LESSON ELEVEN: ASSET CLASS REVIEW: ALL COMMERCIAL PROPERTIES WERE NOT CREATED EQUAL

1.1 OFFICE PROPERTIES

In general, office buildings are viewed in three classes that relate to the building quality, not location:

- Class A: The newest, nicest, beset in the market.
- Class B: Might be 1970s vintage. Does not have “modern” features.
- Class C: The older, “unkempt” properties.

Office buildings are also viewed in the following categories:

- Urban: Downtown locations, typically with higher barriers to entry.
- Suburban: Fewer barriers to entry, but closer to new employment bases.
- Flex Space: Typically suburban; typically one story and used as part warehouse, part light manufacturing. Typically have driven in doors and some warehouse space.

Factors to consider when Underwriting an office loan:

- Lease-Up Period
  - What will be the absorption pace on new leases?
  - This needs to be calculated by looking at historic absorption levels, the strength of the local economy (job growth), and the supply of office space in the market.
- Occupancy Level: How well leased is the market? Will the subject property under or over perform in the market? Underwriting to the lesser of 95% or actual market vacancy.
- Rent Concessions: If the market is offering concessions, this deduction from revenue must be factored into the pro forma underwriting. Concessions are typically:
  - Free rent
  - Large tenant improvement packages

- Tenant Improvements: The investor must understand the quality of the existing buildout/finishes of the building. Tenant improvements are expensive, and office buildings require the most tenant improvements. Typical improvements are:
  - New leases: Typically the space is re-done at $25-$35 per square foot.
  - Renewal leases: Typically the tenant will ask for new paint or carpet at $5 per square foot.
- Operating expenses
  - The investor must understand the normal expenses required to operate the building in the market.
  - This is described in cost per square foot terms.
  - The investor will need to understand what expenses are "passed through" to the tenant and which are not.
  - Also, leases may contain "expense stops" which limit the amount of expenses that can be passed through to a tenant.
  - Typical office operating expenses are from $9.00-$14.00/ square foot.

1.2 RETAIL PROPERTIES

In general, there are five basic types of retail centers. These retail types are discussed below:

Retail Underwritings:

- Grocery anchor: Viewed as the most stable-everyone has to eat.
- Unanchored retail: Small centers of local tenants – these are the least stable, and trade at the highest cap rate.
- Neighborhood center: Local center, servicing surrounding residential areas, may have a grocery store.
- Power center: A destination center, typically with a combination of "big box" and local inline space.
- Regional malls: Large restaurants centers, typically with multiple anchors being department stores.

Retail Underwritings: Retail specific issues include the following:

- Tenant credit: Tenants have different financial strengths. The better tenants are "credit tenants." The more credit tenants a property has, the more valuable the property.
- Co-tenanting provisions: Retail revolves around consumer sales. Thus, many tenants want to be next or in the same center as large, well known tenants that produce a lot of traffic, such as Target. Smaller tenants will have "go dark" provisions that allow

them out of their leases if the anchor tenant leaves.

- Go dark/recapture provisions: If a tenant goes dark, the landlord will want the ability to “reclaim” or release that space. Some retailers will go dark as a defensive move and purposely not allow competition in the trade area.
- Percentage rents: The landlord collects a portion of the rent based on tenant sales.

1.3 INDUSTRIAL

Industrial properties are viewed as a “safe” asset class because it is very homogeneous. The differentiating factors in industrial properties are:

- Location to major transportation routes
- Ceiling heights: the higher, the better for more storage
- Docks/bays: two types:
    - Bays for tractor trailers
    - Docs for delivery trucks

Rents on industrial properties are mostly driven by supply and demand. It is difficult to drive price via asset quality like in office and multifamily.

1.4 MULTIFAMILY

Multifamily property is viewed as the safest asset class. This is due to the following factors:

- Everyone needs a place to live.
- At some level, the sponsor can drive occupancy by lowering rent.

Multifamily drivers include the following:

- Vacancy factor
- Rent levels (prices)
- Concessions (i.e. free month’s rent, giveaways)
- Actual Vacancy: The amount of unoccupied space or square feet.
- Economic Vacancy: Economic vacancy is defined as the total vacancy when dark or vacant units and concessions are taken into account.

Example:

Total Potential Rent (Full rent at 100% occupancy)

Less:	Total Rent Collected
Equals:	Total Economic Collections

Total Economic Collections

Divided by:	Total Potential Rent
Equals:	Total Vacancy Cost

Economic vacancy cost/total potential rent = Economic vacancy

RETAIL PROPERTIES

TYPES OF RETAIL

GROCERY ANCHOR
Viewed as the most stable - everyone has to eat.

UNANCHORED RETAIL
Small centers of all local tenants - these are the least stable, and trade at the highest cap rate.

NEIGHBORHOOD CENTER
Local center, servicing surrounding residential areas, may have a grocery store.

POWER CENTER
A destination center, typically with combination of "big box" and local inline space.

REGIONAL MALLS
Large restaurant centers, typically with multiple anchors being department stores.

FACTORS TO CONSIDER

TENANT CREDIT
Tenants have different financial strengths. The better tenants are credit tenants.

The more credit tenants a property has, the more valuable the property.

CO-TENANTING PROVISIONS
Retail revolves around consumer sales. Thus, many tenants want to be next or in the same center as large, well known tenants that produce a lot of traffic (like Target).
Smaller tenants will have "go dark" provisions that allow them out of their lease if the anchor tenant leaves.

GO DARK / RECAPTURE PROVISIONS
If a tenant goes dark, the landlord will want the ability to "reclaim" or release that space.

Some retailers will go dark as a defensive move and purposely not allow competition in the trade area.

PERCENTAGE OF RENTS
The landlord collects a portion of the rent based on tenant sales.

INDUSTRIAL

THE DIFFERENTIATING FACTORS IN INDUSTRIAL PROPERTIES ARE

Location to major transportation routes

Ceiling heights: **the higher, the better for more storage**

- Docks / Bays: Bays for tractor trailers
- Docks for delivery trucks

Rents on industrial properties are mostly driven by **supply and demand.**

It is difficult to drive price via asset quality like in office and multifamily.

Industrial is viewed as a "safe" asset class because it is very homogenous.

ASSET CLASS REVIEW

MULTIFAMILY

MULTIFAMILY DRIVERS	VACANCY	ACTUAL VACANCY	ECONOMIC VACANCY
Vacancy factor Rent level (prices) Concessions (i.e.: free month's rent, giveaways)	There are two types of vacancy used to underwrite multifamily properties	The amount of unoccupied space or square feet	Economic vacancy is defined as the total vacancy when dark or vacant units and concessions are taken into account.

MULTIFAMILY HAS TRADITIONALLY BEEN VIEWED AS THE SAFEST ASSET CLASS. THIS IS DUE TO THE FOLLOWING FACTORS:

1. Everyone needs a place to live. **2.** At some level, the sponsor can drive occupancy by lowering rent.

FORMULA

FORMULA FOR DETERMINING ECONOMIC VACANCY
Total Economic Collections = Total Potential Rent (Full rent at 100% occupancy) - Total Rent Collected
Economic Vacancy Cost = Total Economic Collections / Total Potential Rent
Economic Vacancy = Economic Vacancy Cost / Total Potential Rent

OFFICE PROPERTIES

FACTORS TO CONSIDER

LEASE-UP PERIOD
What will be the absorption pace on new leases?
This needs to be calculated by looking at historic absorption levels, the strength of the local economy (job growth), and the supply of office space in the market.

OCCUPANCY LEVEL
How well leased is the market?
Will the subject property under or over perform the market?
Underwriting to the lesser of 95% or actual market vacancy.

RENT CONCESSIONS
If the market is offering concessions, this deduction from revenue must be factored into the pro forma underwriting. Concessions are typically:
• Free Rent. • Large tenant improvement packages.

TENANT IMPROVEMENTS
The investor must understand the quality of the existing build-out/finishes of the building. Tenant improvements are expensive, and office buildings require the most tenant improvements.

TYPICAL IMPROVEMENTS ARE:

NEW LEASES
Typically the space is re-done at $25-$35 per square foot

RENEWAL LEASES
Typically the tenant will ask for new paint or carpet at $5 per square foot.

OPERATING EXPENSES
The investor must understand the normal expenses required to operate the building in that market.
- This is described in cost per square foot terms.
- The investor will need to understand what expenses are "passed through" to the tenant and which are not.
- Also, leases may contain "expense stops" which limit the amount of expenses that can be passed through to a tenant.
- Typical office operating expenses are from $9.00-$14.00/square foot.

In General, Office Buildings are Viewed in Three Classes that Relate to Building Quality, Not Location.

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