INTRODUCTION TO COMMERCIAL REAL ESTATE (CRE)

Commercial Real Estate (CRE) refers to properties purchased to generate rental income, typically used for business operations such as office buildings, retail spaces, strip malls, restaurants, and industrial warehouses. It can also include single-family homes, apartment complexes, and vacation properties, provided they are bought to rent.

Why Investors Choose CRE:

- **Income Generation**: CRE provides consistent cash flow through tenant rents, ensuring a stable income.
- **Appreciation**: Investors can profit from increased property value when selling, especially if the property is vacant or has short-term leases. Long-term leases may affect valuation as properties are valued by capitalizing the rental income stream.
- **Tax Benefits**: Property owners can deduct depreciation expenses, reducing taxable income. Losses can offset profits from other income-producing properties.
- **Leverage**: Investors can use borrowed funds (mortgages) to finance a significant portion of the property, increasing potential returns.
- **Diversification**: CRE allows investors to diversify beyond stocks and bonds, offering tangible assets.

Challenges of CRE Investment:

- **Financing Challenges**: Commercial loans have stricter requirements, including:
  - Higher loan-to-value ratios (typically under 70%).
  - Discounted rental income when assessing repayment capacity.
  - Higher interest rates and personal liability for borrowers.
- **Entry and Exit Costs**: CRE transactions involve significant costs, such as:
  - **Purchasing**: Appraisal, title insurance, legal fees, and mortgage taxes.
  - **Selling**: Brokerage fees, real estate transfer taxes, and depreciation recapture tax.
- **Market Risk**: Property values are influenced by rental income and interest rates, which can cause significant fluctuations.
- **Management Complexity**: Managing CRE requires time and expertise in tenant relations, maintenance, and regulatory compliance.
- **Vacancy Risk**: Vacancies can result in income loss and higher holding costs.
- **Illiquidity**: CRE is less liquid than stocks or bonds, making it harder to access cash quickly.

Key Financial Criteria for Evaluating CRE:

- **Cash Requirements**: Initial down payments, closing costs, and property preparations.
- **Financing Costs**: Consider loan terms, interest rates, and any prepayment penalties.
- **Net Operating Income (NOI)**: The income from the property after operating expenses, excluding financing costs and depreciation.

Example:

Annual Rental Income:	$100,000
Operating Expenses:	$ 40,000
NOI:	$ 60,000

- **Cash Flow**: The money remaining after operating and financing costs, including mortgage payments. *Example*:

NOI:	$60,000
Mortgage Payments:	$48,000
Cash Flow:	$12,000

If the CASH FLOW is negative, the investor must plan
How will they fund the gap until the cash flow becomes positive?

- **Taxable Profit**: NOI minus mortgage interest and depreciation expenses. *Example*:

NOI:	$60,000
Mortgage Interest:	$36,000
Depreciation:	$45,000
Taxable Profit (Loss):	($18,000)

Costs to enter and exit CRE – There are many soft costs associated with CRE.

- **When purchasing** appraisal fees, financing application fees, title insurance, legal fees, mortgage taxes, and prepayments for escrowed real estate taxes and insurance
- **When selling,** brokerage fees, legal fees, real property transfer tax, and depreciation recapture tax.

It is common for real estate investments to generate a taxable loss because of the ability to deduct depreciation expenses.

While the tax-deductible loss is an advantage of owning real estate, the sale of the property triggers a tax known as **Depreciation Recapture Tax**.

Rental Real estate income and expenses, which flows to the investor's 1040 tax returns, are reported on Schedule E.

SCHEDULE E (Form 1040)
Department of the Treasury
Internal Revenue Service

Supplemental Income and Loss
(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)
Attach to Form 1040, 1040-SR, 1040-NR, or 1041.
Go to *www.irs.gov/ScheduleE* for instructions and the latest information.

OMB No. 1545-0074
2024
Attachment Sequence No. **13**

Name(s) shown on return | **Your social security number**

Part I **Income or Loss From Rental Real Estate and Royalties**
Note: If you are in the business of renting personal property, use **Schedule C**. See instructions. If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2024 that would require you to file Form(s) 1099? See instructions . . . . . ☐ **Yes** ☐ **No**
B If "Yes," did you or will you file required Form(s) 1099? . . . . . ☐ **Yes** ☐ **No**

1a	Physical address of each property (street, city, state, ZIP code)
A	
B	
C	

1b	Type of Property (from list below)	**2** For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.		**Fair Rental Days**	**Personal Use Days**	**QJV**
A			**A**			☐
B			**B**			☐
C			**C**			☐

Type of Property:
1 Single Family Residence
2 Multi-Family Residence
3 Vacation/Short-Term Rental
4 Commercial
5 Land
6 Royalties
7 Self-Rental
8 Other (describe)

			Properties: A	**B**	**C**
Income:					
3	Rents received	3			
4	Royalties received	4			
Expenses:					
5	Advertising	5			
6	Auto and travel (see instructions)	6			
7	Cleaning and maintenance	7			
8	Commissions	8			
9	Insurance	9			
10	Legal and other professional fees	10			
11	Management fees	11	Download		
12	Mortgage interest paid to banks, etc. (see instructions)	12			
13	Other interest	13			
14	Repairs	14			
15	Supplies	15			
16	Taxes	16			
17	Utilities	17			
18	Depreciation expense or depletion	18			
19	Other (list)	19			
20	Total expenses. Add lines 5 through 19	20			
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file **Form 6198**	21			
22	Deductible rental real estate loss after limitation, if any, on **Form 8582** (see instructions)	22	( )	( )	( )

23a	Total of all amounts reported on line 3 for all rental properties	23a	
b	Total of all amounts reported on line 4 for all royalty properties	23b	
c	Total of all amounts reported on line 12 for all properties	23c	
d	Total of all amounts reported on line 18 for all properties	23d	
e	Total of all amounts reported on line 20 for all properties	23e	
24	**Income.** Add positive amounts shown on line 21. **Do not** include any losses	24	
25	**Losses.** Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	( )
26	**Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, and IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 2	26	

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11344L **Schedule E (Form 1040) 2024**

How is Commercial Property Valued when it has a long-term Tenant?

A property is tied up with a long-term lease is not valued by the bricks and mortar, but by the anticipated rent role. The formula is:

Net Operating Rental Income (NOI) divided by a Capitalization Rate = Property Value.

What is Net Operating Income (NOI)?
The total income from a property, minus operating expenses (maintenance, insurance, and property taxes.) Operating expenses do NOT include mortgage payments.

What is a Capitalization Rate (aka "Cap Rate)?

The Cap Rate is a standard metric to determine a CRE's return on investment (ROI). Commercial real estate brokers often list a property's cap rate when advertising it for sale. It is calculated by dividing the property's Net Operating Income (NOI) by its purchase price.

EXAMPLE: If the NOI is $100,000 and the purchase price is $1,000,000, the cap rate would be 10%.

The cap rate can apply when a property has a long-term lease, tying up its use, but an investor wants to sell it. The cap rate is used to determine the sales price; it represents an investor's expected return from a CRE investment.

The cap rate changes based on economic times and what other investments are available.
For example, assume the stock market is delivering a steady 8% return. Knowing that,
an investor would want a higher return on their CRE purchase.

Assume the investor is looking for a five-point spread above stock market returns, thus 13% and the property is leased under a long-term agreement at $100,000 annually. What price would the investor be willing to pay for the property and achieve their goals? $100,000/.13 = $769,231

Now, let's say that returns in the general marketplace change.

Challenge #1.
The tenant pays $100,000 annually in rent.
Stock market returns average 6%,
The CRE investor wants to earn a 5-point spread over the stock market.
How much would the investor pay for the property?

ENTER YOUR ANSWER: $____________________

Challenge #2 –
The tenant is paying $100,000 annually in rent.
Stock market returns average 10%,
The CRE investor wants to earn a 5-point spread over the stock market
How much would the investor pay for the property?

ENTER YOUR ANSWER: $____________________

SUMMARY

- **The property value decreases as the cap rate increases** because the investor is looking for a higher return on investment.
- **The property value increases as the cap rate decreases** since the investor is willing to accept a lower return.

What type of leases are typical in Commercial Real Estate?

Gross Lease (Full-Service Lease) - the landlord covers most of the property's operating expenses (such as property taxes, insurance, and maintenance) while the tenant pays a fixed monthly rent.
Used for office buildings or small retail properties where tenants prefer predictable costs.

Net Lease - the tenant pays rent plus additional costs, such as property taxes, insurance, and maintenance. The net lease can come in different variations.

- Single Net Lease (N): The tenant pays rent and one additional expense, typically property taxes.
- Double Net Lease (NN): The tenant pays rent, property taxes, and insurance premiums.
- Triple Net Lease (NNN): The tenant is responsible for rent plus property taxes, insurance, and maintenance costs (sometimes even including structural repairs).

Used in retail or industrial spaces where tenants need more control over the property, the landlord seeks to limit their financial responsibility.

Modified Gross Lease - is a hybrid between a gross lease and a net lease. In this arrangement, the landlord and tenant share responsibility for certain operating costs. Some expenses may be included in the rent, while others are paid separately by the tenant. This is common in office leases where the landlord and tenant want to share the responsibility of operating costs.

Percentage Lease is often used in retail properties. In this lease, the tenant pays a base rent plus a percentage of their sales, usually when their business generates a higher-than-expected income. This is common in retail spaces like malls, shopping centers, or restaurants where the tenant's revenue is more variable.

Ground Lease - A ground lease is a long-term lease (often 50–99 years) in which the tenant leases the land rather than the building. The tenant typically builds their structure on the land and is responsible for maintaining it. Ground leases are usually used for significant commercial developments like retail centers or apartment complexes.

Short-Term Lease - A short-term lease typically lasts less than one year and is often used by tenants who only need temporary space, such as pop-up shops or seasonal businesses. It is ideal for companies with temporary needs or testing out a market location. For example, a pop-up shop for a holiday season might sign a 6-month lease in a high-traffic mall to capitalize on seasonal shopping.

What are Typical Types of Fraud in Real Estate?

Anyone investing in real estate needs to be vigilant and aware of everyday fraud activity. While many of the issues below apply to all real estate, some are particularly important for the small investor who is often brought to "a deal" by a friend, relative, or acquaintance.

Below are some of the typical frauds prevalent in real estate.

Mortgage Fraud

- **False Documentation:** Secure a mortgage loan by providing fake financial documents, such as inflated income statements or false appraisals.
- **Straw Buyer Schemes:** Using a third party (the "straw buyer") to obtain a loan under pretenses when the buyer has no intent to repay the loan or may not qualify on their own.
- **Loan Stacking:** Borrowing multiple loans from different lenders using the same collateral without them knowing about the other loans.

Appraisal Fraud

- **Inflated Property Valuations:** A property appraiser may deliberately inflate the value of a property to facilitate a higher loan amount or to create a misleading impression of the property's worth.
- **Kickbacks:** Appraisers or brokers might receive kickbacks for inflating a property's value, making it appear more profitable than it is.

Kickback Schemes

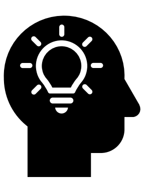
- **Bribery of Contractors or Brokers**: Brokers, contractors, or agents might receive kickbacks for directing clients toward specific properties or services, inflating the cost of work to benefit from the difference.
- **Overbilling:** Contractors or service providers may submit invoices that include inflated charges or services not rendered.

The 2008 real estate market crash occurred mainly because of appraisal fraud and loose lending to unqualified buyers.

In some cases, there were outright kickbacks of brokerage and mortgage fees.

Title Fraud

- **Stolen Property Title**: Criminals may steal the title of a property and then sell it or take out loans using the fraudulent title, leaving the legitimate owner responsible for dealing with the consequences.
- **Forged Signatures:** In some cases, forgeries may be used in deeds, mortgages, or other documents to transfer or encumber property illegally.



Many municipalities offer a program whereby the property owner can register with the city to be notified if someone attempts to change the title of their property. Registering your property for a title change alert is an excellent idea for **senior citizens,** who often are victims of stolen property titles.

Tenant Fraud

- **Fake Lease Agreements:** A tenant may create fraudulent lease agreements to illegally claim possession of a property or gain an undue advantage in negotiations.
- **False Representation of Income:** A tenant may falsify their financial stability, leading to the landlord being misled into accepting the tenant when they might otherwise have been rejected.

Bait-and-Switch Leasing

- **Deceptive Advertising**: Commercial property owners or managers might advertise properties at one price or with specific features only to offer a different (often less favorable) deal once the prospective tenant is committed or has made a deposit.

Zoning Fraud

- **False Zoning Changes:** Misrepresenting or fabricating zoning changes or land use approvals to secure investments in properties that are not approved for the intended purpose.
- **Undisclosed Encumbrances:** A property seller may fail to disclose zoning issues, easements, or other legal restrictions that affect the property's use.

Concealing Defects or Liabilities

- **Failure to Disclose Property Issues**: Sellers or brokers might intentionally hide structural defects, environmental issues (e.g., mold, asbestos), or other problems with the property to secure a higher sale price or avoid liability.
- **Undisclosed Environmental Contamination**: This involves intentionally not disclosing known contamination (e.g., soil contamination, hazardous waste) when selling or leasing the property.

Ponzi Schemes or Investment Fraud

- **False Investment Opportunities:** Developers or syndicators may offer fraudulent investment opportunities in commercial real estate, promising returns that don't exist and using new investor funds to pay returns to earlier investors.
- **Misrepresentation of Investment Risks:** Misleading potential investors about the risks and potential returns on a commercial real estate project to secure funding under false pretenses.

What Contributes to a Successful Real Estate Investment?

Success is more likely when the following factors are present:

- **Strategic Location**: The property is near key infrastructure (e.g., public transportation, highways, airports) and benefits from high tenant demand.
- **Accurate Cash Flow Projections**: The investor has made detailed projections for rental income, operating expenses (property management, maintenance, taxes), and debt service (loan repayments).
- **Financial Flexibility**: The investor has post-closing cash reserves to cover unexpected repairs or expenses.
- **Strong Credit History**: A solid credit score allows the investor to secure favorable financing terms.
- **Long-Term Commitment**: The investor has a long-term outlook and is prepared to tie up capital for seven years or more.
- **Strategic Business Use**: The investor intends to use the property for their own business, gaining a strategic advantage.

- **Reliable Property Management**: The investor has access to a reputable property management company and skilled staff for efficient property maintenance.
- **Attractive to Quality Tenants**: The property appeals to high-quality, long-term tenants with strong financial standing.
- **Diversified Tenant Mix**: Multi-tenant properties (e.g., office buildings, shopping centers) benefit from a varied tenant mix, reducing reliance on any single tenant.
- **Tax Benefits**: The investor can take advantage of depreciation-related tax deductions.
- **Clear Exit Strategy**: The investor has a defined exit strategy, whether it's holding the property for cash flow, selling for capital appreciation, or refinancing to access equity.
- **Insurance Coverage**: The investor can secure comprehensive, competitively priced insurance.
- **Geographic Diversification**: Owning properties in multiple locations reduces the impact of an economic downturn in any single area.
- **Aligned Investment Strategy**: The investor's strategy aligns with their goals—whether focused on income generation or capital gains.
- **Compliance with Regulations**: The property complies with local zoning laws and regulations to avoid costly legal issues.
- **Well-Structured Lease**: The lease terms are favorable, including rent escalations, tenant improvements, and long-term commitments.

What Factors Negatively Impact CRE Profitability?

Several factors can undermine the profitability of CRE investments, often due to insufficient due diligence:

- **Inaccurate Projections**:
    - Costs and timelines for property acquisition.
    - Renovation and maintenance expenses.
    - Tenant turnover costs (e.g., broker fees, repairs, vacancies).
- **Tenant Screening**: Failing to conduct thorough credit checks on tenants can lead to payment issues.
- **Tenant Instability**: Unforeseen tenant issues, such as health or employment disruptions, can affect their ability to pay rent on time.
- **Regulatory Changes**: Not staying updated on local landlord-tenant regulations, which have evolved significantly in recent years.
- **Exit Costs**: Overlooking the expenses of selling the property, including vacancies, legal fees, taxes (capital gains, depreciation recapture, transfer tax), and other costs.
- **Forced Sale**: The need for liquidity may force the investor to sell at a discount.

What legal holding entity is common for real estate investments

Limited Liability Company (LLC) - The LLC is one of the most popular structures for owning commercial real estate due to its flexibility and liability protection.

- **Liability Protection**: It protects the owner's personal assets from business debts or legal actions related to the property.
- **Tax Flexibility**: LLCs are typically "pass-through" entities, meaning income passes through to the individual owners (members) and is taxed on their personal returns, avoiding double taxation.
- **Management Flexibility**: LLCs allow for flexible management structures, which can be helpful when there are multiple investors.

Limited Partnership (LP)

- **Structure**: A Limited Partnership consists of at least one general partner (who manages the property and has entire liability) and one or more limited partners (who invest capital but are not involved in day-to-day management and have liability limited to their investment).
- **Liability Protection**: Limited partners have liability protection, while the general partner retains entire liability unless structured as a limited liability partnership (LLP).
- **Tax Treatment**: LPs are typically pass-through entities for tax purposes, so they avoid corporate tax rates.

S Corporation

- **Tax Benefits**: An S Corporation is a corporation that elects to pass corporate income, losses, deductions, and credits to shareholders for federal tax purposes, meaning the income is taxed at the shareholder's individual rates. (same as an LLC)
- **Liability Protection**: Like LLCs, S Corporations provide liability protection for owners.
- **Restrictions**: An S Corporation restricts the number of shareholders (no more than 100) and the types of shareholders (must be U.S. citizens or residents).

C Corporation

- **Structure**: A C Corporation is a standard corporation taxed separately from its owners. It provides liability protection but comes with the downside of potential double taxation—first at the corporate level, then at the shareholder level when dividends are distributed.
- **Tax Disadvantages**: Due to double taxation, C Corporations are less commonly used for real estate ownership. Still, they may be suitable for larger businesses or those seeking to reinvest profits at the corporate level.

Real Estate Investment Trust (REIT)

- **Public or Private**: A REIT is typically used for large-scale real estate investment, whether public or private. REITs pool capital from many investors to buy, manage, and sell real estate.
- **Tax Benefits**: REITs benefit from pass-through taxation, meaning they avoid paying corporate income tax on the condition that they distribute at least 90% of taxable income as dividends to shareholders.
- **Complexity**: REITs are more complex to set up and manage and are typically used for institutional or larger-scale commercial real estate operations.

Trust (Land Trust or Property Trust)

- **Common Use**: Trusts, especially land trusts, hold property anonymously or separate ownership from control.
- **Liability Protection**: A trust can provide liability protection Depending on the structure.
- **Use**: This is often used when the owner wants to maintain privacy or for estate planning purposes.

Joint Venture (JV)

- **Partnership Structure**: A Joint Venture is a partnership between two or more parties to invest in a specific real estate project. It can be structured in various ways and may include an LLC, LP, or other entities as the operational vehicle.
- **Flexibility**: JVs are flexible but require careful negotiation of terms, especially regarding capital contributions, profit-sharing, and management control.

The **LLC** is the most popular and commonly used entity for small to medium-sized commercial real estate investments due to its flexibility, liability protection, and pass-through taxation.
For larger investments or complex deals, entities like **LPs**, **REITs**, and **C Corporations** might be used.

What is a REIT?

A **REIT** (Real Estate Investment Trust) is a company that owns, operates, or finances income-producing real estate. It allows investors to pool their money to invest in a diversified portfolio of real estate properties, such as shopping centers, office buildings, apartments, hospitals, or hotels, without owning the properties themselves.

REITs are designed to give individual investors access to large-scale real estate investments that would otherwise be out of their reach. They often operate like mutual funds and are required to distribute a significant portion of their taxable income (usually 90% or more) to shareholders as dividends. Investors can purchase REIT shares as they would a stock or bond fund.

There are different types of REITs, including:

- **Equity REITs**: These own and operate physical properties. Their income is mainly derived from renting out space in their properties.
- **Mortgage REITs** provide financing for income-producing real estate by purchasing or originating mortgages and mortgage-backed securities. Their income is primarily generated from the interest on these loans.
- **Hybrid REITs**: These combine the strategies of both equity REITs and mortgage REITs.

Investors purchasing shares in a REIT often diversify between REITS specializing in domestic properties (within the United States) and international properties (outside of the United States). REITs offer a way for individuals to gain exposure to the real estate market without the need to buy or manage properties themselves directly. Many factors impact REIT values, including the cost and ease of borrowing, interest rates, and economic conditions. For example, during COVID-19, when many commercial properties became vacant, and it was unclear whether people would be returning to the office spaces, REIT values dropped drastically. Here are a few popular

Domestic REIT funds:

1. Vanguard Real Estate ETF (VNQ)
2. Schwab U.S. REIT ETF (SCHH)
3. iShares Cohen & Steers REIT ETF (ICF)
4. SPDR Dow Jones REIT ETF (RWR)
5. Real Estate Select Sector SPDR Fund (XLRE)

International REIT funds:

1. Vanguard Global ex-U.S. Real Estate ETF (VNQI)
2. iShares International Developed Real Estate ETF (IFGL)
3. SPDR Dow Jones International Real Estate ETF (RWX)
4. Schwab International Equity REIT ETF (SCHF)

A REIT slogan: “Reap the rewards of real estate without the hassle of dealing with tenants."

How have REITs performed compared to the US stock market over the past 25 years?

Over the past 25 years, Real Estate Investment Trusts (REITs) have generally outperformed the broader U.S. stock market. From 1999 to 2024, REITs achieved an average annual total return of approximately 11.4%, compared to the S&P 500's 7.6% during the same period. The Motley Fool

However, returns were quite volatile

- **1999-2009**: During this decade, REITs demonstrated resilience, especially in the aftermath of the early 2000s tech bubble, leading to favorable returns compared to the broader market. Investopedia
- **2009-2019**: After the 2008 financial crisis, REITs and the overall stock market experienced significant recoveries. However, REITs often provided higher dividend yields, contributing to their competitive total returns.
- **2019-2024**: In recent years, REITs faced challenges due to the pandemic and rising interest rates, resulting in more modest returns. Nonetheless, specific sectors like self-storage and data centers showed resilience. Investopedia

ANSWERS TO

Challenge #1.

ANSWER: Rent of $100,000 is divided by the cap rate of 11%, so the property is worth $909,090

Challenge #2 –

ANSWER: Rent of $100,000 is divided by the cap rate of 15%, so the property is worth $666,666