

# Introduction to Commercial Real Estate: *An Overview*

By

*www.The-Commercial-Group.com*



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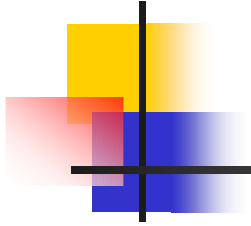




# Agenda

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- Legal Obligations
- Commercial Leasing
- Business Opportunities
- Real Estate Economic Analysis
- Supply – Demand Analysis
- Macro-Micro Economic Analysis
- Apartment Valuation
- Annual Property Operating Data (APOD)
- Effect of Financing on Returns
- Commercial Financing
- 1031 Tax-Deferred Exchanges
- Tenants in Common and Private Annuity Trusts
- Questions & Answers



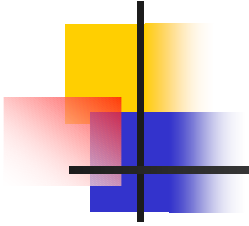
# Legal Obligations



# Legal Obligations of Broker Agent

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1. Fiduciary Duties
2. Common Law Duties
3. Statutory Duties



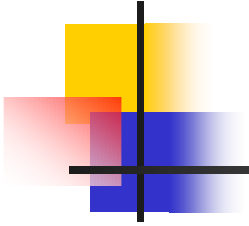
# Commercial Leasing



# Commercial Leasing

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- Lease Space Conditions
- Lease Terminology
- Lease Conditions



# Business Opportunities

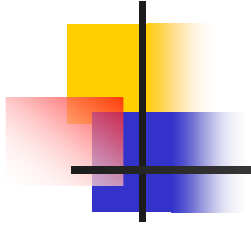




# Sale of Business Opportunities

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- Representation for Seller and Buyer
- Valuing the Business
- Allocations of Purchase Price
- Real Estate Agent's E&O Insurance does **not** cover Business Sales



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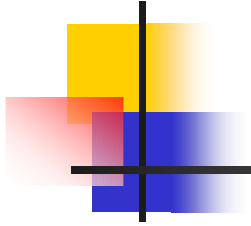
# **Real Estate Economic Analysis**

# Real Estate in a Social, Cultural and Economic Context



Interdisciplinary/Cross-Sectional Approach to Real Estate Market Analysis:

- Biological/Physiological/Psychological
- Philosophical Systems
- Legal Systems
- Political Systems
- Economic Systems
- Financial Systems

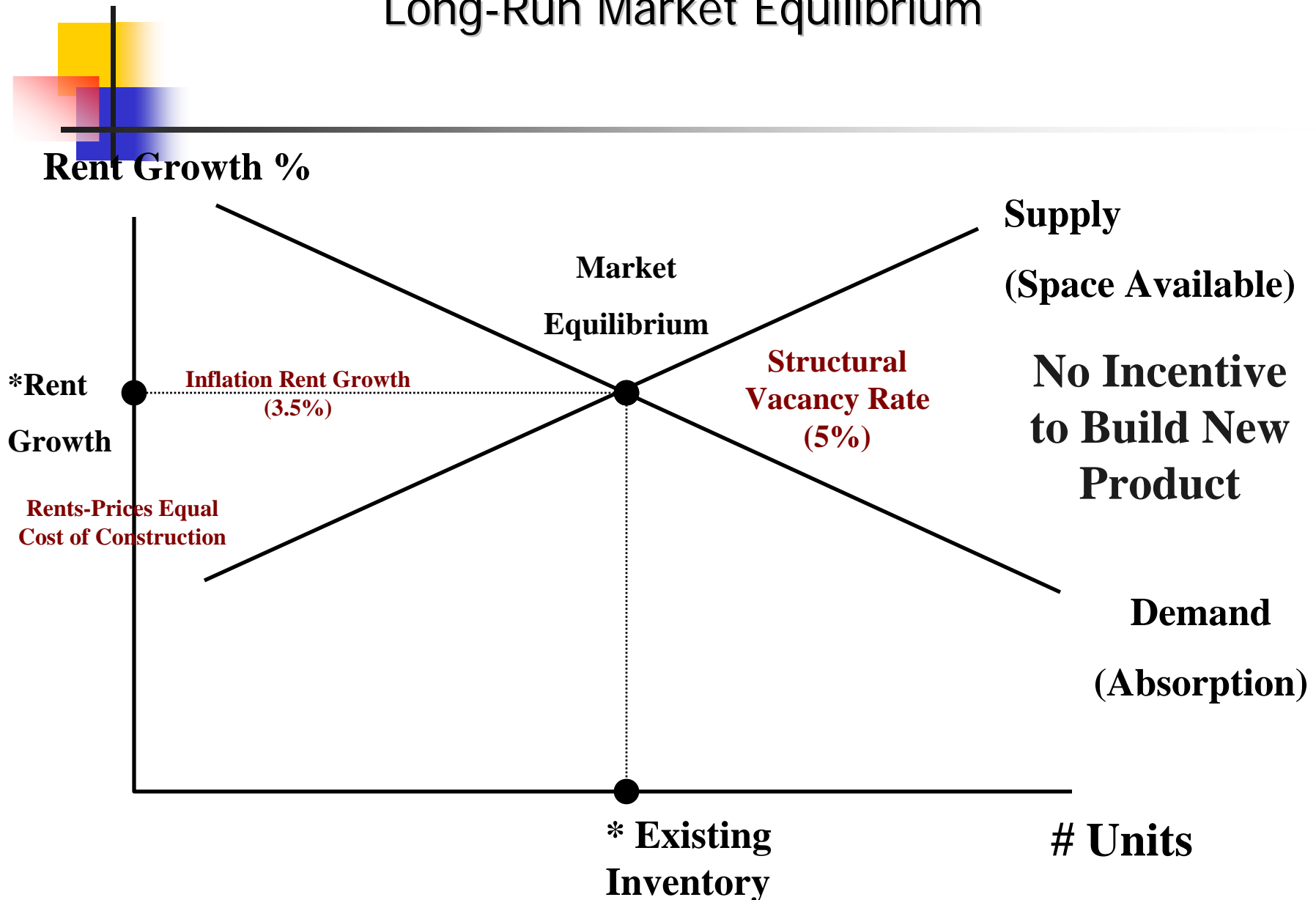


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# **Supply – Demand Analysis**

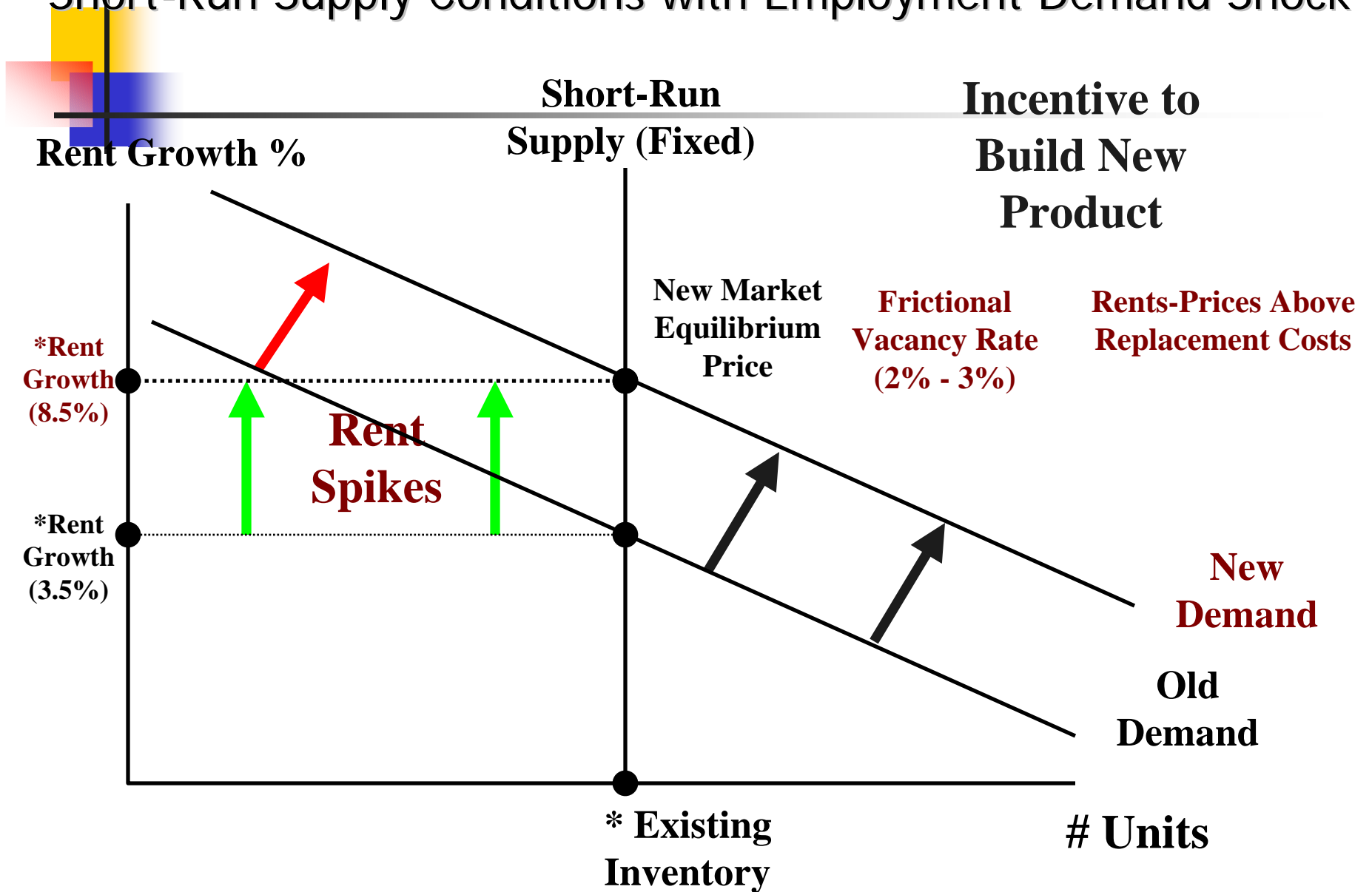
# Real Estate Supply and Demand Analysis

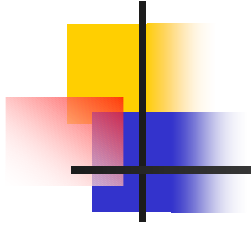
## Long-Run Market Equilibrium



# Real Estate Supply and Demand Analysis

Short-Run Supply Conditions with Employment Demand Shock





# **Macroeconomic (Metro Area) Analysis**



# Economic Environment 2005

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## Bay Area



- Job losses since 2000 exceeds 350,000 -- driven by tech sector, 32% of wages -- job growth strong upward trend
- High home prices, extremely low affordability
- Rental rate declines bottoming, below inflation growth
- Reduced use of concessions, normal turnover

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## Sacramento



- Weakness in economy from state budget deficits, expenditure reductions-layoffs in gov-tech sectors
- Rapidly rising, but more affordable home prices
- Benefiting from continued firm-population in-migration
- New supply being absorbed, more competitive

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## Southern California



- Diversified economic base, exposure to declining dollar, competition from cheap China imports
- Housing demand in excess of supply, price exposure to rising mortgage interest rates
- Orange County improving; Inland Empire regional job leader



# Gross National Product (GDP)



U.S. Bureau of Economic Analysis

# Yield 10-Year Treasury

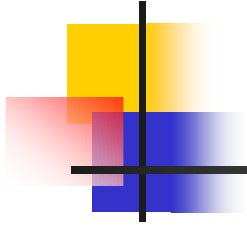
CBOE 10-YEAR YIELD  
as of 8-Jul-2005

Imputed Mtg. Int. Rt.  $4.11\% + 2\% = 6.11\%$



**10-Year Treasury Yield up over 113 basis points since June 03' due to rising inflation expectations, geo-political risk, and government deficit financing**

<http://finance.yahoo.com/>

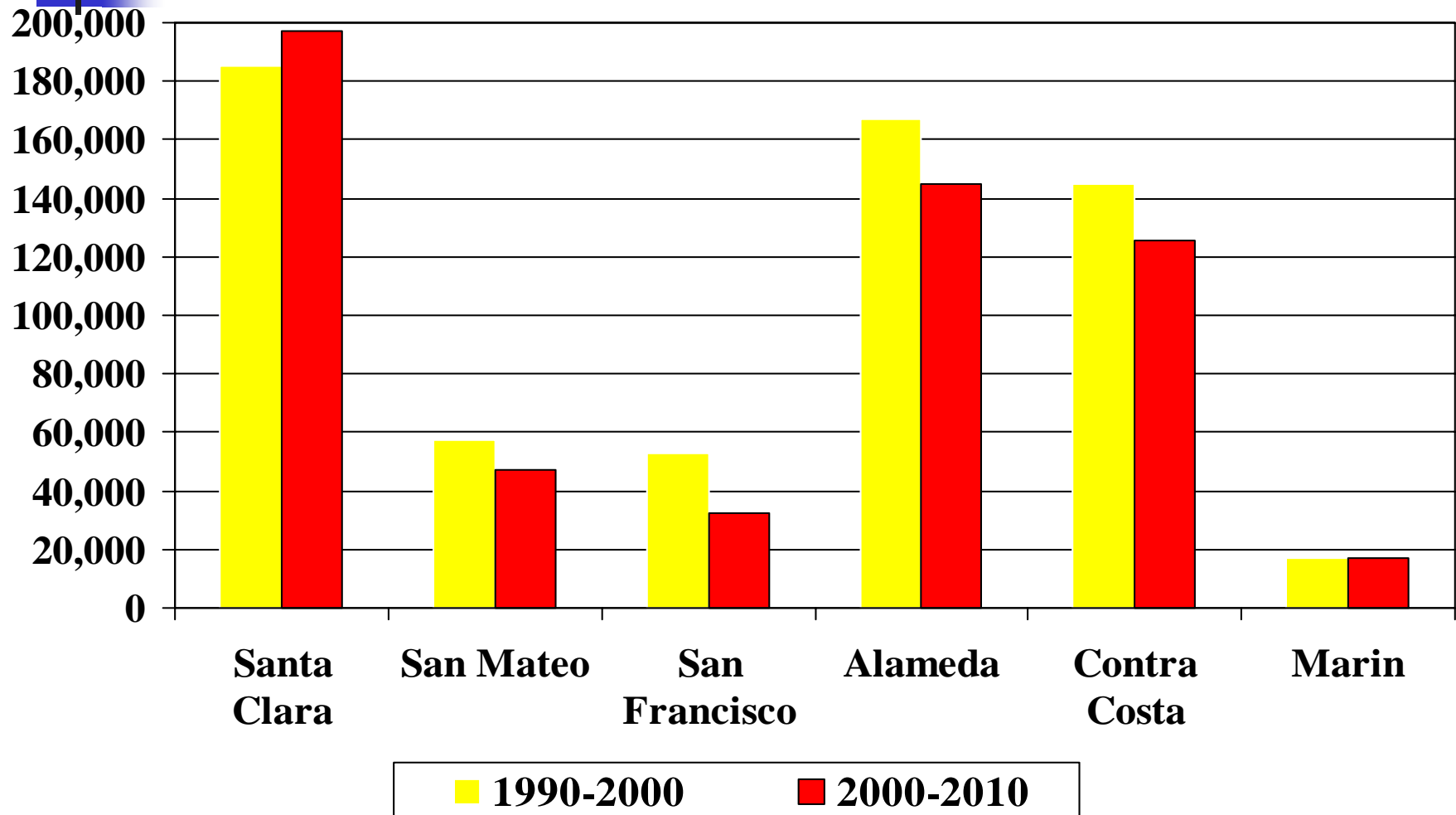


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# **Microeconomic (Submarket) Analysis**

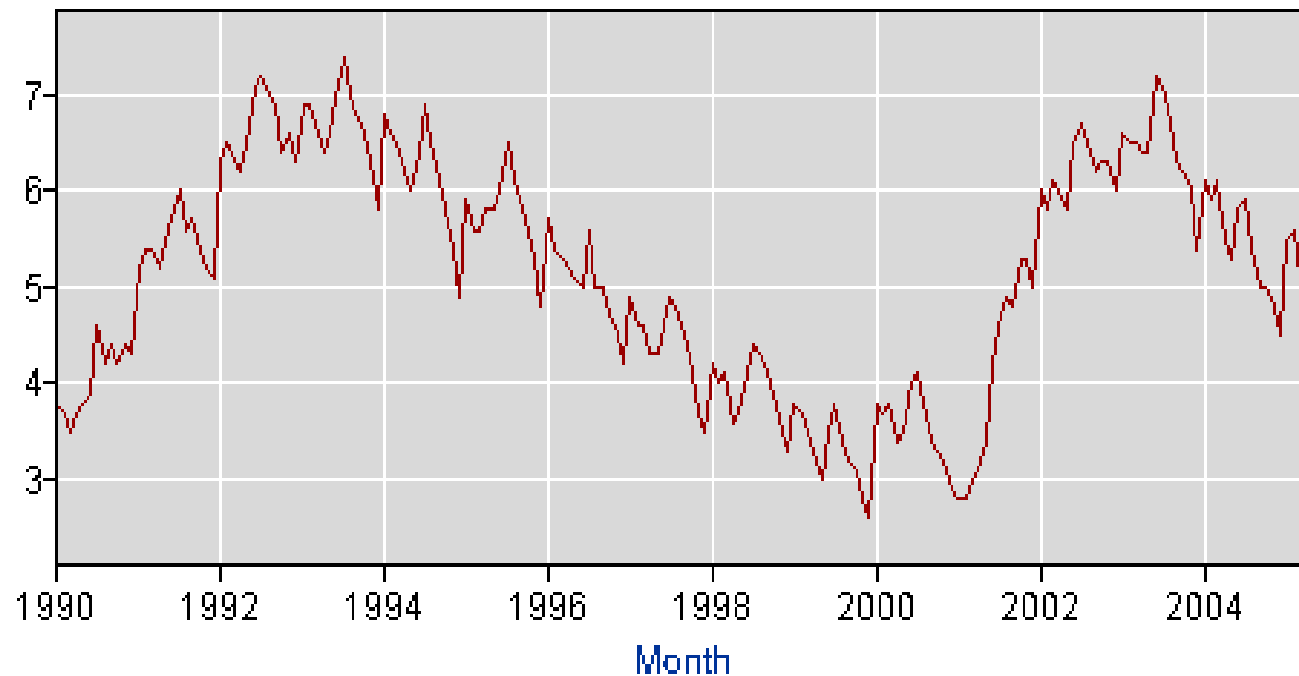
# *Bay Area Demographics*

## Population Change by Bay Area Counties



# Oakland PMSA Unemployment Rate 1990 – 2005

unemployment rate



Source: Bureau of Labor Statistics

<http://data.bls.gov/PDQ/servlet/SurveyOutputServlet>

# Housing Market

## *Median Home Prices*

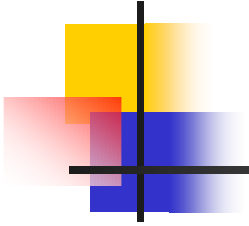
Home Prices	May'04	May'05	Y-O-Y % Ch.
<b>United States</b>	<b>\$172,100</b>	<b>\$188,800</b>	<b>9.7%</b>
<b>West</b>	<b>\$242,000</b>	<b>\$282,900</b>	<b>16.9%</b>
<b>California</b>	<b>\$463,320</b>	<b>\$522,590</b>	<b>12.8%</b>
<b>Bay Area</b>	<b>\$649,240</b>	<b>\$721,730</b>	<b>11.2%</b>
<b>Los Angeles</b>	<b>\$434,790</b>	<b>\$503,450</b>	<b>15.8%</b>
<b>Santa Clara</b>	<b>\$635,200</b>	<b>\$749,000</b>	<b>18.0%</b>
<b>Sacramento</b>	<b>\$306,230</b>	<b>\$379,790</b>	<b>24.0%</b>
<b>Riv.-San. Co.</b>	<b>\$292,060</b>	<b>\$364,700</b>	<b>24.9%</b>
<b>Orange Co</b>	<b>\$662,290</b>	<b>\$704,150</b>	<b>6.3%</b>
<b>San Diego</b>	<b>\$565,030</b>	<b>\$608,300</b>	<b>7.7%</b>

Source: California and National Associations of Realtors and Johnson/Souza Group, Inc.



# Market Vacancy Rate Trends

Asking Rents	Vacancy Rate		*Vacancy Rate	
	2003	2004	2005f	2006f
Los Angeles	5.3%	4.9%	4.5%	4.0%
Orange Co.	4.9%	4.5%	4.4%	3.7%
San Diego	5.2%	4.2%	3.9%	3.4%
Riverside	4.3%	4.1%	3.9%	3.8%
SF Bay Area	7.4%	6.6%	5.2%	4.5%
Sacramento	6.9%	7.7%	6.9%	5.8%
Seattle	7.8%	7.0%	5.6%	4.3%
Denver	10.5%	9.9%	8.6%	7.2%
Phoenix	10.0%	8.7%	7.6%	6.4%



# Commercial Valuation





# Valuation Techniques (3)

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## **Sales Comparison Approach**

Recent sales and listings of similar type properties in the area are analyzed to form the opinion of value.

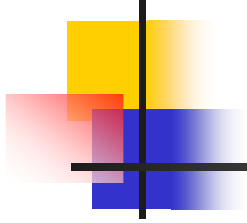
## **Cost Approach**

This approach considers the value of the land, assume vacant, added to the depreciated cost new of the improvement.

## **Income Approach**

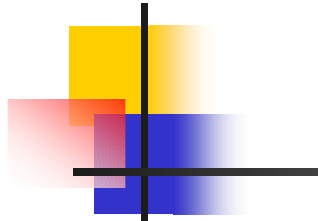
The estimated potential net income of real property is capitalized into value by this approach.

- a) Present Value Approach
- b) Income Capitalization



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# **Annual Property Operating Data (APOD)**



## Annual Property Operating Data

Property Name \_\_\_\_\_  
 Location \_\_\_\_\_  
 Type of Property \_\_\_\_\_  
 Size of Property \_\_\_\_\_ (Sq. Ft./Units)  
 Purpose of analysis \_\_\_\_\_  
 Acquired/Appraised Value  
 Land \_\_\_\_\_ \$ \_\_\_\_\_  
 Improvements \_\_\_\_\_ \$ \_\_\_\_\_  
 Personal Property \_\_\_\_\_ \$ \_\_\_\_\_  
 Total \_\_\_\_\_ \$ \_\_\_\_\_  
 Adjusted Basis as of  12-Jul-85 \_\_\_\_\_

Purchase Price \_\_\_\_\_  
 Plus Acquisition Costs \_\_\_\_\_  
 Plus Loan Fees/Costs  \_\_\_\_\_  
 Less Mortgages \_\_\_\_\_  
 Equals Initial Investment  \_\_\_\_\_

	Balance	Periodic Pmt	Pmts/Yr	Interest	Amort Period	Loan Term
1st	<input type="checkbox"/>	<input type="checkbox"/>	12	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2nd	<input type="checkbox"/>	<input type="checkbox"/>	12	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

	\$/50 FT or \$/Unit	X of G01		COMMENTS/FOOTNOTES
<b>1 POTENTIAL RENTAL INCOME</b>			<input checked="" type="checkbox"/>	
2 Less: Vacancy & Cr. Losses		<input checked="" type="checkbox"/> [7.X % FRI]	<input checked="" type="checkbox"/>	
<b>3 EFFECTIVE RENTAL INCOME</b>				
4 Plus: Other Income (unreliable)				
<b>5 GROSS OPERATING INCOME</b>				
<b>OPERATING EXPENSES:</b>				
7 Real Estate Taxes			<input checked="" type="checkbox"/>	
8 Personal Property Taxes			<input checked="" type="checkbox"/>	
9 Property Insurance			<input checked="" type="checkbox"/>	
10 Off-Site Management			<input checked="" type="checkbox"/>	
11 Payroll			<input checked="" type="checkbox"/>	
12 Expenses/Over-File			<input checked="" type="checkbox"/>	
13 Taxes/Worker's Compensation			<input checked="" type="checkbox"/>	
14 Repairs and Maintenance			<input checked="" type="checkbox"/>	
Utilities:			<input checked="" type="checkbox"/>	
15 _____			<input checked="" type="checkbox"/>	
16 _____			<input checked="" type="checkbox"/>	
17 _____			<input checked="" type="checkbox"/>	
18 _____			<input checked="" type="checkbox"/>	
19 Accounting and Legal			<input checked="" type="checkbox"/>	
20 Licenses/Permits			<input checked="" type="checkbox"/>	
21 Advertising			<input checked="" type="checkbox"/>	
22 Supplies			<input checked="" type="checkbox"/>	
23 Miscellaneous Control Services			<input checked="" type="checkbox"/>	
24 _____			<input checked="" type="checkbox"/>	
25 _____			<input checked="" type="checkbox"/>	
26 _____			<input checked="" type="checkbox"/>	
27 _____			<input checked="" type="checkbox"/>	
28 _____			<input checked="" type="checkbox"/>	
<b>29 TOTAL OPERATING EXPENSES</b>			<input checked="" type="checkbox"/>	
<b>30 NET OPERATING INCOME</b>			<input checked="" type="checkbox"/>	
31 Less: Annual Debt Service			<input checked="" type="checkbox"/>	
32 Less: Participation Payments			<input checked="" type="checkbox"/>	
33 Less: Leasing Commissions			<input checked="" type="checkbox"/>	
34 Less: Funded Reserves			<input checked="" type="checkbox"/>	
<b>35 CASH FLOW BEFORE TAX</b>				

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Prepared for: \_\_\_\_\_  
 Prepared by: \_\_\_\_\_

# Cash Flows

## Cash Flow Analysis Worksheet

Property Name	_____	Purchase Price	_____
Prepared For	_____	Plus Acquisition Costs	_____
Prepared By	_____	Plus Loan Fees/Costs	_____
Date Prepared	13-Jul-05	Less Mortgages	_____
		Equals Initial Investment	_____

	Mortgage Data		Cost Recovery Data	
	1st Mortgage	2nd Mortgage	Improvements	Personal Property
Amount			Value	
Interest Rate			C. R. Method	SL
Amortization Period			Useful Life	33
Loan Term			In Service Date	1-Jan-02
Payments/Year	12	12	Date of Sale	December-06
Periodic Payment	-	-	Recapture	
Annual Debt Service	-	-	Investment Tax Credit (\$\$ or %)	
Loan Fees/Costs				

Toggle Highlighting

Toggle the explanatory high red comments by using the (Suggest turn off before pr

### Taxable Income

End of Year :	1	2	3	4	5	6
1 Potential Rental Income						
2 -Vacancy & Credit Losses						
3 =Effective Rental Income						
4 +Other Income (collectable)						
5 =Gross Operating Income						
6 -Operating Expenses						
7 =NET OPERATING INCOME						
8 -Interest - 1st Mortgage						
9 -Interest - 2nd Mortgage						
# -Participation Payments						
11 -Cost Recovery - Improvements						
# -Cost Recovery - Personal Property						
# -Amortization of Loan Fees/Costs						
# -Leasing Commissions						
15 =Real Estate Taxable Income						
# Tax Liability (Savings) at 36.0%						

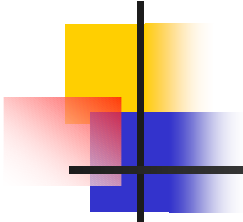
### Cash Flow

17 NET OPERATING INCOME (Line 7)						
# -Annual Debt Service						
# -Participation Payments						
# -Leasing Commissions						
# -Funded Reserves						
# =CASH FLOW BEFORE TAXES						
# -Tax Liability (Savings) (Line 16)						
# =CASH FLOW AFTER TAXES						

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# Mortgage Payoff and Sales Alternatives



## Alternative Cash Sales Worksheet

Mortgage Balances					
End of Year:	1	2	3	4	5
Principal Balance - 1st Mortgage					
Principal Balance - 2nd Mortgage					
TOTAL UNPAID BALANCE					

Calculation of Sale Proceeds			
PROJECTED SALES PRICE			
	(At 9. % cap)	(At 10. % cap)	(At 11. % cap)

# Calc. Basis, Gain and Income (for each Sales Price)



## CALCULATION OF ADJUSTED BASIS:

- 1 Basis at Acquisition ▶ \_\_\_\_\_
- 2 +Capital Additions ▶ \_\_\_\_\_
- 3 -Cost Recovery (Depreciation) Taken ▶ \_\_\_\_\_
- 4 -Basis in Partial Sales ▶ \_\_\_\_\_
- 5 =Adjusted Basis at Sale ▶ \_\_\_\_\_

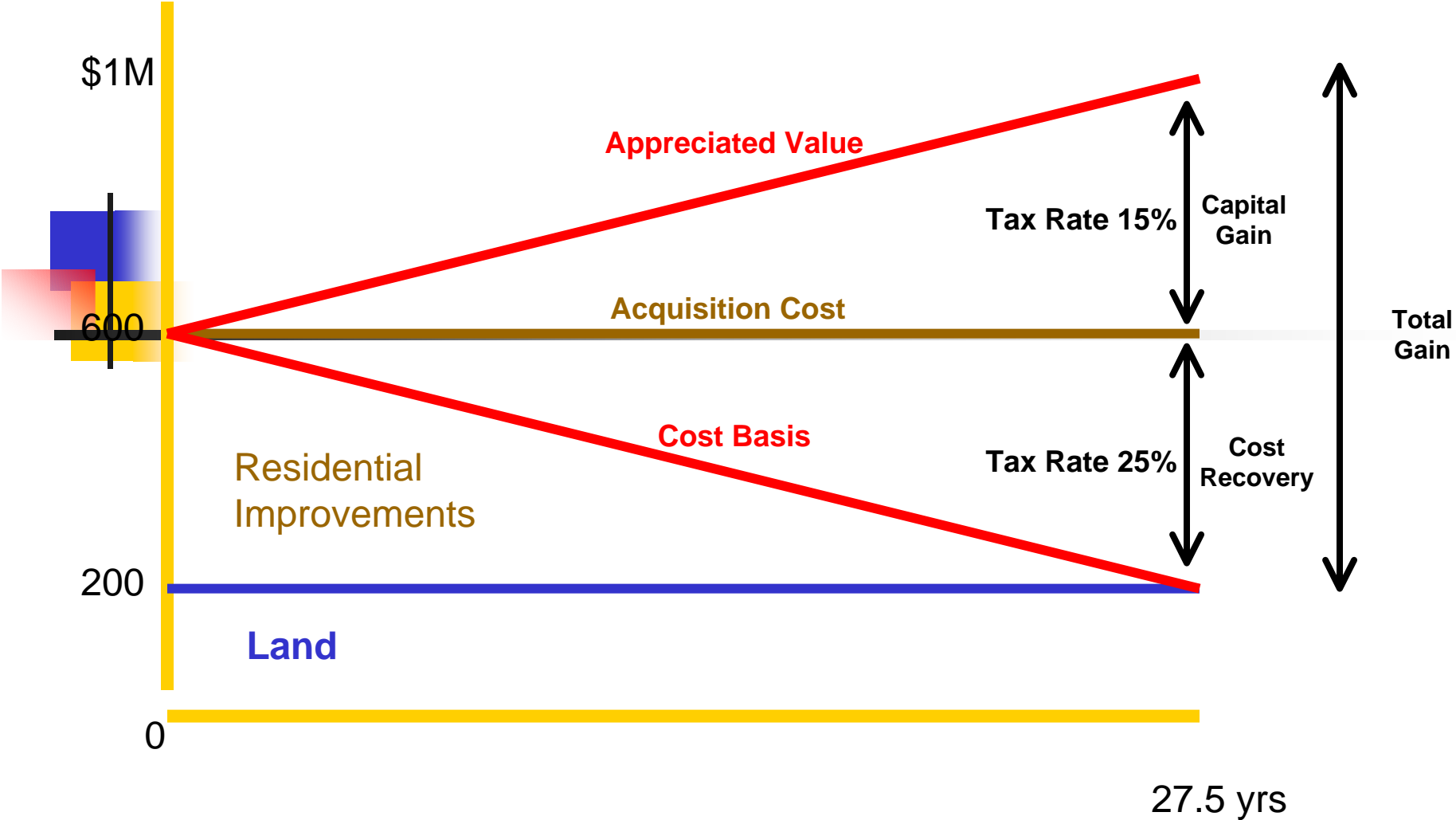
## CALCULATION OF CAPITAL GAIN ON SALE:

- 6 Sale Price ▶ \_\_\_\_\_
- 7 -Costs of Sale ▶ \_\_\_\_\_
- 8 -Adjusted Basis at Sale (Line 5) ▶ \_\_\_\_\_
- 9 -Participation Payment on Sale ▶ \_\_\_\_\_
- 10 =Gain or (Loss) ▶ \_\_\_\_\_
- 11 -Straight Line Cost Recovery (limited to gain) ▶ \_\_\_\_\_
- 12 -Suspended Losses ▶ \_\_\_\_\_
- 13 =Capital Gain from Appreciation ▶ \_\_\_\_\_

## ITEMS TAXED AS ORDINARY INCOME:

- 14 Unamortized Loan Fees/Costs (negative) ▶ \_\_\_\_\_
- 15 + ▶ \_\_\_\_\_
- 16 =Ordinary Taxable Income ▶ \_\_\_\_\_

# Tax Treatment of Gains





# Time Value of Money

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End of Period	
0	(Initial Investment)
1	Payment
2	Payment
3	Payment
4	Payment
5	Payment
↓	
n	Payment + Sales Proceeds

I/YR = 0.00 %

NPV @ 0.00% = \$0.00



# How to Calculate It



Microsoft Excel - CCIM Financial Calculator V 3.5

Input	
YEARS	0
P/YR	12
N	0
I/YR	0.00%
PV	\$0.00
PMT	\$0.00
FV	\$0.00
Beg 1/End 0	0

EOP      \$

0      PV = 0.00

1      PMT = 0.00

0      PMT = 0.00 + FV = 0.00

I/YR = 0.00%

Clear      N      I/YR      PV      PMT      FV

Ready

# Evaluate IRR and NPV

INTERNAL RATES OF RETURN

## BEFORE TAX

Alternative 1		Alternative 2		Alternative 3	
n	\$	n	\$	n	\$
0		0		0	
1		1		1	
2		2		2	
3		3		3	
4		4		4	
5	+	5	+	5	+
IRR= Zero		IRR= Zero		IRR= Zero	
NPV= \$0		NPV= \$0		NPV= \$0	
@ 0.%		@ 0.%		@ 0.%	

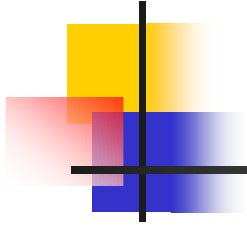
## AFTER TAX

Alternative 1		Alternative 2		Alternative 3	
n	\$	n	\$	n	\$
0		0		0	
1		1		1	
2		2		2	
3		3		3	
4		4		4	
5	+	5	+	5	+
IRR= Zero		IRR= Zero		IRR= Zero	
NPV= \$0		NPV= \$0		NPV= \$0	
@ 0.%		@ 0.%		@ 0.%	

Cap rate used on Sale = 9.0%

Cap rate on Sale = 10.0%

Cap rate on Sale = 11.0%



# Effect of Financing on Returns

# **IMPACT OF LEVERAGE**

## **BEFORE AND AFTER TAX**

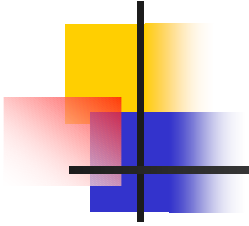
	<b><u>REAL ESTATE W/O FINANCING</u></b>		<b><u>REAL ESTATE WITH FINANCING</u></b>
<b>BEFORE TAX YIELD</b>	12.25%	57%	19.21%
<b>AFTER TAX YIELD</b>	8.34%	80%	15.02%
<b>EFFECTIVE TAX RATE</b>	32%		22%

# SUMMARY

## Without Financing *V S.* With Financing

Total Capital Invested    \$5,000,000

<u>Measures of Performance</u>	<u>Without Financing</u>	<u>With Financing</u>
Before Tax IRR	12.25%	19.21%
After Tax IRR	8.34%	15.02%



# Commercial Financing



# Kinds of Financing Available

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- Office Buildings
- 5+ Apartment Buildings
- Mixed Use
- SBA Loans (Owner Occupied)
- Non-Profit

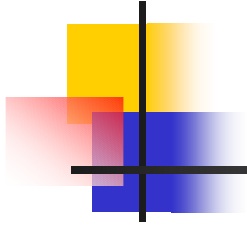


# Loan Qualification

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- Must Qualify all three
  - The Client
  - The Business
  - The Building





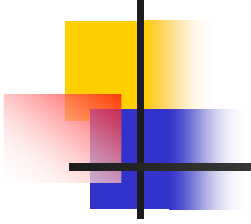
# 1031 Tax-Deferred Exchanges



# 1031 Exchange

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- Tax Shelter for Real Estate
- Exchange like-kind property held for business or investment
- No taxable gain recognized if trading for equal or greater value
- Taxable gain deferred until owner sells property and receives proceeds



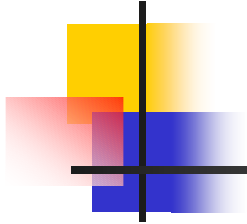
# **1031 Tenants in Common (TIC)**



# 1031 Tenants in Common (TIC) Option

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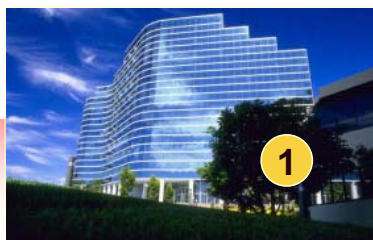
- ❖ Eliminates problems of locating Upleg.
- ❖ Eliminates all management responsibilities.
- ❖ Allows investment grade commercial real estate investment.
- ❖ Provides net cash flow of 7%+. (Some cases guaranteed)
- ❖ Non-recourse debt structure.



# Private Annuity Trust Structure (PAT)

# Establish Private Annuity Trust

## Assets Protected



1

Transfer Property To Trust \$2M

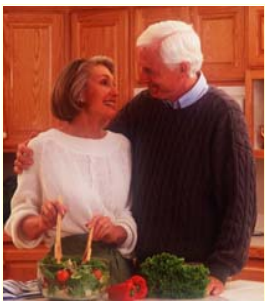
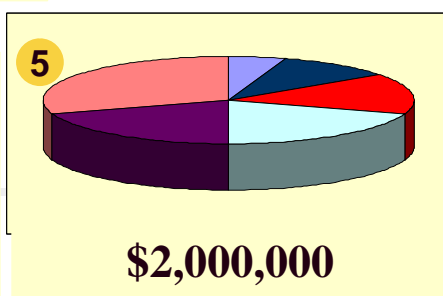
3  
Sell Property For \$2,000,000



4

\$0 Tax

8  
Invest Proceeds In Diversified Portfolio

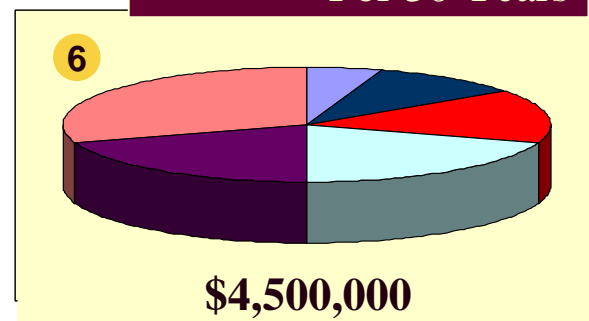


Sellers

2  
Lifetime Income  
\$113,515 Annual Payment  
30 Years = \$3,405,450  
IRS PV = \$2,000,000

Approximate 5% Payout

Actual 8% Earnings For 30 Years



9  
Income Can Be Deferred To 70 1/2

10  
Loans Can Be Taken From Trust

7  
Passes Estate Tax Free To Beneficiaries



Beneficiaries

### Annual Income Recap:

Non Taxable	\$31,313
Capital Gain	\$31,313
Ordinary	\$50,889
<b>Total Income</b>	<b>\$113,515</b>

The 8% portfolio rate we use in all our presentation examples is for illustrative purposes only and is not guaranteed. Past performance is not a guarantee of future performance or results.



## Steps To Establish Private Annuity Trust

Establish Private Annuity Trust - PAT

Transfer Asset To PAT

PAT Provides Lifetime Income

PAT Sells Asset Without Incurring Capital Gains

Sales Proceeds Invested To Fund Lifetime Income

Income Can Be Deferred Until Age 70 ½

Pay Tax Only On Income Actually Received

PAT Assets Protected From Creditors & Lawsuits

Remaining Assets Pass Estate Tax Free To Heirs

# Questions and Answers

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