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This publication is not a solicitation but is an information service from this office.

When ideas in tax and other legal areas in this publication seem to fit your situation, it is recommended that you discuss them with your professional advisor before taking action.

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YOUR COMMERCIAL REAL ESTATE CONNECTION

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THE COMMERCIAL REAL ESTATE INVESTOR

The "Center of the Community"

The shopping center coming into its own as the "center of the community" is a change from the centers built originally. They were a collection of stores for retailing, rather than a newer, more modern "down town" or "town center".

The average shopping center or mall has had certain characteristics in the past:

- The stores in the center usually complement each other rather than compete with one another. A large center often has a major department store or supermarket as an "anchor" tenant. It may also have stationery, drug, hardware, variety stores and other retail operations. It could also have service type operations such as dry cleaners, restaurants, gasoline stations and often a minor repair shop for automobiles.
- It always will have large parking areas, often covering more than half of the entire site.
- In a well-planned center, there will be a unified architectural design with the stores connected by malls. Newer centers have these malls completely enclosed and air-conditioned.
- Built into the original design are special facilities to service the stores, with loading docks and platforms as needed.
- There will usually be a merchant's association in larger centers, responsible for the maintenance of common areas, lighting, cleaning parking lots, landscaping, security and other items of common interest.

How To Set The Value

When a person is either a buyer or a seller of a shopping center, ➠

the question of value for a sale is paramount. How do you appraise such a property? In commercial properties, there are three types of approaches to value commonly used. They are: The Market Data Approach, The Cost or Replacement Approach or The Income Approach.

The Market Data Approach to appraisal is seldom used in a shopping center. It relies on a comparison of sales of similar properties. Since this type of property may be unique in an area, there usually are just not enough properties to compare with it to establish a true value.

The Cost or Replacement

Approach to appraisal is computed on a per-square-foot basis of construction costs to replace the buildings with the current value of land added to the formula. This type of appraisal might be a little closer to the current value than a market data approach.

The Income Approach to value would usually be the most appropriate method for a shopping center. The appraiser would use the net income from the current rents, capitalized at a determined rate to establish the value. The value would then be based on what the property is actually doing financially, and would be more accurate than the other two approaches.

A good appraisal would usually have all three of these approaches to value contained in the report. While the other two should have some bearing on the value, the Income Approach would be given the most attention.

Existing Leases

The existing leases could have an effect future income, even if a good estimate of current value has been obtained. Some things to look for in the existing leases in a shopping center would be as follows:

1. Do the leases contain rent escalation clauses? On what are they based?

2. Are tenants required to keep their stores open, or merely pay the rent? A major chain store could find that closing the store that is losing money could be less of a loss than just paying basic rent for the balance of the lease.

3. Are all of the expenses or common-area maintenance shared among the tenants of the center?

4. Do the leases have the provision that tenants must be members and contributors to the center's merchant's association?

5. Do any of the leases place any burdensome restrictions on the owner? Are there exclusives?

6. Do any leases contain options for renewals? If so, what are the terms?

7. Do any of the leases allow the tenant the right to cancel?

Since leases with major tenants were originally negotiated skillfully with legal experts on both sides, they should now be evaluated carefully by an expert real estate broker and attorney.

This is the very basic data to start an owner or buyer into a transaction on a shopping center. On a specific property, you should be guided beyond this by your real estate professional. ❏

Apartments To Condo Conversions

With the real estate prices stabilizing, conversions of apartments to condos may be back in business. Like homes, value is there. Homes and condos still may be at bargains in price and both may be attractive buys. Condos can be more affordable, particularly for first-time homebuyers.

The demand has been stronger for condos before the temporary turndown. In many markets throughout the country condominiums are still strong competitors to rental apartments. For many people, a third alternative—owning a condominium apartment—is the answer. Tax deductions for mortgage interest and property taxes can be beneficial in bringing down the monthly cost of the unit below a rental unit of the same size and quality.

There are buyers for condo units in most communities. Young singles and couples looking for a first home that is affordable make up some of the buyers. Professionals and empty nesters that can afford the more up-scale units make up another phase of the market. These groups still want the convenience of living in downtown or close-in locations because of the benefits of the urban environment.

Investors

The developer can build a condominium complex from scratch. The time will vary on the location, but it may take years from the start of the first unit. For a quicker time period, the alternative might be a condo conversion.

The Condo Conversion

When an investor is seeking an investment in a new condominium project, the possibility of purchasing an existing rental property for conversion to condominiums should be considered. While building a new property can be profitable, there are many benefits to converting the existing property.

There could be a number of reasons why an owner of a rental apartment property would want to convert his project to condominium ownership. For example, he could want to convert because his tax shelter may have changed because of tax laws. He could be at the point where an increase in rents should be made, but that could heighten the risk of vacancies and turnover in tenants. The owner could just want to make the conversion for profits.

Benefits that an owner or purchaser of an apartment property or commercial building that could be converted to a condominium might seek are:

1. Profit. The per-unit value of a condominium for sale is usually higher than the value of a rental unit. (Value of a rental unit is based on the cash return from the rental of the property. Sale prices are based on a comparable house or unit sales based on square footage and amenities.)

2. An excellent way to free ➠

(continued)

funds for new investments.

3. The owner may be offering his units for sale in a market in which there is a high demand for purchase of housing vs. a low demand for rentals.

If the apartment or commercial building has an older mortgage with interest that is lower than the current market, the lending institution could be helpful with financing. With the conversion completed, the old loan could be repaid before maturity, with the lender then able to reinvest the money at current rates. Also, the lender would be able to invest in mortgage loans on the condominium units, which have been very sound investments over the years.

The Condominium and Co-Operative Abuse Relief Act of 1980 (P.L. 96-399) seeks to minimize the impact of conversions on low-income, elderly and handicapped tenants. The law is restricted to conversion or rental properties and does not cover projects that were originally built as condominiums or co-operatives. The federal law is not applicable if any state or local government opted out of the federal scheme of regulation by enacting appropriate laws.

Advantages of a Conversion

When an owner converts existing rental apartments to a condominium project, there are certain advantages over building a new property. Some of these are:

1. FINANCING. Since the structure is already there, loans may be easier to secure.

2. MARKETING. The owner is estimating market conditions for selling the units only weeks or months ahead rather than years.

3. MATERIALS AND INFLATION. Cost factors will be easier to estimate, again because of the shorter time span. This reduces problems of cost spiraling of labor or materials, labor strikes or shortages.

4. LESS FACTORS IN PLANNING. As in item #1, since the structure is already there, many less cost factors will come into the planning. Only permits, engineering, legal and selling costs, etc., will come into planning.

5. LOCATION can be a definite advantage. Owner can pick older units near a downtown or other desirable location where no open land for construction is available.

6. SALES. Units can be offered at prices that are competitive. Units that are in a sound structure built years ago can offer greater values than newly built units, even after major improvements and refurbishing. Often, according to HUD data, 25% of the units can be expected to be purchased immediately by the existing tenants.

7. LESS PROBLEMS. The structure is already located in an established area and shouldn't be affected by density or zoning requirements.

Benefits to Tenants in a Conversion

As stated, only about 25% of the tenants will be expected to purchase one of the units. There are advantages for this tenant to make this purchase, and this should be communicated in sales information to tenants.

The property is located in a familiar area. The tenant already knows this neighborhood.

After the purchase, the former tenant now has the usual advantages of ownership: A tax deduction on the portion of the monthly payment that is interest. The benefits of appreciation of value of the unit in the future. The reduction of loans each month from the principal payment.

Above all, the new unit owner is free from the problems of rent increases. The monthly payment is an amortized loan, which does not change during the life of the loan. There could be small increases in the charge for common area maintenance, but this is not in the same league with rent increases.

Ideal Conditions for a Condo Conversion

The investor cannot just pick any apartment property that is available. Not every property can be a successful condo. There are certain conditions that should exist for a successful conversion. Here is a checklist of some of the most important factors that should be considered before starting a conversion of an apartment property:

- **The location** would preferably be in a highly desirable residential community. The local market for single-family homes and apartments should be active and doing well. If there are other condominium projects in the area, they should be checked to see how sales are moving.
- **Vacancy** factors and turnover in rentals to tenants are important. If the building is not desirable as a rental property, who will be the buyer of a unit? Both the turnover factor and vacancy factor should be low.
- **Zoning.** Ordinarily, a rental project that complied with local zoning and subdivision ordinances will not face zoning problems when the building is converted, since the conversion is not considered a change in use.
- **Check the leases.** When do leases expire? A few long leases scattered throughout the building could play havoc with a planned conversion. Do the lease applications of the present tenants show people who are prospective buyers?
- **Demand.** Is there a demand for housing in the projected price range of these units?
- **Size of units.** Units should be larger than the average local rental apartment. The prospects will be most likely ex-renters who want more space, or previous homeowners who are used to having plenty of space.
- **Amenities.** Location, as we said. Air conditioning, new carpeting, appliances. Each unit offered for sale should be returned to "like-new" condition.
- **Condition of structure.** A well-built, high quality building is best. Make sure the roof, wiring, plumbing, etc., are in good condition. Hire an engineer for the inspection.
- **Experience.** If the owner is not experienced in condo conversions, have a real estate agent or attorney who is. This type of action is more of a legal problem than a construction or real estate problem. ❏

Downtown Business District

205, 209 & 211 E. State Street, Redlands, CA 92373
(San Bernardino County)
List Price: $1,500,000

Distinct Owner/User or Investment Property consisting of 3 separate addresses, located within the heart of downtown business district. Impeccably maintained masonry structure with attractive brick facade & upgraded amenities throughout: #205 (+/- 4,755 sf.) Currently, occupied by a professional medical service provider. #209 & 211 (+/- 2,040 sf.) Both of these spaces are combined together for a single retail merchant. Note: Tenants are Holding-Over, but would like long-term leases.

Year Built: 1964
Building Size: +/- 6,795 SF
Property Type: Office/Retail
APN / Parcel ID: 0171-071-13
Property Use: General Commercial (C-3)
Building Class: A
Lot Size: +/- 9,200
Price/SF: $220.75
Parking: 12 Spaces (On-Site)

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As commercial brokers, we are part of your professional team. It is our job to create the real estate transactions that will be needed to enhance your estate.