CAM over and above that rent to reimburse them for the property taxes for their space. This lowers the risk to the landlord of the taxes on the building going up as the tenant is the one who is now responsible for them.

Double Net leases

Also called net-net leases. These leases function just like the net lease, but they also make the tenant responsible for the insurance on the property. This again lowers the risk to the landlord of not just the taxes but also the insurance premiums for their property.

Triple Net leases

The name of this is very creative after having seen the last one. These are also called net-net-net leases. As you can imagine, it is putting the tenant on the hook for even more of the property's expenses. This time it is adding to the taxes and insurance the repairs and maintenance. This pretty much isolates the owner from having these variable expenses change their properties cash flow. This only typically leaves the landlord responsible for major capital improvements.

Subdividing space

It is not often that you rent a home to someone, and they ask you if you can split the home in half because they don't want so much space. It happens all the time in commercial. A tenant doesn't need all of the available space so they will ask the landlord to rent them a portion of the space and then find a tenant for the remainder. Often landlords can charge more for the smaller spaces per sq.ft. and this is why they will often do this. The issue becomes making sure the subdividing doesn't run afoul of any of the laws such as ingress and egress requirements, fire codes, etc.

Subletting

Often tenants will want to rent a portion of the space they rent from the landlord to someone else. In residential we see this with folks that want to rent out places and then turn around and rent them out as air B and B's. Most leases will have provisions allowing or disallowing subletting. When working with your tenant customer it is important to make sure you know whether this is something they plan to do or not, and make sure the lease doesn't preclude them from doing it.

As you can imagine all of these things makes for some very interesting analysis for us as agents when we are trying to figure out the net operating income of the property. For that reason, it is very important that you only analyze property types and leases you understand fully. If you don't know how leases work for a certain property type find someone who does and partner with them, get the attorney and or the accountant involved, or refer the customer to another agent that knows how to do the work.

The customer always comes first and if we don't have the "chops" to look out for them then we need to get them someone who can. The one thing that is not acceptable is the customer not being adequately protected.

Chapter 5:

The Analysis & Proforma

To analyze real estate, it takes a bit of work. It is not the cleanest investment out there but if it were super simple, a real estate professional would not be needed. Luckily, it is complicated enough to provide us a bit of job security – **this is where your customer needs your expertise!** We will start with the quick and dirty method of real estate investment analysis, which most agents know, called the Capitalization Rate (but his friends call him Cap Rate). A cap rate is a simple comparison of the net income of a property to its purchase price. It says if I invest this much cash now, I will receive this much net cash flow. The part that makes this a bit of work is we need to go from the gross rent to get the net operating income. In other words, we need to go from GPI to GOI to NOI and then divide that by the purchase price.

This starts with "The Stack"

GPI
-Vacancy factor
=GOI
-Expenses

- Taxes
- Insurance
- Repairs

- Maintenance
- Utilities
- Etc.

An example would be if we had a GPI (gross potential income of $25,000.00 per month and a market with 5% vacancy. We would subtract 5% from the $25,000.00 to get our GOI of $23,750.00 per month. We would then add all of the property's expenses and subtract them from the GOI. Let's say that the expenses came to $10,450.00 per month. We would then subtract that from the GOI to give us $13,300.00 per month. **Investment returns are always calculated annually.** So, we now multiply that monthly NOI by 12 to get an annual income of $159,600.00. We now divide that by what we paid for the property, let's say $2,800,000.00 to get our cap rate of 5.7%. Let's practice a couple of these together:

Class Exercise:

Cap Rate 1

Purchase price $12,000,000.00

Gross rent monthly $95,000.00

Monthly expenses $40,000.00

What is the NOI? ___________

What is the Cap Rate? _______________

Class Exercise:

Cap Rate 2

Purchase price $2,500,000.00

Gross operating income monthly $19,000.00

Taxes $50,000.00 Per year

Insurance $27,500.00 Per year

Monthly repairs $750.00

What is the NOI? ___________

What is the Cap Rate? _____________

Class Exercise:

Cap Rate 3

Purchase price $16,500,000.00

Monthly GPI $190,000.00

Vacancy 5%

Annual taxes 2% of purchase price

Insurance annually $225,000.00

Repairs $3,500.00 per month

Water $2,800.00 per month

Municipal Special assessment $220,000.00 annually (for more than 5 years)

What is the NOI? _____________

What is the Cap Rate? _____________

The problem with Cap Rates is they are only good for comparing real estate to other real estate, and then only really comparable properties in similar areas. *They do not consider rent increases and more importantly it doesn't consider the appreciation of the property*. That's not a problem when comparing two office buildings but if I am using a cap rate to try to show how my investment is better than their stock portfolio, I am seriously undervaluing the wealth real estate can build. We need to see what our investment does over time. We need to show how compounding works and go from ROI to ROR. What we need is TVM.

In order to get a rate-of-return for our investment we need to calculate the compounding effect of increases to rent and value. When someone says rents went up 3 percent they mean from last year. They do not mean since the property was built. To illustrate let's say a brand-new property has a rent of $100 in its first year and the following year rents go up 5%. That means the new rent will be $105. If the next year rents, go up 5% again does that mean another $5? If we were increasing the original rent amount of $100 the answer would be yes, but because we are increasing the current rent of $105 so the increase is actually $5.25. That minor difference (of compounding versus simple interest) over time becomes huge and this is the reason why we must use compounding when looking at our investments.

We can figure out compounding in the short term pretty easily. Could you finish the chart below?

Year	Investment amount beginning of year		Interest rate	Investment amount end of year	
1	$	100,000.00	9%	$	109,000.00
2	$	109,000.00	9%	$	118,810.00
3	$	118,810.00	9%		
4			9%		
30			9%		

You are probably thinking, yes, we could finish this and up until the last line it was no big deal. Figuring out the compounded interest one year at a time is super time consuming and leaves a lot of opportunities for a calculation mistake. There has to be an easier way. By the way if you want to try to solve the chart one year at a time, I will do it my way and we can race. On your marks, get set….no cheating…..Go! The answer is $1,326,767.85. It took me less time to solve this than type it, so you lose. How did I do that? The simple is knowing how to use the right tools.

The financial calculator is a real estate professionals' best tool to analyze their products income potential and is the indicator of a true real estate professional. The calculator I recommend is the HP 10bii financial calculator. This is the one recommended by the most elite real estate agents in the business so let's be like them I figure. Rather than buying a separate calculator it is best to download it directly to your phone. The phone app gives some definite benefits over the handheld model not the least of which is showing you the numbers stored in the memory keys we are going to use. Don't get nervous. We will go through this slowly and this calculator happens to be the easiest calculator to use there is. There are 5 main keys we are going to work with a lot and one other one I will show you that we will use as well. There is also one setting we will need to change, and we will start with that.

Compounding can be done over any time period. We could compound annually which is what we do whenever doing an investment return. We can compound monthly which is what the bank does when calculating a mortgage with monthly payments. For our calculator to give us an accurate answer we need to give it correct information so it can do what we want. The setting we need to adjust to tell the calculator if we are doing a mortgage or investment return is called the payments per year. When originally downloaded the calculator comes preset to 12 payments per year. This mean it is all set to calculate mortgages. We are working on investment return right now so let's change this setting right now. Here are the steps

1. On your calculator type in the number 1
2. Now press the orange shift key which is the third key up on the left side
3. Now press the key that is highlighted in orange P/YR top row fourth column

That is all that's required to do that. You should notice just below the numbers it will read P/YR 1 now. This is how you can verify what setting the calculator is on.

Now on to the 5 keys we need to work with and what the items that need to get saved into them are. The keys we need from the top row, and they are as follows:

1. **N: Number of years or payments** - this key represents the number of years an investment is held or the total number of payments when doing a mortgage
2. **I/YR: Interest rate per year** - This would be the rate of return which we are typically trying to solve with an investment. With a mortgage we would simply put in the interest rate of the mortgage they are getting.
3. **PV: Present Value** - With an investment this will be how much money is being invested today. With a loan how much money is being borrowed.
4. **PMT: Payment** – This would be the annual rent payment amounts for an investment and for a mortgage this is our mortgage payment which is typically what we are solving for with mortgages.
5. **FV: Future Value** – What we will sell for in the future with an investment. With a loan it is how much we will owe at the end of the loan. We also use this to get the loan payoff amount.

One important note is we need to be careful with using the proper signs. If the investor is spending money, the cash flow is negative; if it is money coming in, the cash flow is positive. So, if we were buying a property, the amount we spend to buy the property would go into the PV and it would be a negative number. The amount we receive in rent would be positive as we are collecting that and the amount, we sell for would be positive as we are collecting that as well. One last note here is that when you press clear the calculator will clear the display, but it will still remember the numbers stored in the various keys. To clear those, you will need to press the orange button first and then the C All will be highlighted on the button which is normally the clear button. This will clear everything except the P/YR. That never goes away it can only be changed.

Class Exercise:

ROR 1

- Buy a property for $9,000,000.00
- Hold for a year
- Receive total net annual rent of $810,000.00
- Sell Property for $9,700,000.00
- **Cap Rate = _________**
- **Total Return = __________**

The solution for this is simple. We do the cap rate as normal. Divide the net rent by the purchase price. To get the total return it is just a matter of putting the right numbers in the right place on the calculator. How long is our investment period? 1 year. Push 1 then the N key. How much did we SPEND in the present? $9 M. We spent it though, so it is negative. Type in -$9,000,000 then push the PV key. We receive net rent payments of $810,000. That is money coming in, so it is positive. Type in $810,000 then touch the PMT key. Last thing is the future sale price of $9.7M. Type in $9,700,000 and touch the FV key. To solve just touch the I/YR key to get the total rate of return for the entire investment period.

What if we held the property for two years? What does that do to our rate of return? Touch 2 and then the N key. Now press the I/YR key and voila! Pretty cool right?

Class Exercise:

ROR 2

Buy a property for $840,000.00

Hold for 3 years

Receive total gross annual rent of $98,000.00

Taxes $16,800.00

Insurance $7,800.00

Repairs and Maintenance $8,468.00

Sell Property for $920,000.00

NOI = ___________

Cap Rate = __________

Total Return = __________

This ROI calculation is nice as it takes into account a future sale price and how long we hold the property for the only issue is that rents don’t stay the same and we only have one payment key so how do we account for the different cash flows. We need a different hero to save us from this mess enter the IRR (internal Rate of return). However, can we get this hero to save us you may say? Introducing the CFJ key on your calculator. This stands for cash flow journal, and it allows you to put in different cash flows for each year of the transaction. This will allow us to deal with a much more real-world example like this:

Purchasing a building for $1,500,000.00

Current rent calls for $112,000.00 in NOI the first year and then they go up by 3%

Those leases expire at the end of year two

You anticipate taking tenant rents up by 5%

With annual 4% increases

You will sell at the end of 5 years, and you are projecting 3.5% annual appreciation.

How the heck do we do this?

Class Exercise:

IRR

What you will need to do is push the CFJ key and then press the + button, usually located on the top of the screen, (sometimes elsewhere depending on phone type). That plus button will add a row for an additional year of the investment. We will need the initial cash flow (year O) and then five additional rows (one for each year). I already added the rent increases to make this easy, but you can easily do this by simply adding the percentage necessary to the previous year's rent.

Year 0	**$ (1,500,000.00)**
year 1	**$ 112,000.00**
year 2	**$ 116,000.00**
year 3	**$ 122,000.00**
year 4	**$ 127,000.00**

You are probably asking what happened to year 5. The answer is we need to do a bit more work for year 5. We are getting our full years rent and then selling at the end of year 5 so we will need to add both the rent income and the sale price in year five to get our overall return for this investment like this:

year 5 income	**$ 132,000.00**
Sale end of year 5	**$ 1,782,000.00**
Year 5 total	**$ 1,914,000.00**

IRR for this investment is _______

Chapter 6:

The Due Diligence

The last thing we will look at is the due diligence process. This is basically the inspection period for the property. This period is much longer than the inspection period would normally be on the residential side. Once again that is because the requirement for disclosure is not as present in commercial deals, so caveat emptor (Buyer beware) prevails. There are many things to check and verify during the due diligence process and it is the agent's responsibility to not exceed their expertise in this endeavor. If there is something that needs to be checked or verified and you don't know how then bring in a professional to help.

Some of the things we need to do are:

Make arrangements for property inspections:

Coordinating with the other agent to make sure that inspectors are scheduled and have necessary access to do whatever inspections the buyer wants to be done is part of our job just like on the residential side. The significant difference is the number of inspections that may be needed can be much greater in a commercial deal. For this reason more coordination will often be needed.

Collect the rent roll:

One of the most important things in a commercial deal for income properties is collecting and verifying the rent roll. This may include collecting tenant estoppels (verification that the information the landlord represents as the terms of the lease and funds collected are what the tenant has agreed to). The main thing we need to do is to get the most accurate summary the seller can provide of who is renting what for how much and for how long. The buyer will cross check the actual leases and estoppels against this summary to verify the rent roll.

Collect copies of the leases:

In order to know what the buyer is buying, copies of the leases they will be assuming need to be provided for them to review. This will also serve as verification of the rent roll and lay out the terms under which the tenant leased their space. This helps to make sure the buyer will not be responsible for something unexpected after purchasing the property.

Collect any reports or documentation they have of any issues or ongoing repairs with the property:

If the property has any issues the buyer discovers, or the seller has disclosed, we want to make sure to get any reports the seller has on the issue. This is an important way to reduce the buyer's inspection cost potentially and help the mitigate risk by learning all they can from available data.

Get copies of any service contracts the property is committed to:

Most service contracts survive the transfer of ownership of the property. This means the current service contract of the seller will be the future sales contracts of the buyer. The buyer is basically buying them too. It is important to review them to see if they provide the service the new buyer thinks they will need, to review what the commitments of the buyer will be during the life of the service contract, and to see what the terms and conditions for cancelation will be.

Get copies of any leasing or rental agreements for equipment:

This would be things like washing machines and dryers. These things are frequently leased rather than purchased. Much like the above item, we want to know what the buyer is being committed to prior to purchasing the property and being saddled with leases they may not want.

Verify what special inspections the lender may want:

When our customer chooses to borrow money to purchase a property, they cease to be the only one that decides what inspections are necessary. Their lender will request certain additional inspections they require that the buyer will need to pay for in order to receive their loan. Here are a couple common ones:

Environmental:

The lender knows environmental issues can be super expensive to clean up and so they want to make sure there are none present prior to letting you pledge the property as collateral. Typically, the lender will want a phase one environmental audit. This is just research into the property's history to see if there are any red flags. If none, they will let you move forward. If something raises a concern though they will require a phase two or more that require sampling and actual testing of the ground.

Reserve Study:

The lender doesn't want a situation where you buy the property and then cannot afford to maintain it. For this reason, they are going to want to make sure that the major systems of the property (like roof, parking lot, paint, etc.) are in good repair or are budgeted for properly with reserve requirements for the buyer. They may require the buyer to put extra money up at time of purchase to fund these reserves for replacement, require some of the net rent to be retained to fund it, or a combination of both.

Confirm lender has all they need from buyer and seller:

The lender is going to typically want documents from both the buyer and seller on many commercial deals. The buyer is often buying an ongoing operation and that is what the bank is underwriting. They want to confirm the investments value is there to warrant the amount of money they are being sked to lend. For this reason, they may request all the things listed above as well as additional information. As the agent we need to be proactive in making sure this information is being provided in a timely fashion.

Meet with the local municipality:

The local municipality has a lot of say as to what can and can't be done in their city. Before letting the customer close it is always a good idea to confirm with the local government that there will be no issues with your customer buying the property. Some things you want to confirm would be:

Confirm use is allowed

Just because the property seems perfect for your buyers use, it doesn't mean the city and their zoning restrictions will allow it**. Have a pre-application meeting with the city to make sure there will be no issues.** You can even request a zoning verification letter (ZVL) to help make sure there is no issues going forward with the intended use or proposed building the buyer plans to construct.

No parking issues:

For those that are new initiates into the way municipalities work and think you could cure cancer with your intended use, if there isn't sufficient parking spaces based on their parking requirements, your use will be disallowed. This can be very frustrating but is the nature of what the customer can expect. If they are repurposing a property, they will need to find out what the parking requirements are per sq. ft. of space will be and confirm that the spaces exist for their use.

No fire issues:

The last ones that typically weighs in on if you will be allowed to do what you want is the fire department. The chief will determine if your potential purchase needs anything for fire to be happy with how they will service the property in the event of a fire.

No grandfathering that will be going away upon purchase:

Sometimes properties have a non-complying use that is due to the fact that the law changed while they were using the property in that way and so the non-complying use was allowed to continue under a grandfathering exception. **Often when the property is sold that grandfathering goes away and the property will be required to be brought into compliance**. This needs to be checked as the current use may not be allowed after your buyer buys the property.

Confirm survey was made and reviewed (typically by council):

Typically, this is just you making sure that everybody has done what they are supposed to do. You don't need to review this yourself. You just want to make sure it came in and it was reviewed.

Confirm title search was done and reviewed (typically by council):

Much like the above, confirm it came in and was reviewed. Nothing more for you to do here.

Confirm lien search was done and reviewed (typically by council):

This one is like the above but this one may also have you making trips to try to get lien releases signed or to discuss reductions with the city to help the title company eliminate these.

Negotiate any credits or repairs:

This is just like residential and far less likely that you will need to negotiate this as the attorneys often do this for us, but not always so that is why it's here. Credits are often significantly larger than on residential real estate as the properties are much more expensive. Whatever you negotiate you want to have an attorney type up though. Mistakes can be much more costly on the commercial side.

Make sure any municipal bills are paid or funds are being withheld by escrow agent:

This is typically part of the title companies' job, but as the real estate professional in the room I want to confirm that they have paid or escrowed enough to settle all outstanding invoices.

Closing date is set, and everyone is notified:

This is one more that is similar to residential, but even less likely to have the parties closing at the same time or even the same location. As the agent, our job here is to just help to "herd the cats" and make sure everyone is where they need to be to close the deal.

Those are the most common responsibilities of the agent. There can be more than those listed here as different property types have specialized due diligence items for them. This will be learned with time and why having a partner or professionals and vendors that know what they are doing and can guide you is huge. Always make sure your customer is protected and the experts are reviewing the things that they need to look at. In that way the due diligence does its job of making sure the buyer is getting what they think they are paying for.

Conclusion

As you can see commercial real estate has a lot of things to know to be successful. As the agent you need to make sure to know what you are doing before doing it. This means some form of mentoring or partnering would probably be the best starting place for your commercial career. The one thing that has to happen is the customer has to be informed, represented, and protected by you. This means you need to know your stuff. Your goal should be just that, to each day **strive to have the best information available to help your customers make the best possible decisions** when it comes to their purchases and sales of property. To be their true 'go-to' person for real estate.