

# INVESTING IN COMMERCIAL REAL ESTATE: LOOK BEFORE YOU LEAP

By Jay Rollins

## HAS TODAY'S COMMERCIAL REAL ESTATE TURNED INTO THE NEW TECH STOCKS?

THE FOLLOWING ARTICLE SHOULD BE VIEWED AS COMMERCIAL Real Estate Investing 101. This will help you understand the terminology, basic math and issues, but it is not a substitute for market knowledge.

### THE BASICS

When discussing commercial real estate at a cocktail party or with a broker, here are the terms you must know:

**Net Operation Income (NOI):** This is the key figure by which all commercial real estate is measured. Simply put NOI is determined by revenues minus expenses. In other words, revenue less expenses equals NOI. This is the cash flow the property produces after expenses, but before debt service payment.

**Cash Flow:** This is the NOI less the debt service. This figure is typically quoted in monthly, quarterly or annual figures. So, NOI less annual principal and interest debt payments equals cash flow.

**Cap Rate (Capitalization Rate):** The commercial real estate industry uses the cap rate to determine the value of a commercial property. Simply stated, the cap rate is the annual return (interest rate) the property provides the owner. A cap rate of 6% means that the property is returning a 6% yield on costs, before debt.

In valuing a commercial property, the property's NOI is divided by the cap rate to establish property value, meaning, NOI/cap rate equals property value. For example: NOI \$100,000/6% cap rate = \$1,666,667 property value.

**Stabilized NOI vs. Unstabilized NOI:** When an NOI is referred to as "stabilized," it means the property is fully leased to tenants with long-term leases. Conversely, unstabilized NOI means the property is not fully leased or the tenants in the property are on short-term, perhaps month-to-month, leases.

### PUTTING IT TOGETHER

When buying commercial real estate, investors are generally seeking one of two things:

**Current Return:** The annual cash flow the property provides. In order for cash flow to be consistent, the property must be stabilized or near stabilized.

**Appreciation Value:** The belief or hope that the property will appreciate over time. There are only a few ways for a property to appreciate:

1. NOI increases due to increased rents or decreasing expenses.
2. Investor return requirement (cap rate) goes down.

In recent years the commercial market appreciation has primarily been due to decreasing cap rates.

### THE VARIABLES

Commercial real estate investing is like a puzzle, and all of the pieces need to be linked together for the investor to see a clear picture. Valuation and cash flows can change quickly based on the following:

**Occupancy:** Increases and decreases in occupancy will impact revenues.  
**Lease Rates:** Fluctuations in lease rates, concessions, etc. will affect revenues.

**Market Considerations:** The surrounding area may be improving or deteriorating, which will affect lease rates and occupancy, which will affect revenues.

**Expenses:** Increase in operating expenses will decrease the NOI and will decrease value.

**Cap Rates:** Investor's return profile will dramatically affect real estate value. This return or acceptable yield is somewhat tied to interest rates, specifically to the 10-Year Treasury Bill.

**Interest Rates:** Changes in interest rates will affect both the cap rate and the cost of debt. Increasing interest rates can be a "double whammy" of increasing the cap rate, which lowers the value of the property and increasing mortgage rates, which lowers cash flow.

### BUYING INTO THE PUZZLE

There are many vehicles available for those who wish to enter the world of commercial real estate. These include:

**Public REITs:** This is the easiest and most liquid way to hold commercial real estate. There are hundreds of REITs who specialize in a variety of asset classes. REITs provide a great deal of transparency due to governmental rules and regulations.

**Limited Partnerships:** Investing in real estate as a limited partner has very specific pros and cons. The positives are:

- Typically a localized approach: Chances are you know the asset and are able to drive by it.
- More targeted strategy: As a limited partner, you are generally investing in a specific plan that you can understand.

The negatives can be:

- There is little transparency and the amount of transparency depends on the general partner.
- There is virtually no liquidity. There is no established market to purchase limited partnership interests if you need your money back before the end of the investment period.

**General Partnerships:** If you invest as a general partner, you are purchasing the asset yourself. Pitfalls can include:

- Title to the property
- Environmental issues and deferred maintenance
- Leasing strategies
- Tenant management

*The views expressed in this article are those of the author and not Real Estate Media or any of its publications.*

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