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Avoid Costly Surprises When Investing in Real Estate

Leon Y. Tuan
Stein & Lubin LLP

Many investors are interested in purchasing commercial real estate, but are not sure what to focus on when they are evaluating properties. Aside from the asking price and the operating income generated from the property, what other matters should you consider before you buy? If you are looking to invest in commercial real estate, you can help avoid costly surprises by paying attention to the following matters:

Do Your Homework

Make sure that you have a "due diligence period" in your purchase contract so that you can conduct a physical inspection of the property and evaluate other key issues relating to your intended use of the property. A professional inspector should inspect the building (roof, foundation, structural elements, windows, existence of hazardous materials) and building systems (electrical, plumbing, heating and ventilation, telecom and data). If you uncover conditions that need repair or replacement, you will have the opportunity to negotiate with the seller before the end of the due diligence period.

If you intend to renovate the property or to change its use, you or your architect should confirm that you can get the necessary approvals from the city and that the property is zoned appropriately. There may be height, bulk, parking or other restrictions that limit your ability to make changes to the building or to its use.

Your architect should also evaluate whether any proposed renovations will trigger unplanned code upgrades. Some buildings may not comply with current building codes, but have been "grandfathered in" (that is, they are exempt from code upgrades unless the owner makes renovations, in which case the building may lose this exemption). Unforeseen code upgrades can greatly increase the scope and cost of your planned renovations.

Finally, you should review the condition of title to the property to see if there are any use restrictions, easements or other rights that could interfere with your use of the property.

Evaluate the Tenants

The value of your building comes from the rents paid by its tenants, so you need to evaluate their creditworthiness and future business prospects. Review the tenants' financial statements, paying particular attention to their cash flow. If they are having trouble paying employees or vendors, they may have trouble paying their rent. If some of the leases will expire soon and you are unsure whether the tenants will renew, you may need to budget for several months or more of decreased cash flow until you can re-lease the space. You may also need to set aside funds to pay for broker commissions and to build tenant improvements or to provide a tenant improvement allowance for replacement tenants.

Understand Lender Requirements

Many investors will take out a loan to finance a portion of the purchase price of a property, so they will need to comply with the lender's underwriting requirements. These requirements can include a maximum loan-to-value ratio (the maximum amount the lender is willing to lend relative to the appraised value of the property) and a minimum debt-service coverage ratio (the minimum ratio of the monthly net operating income generated by the property relative to the amount of the monthly loan payment).

Some real estate loans are "non-recourse", so if the borrower defaults the lender's only recourse is against the property and not against the personal assets of the borrower. However, most lenders will still require a personal guaranty of "non-recourse carve outs" (for example, the borrower will be personally liable for damage caused by waste on the property, the misapplication of security deposits, or filing bankruptcy, which will delay the lender's ability to take back the property following a loan default). Also, lenders will usually require personal guaranties for construction loans.

You may want to negotiate for an assumable loan. If prospective buyers for your property have the ability to assume an existing low interest rate loan, it may generate more interest in your property. You should also see if the loan contains a prepayment premium, which allows the lender to preserve its yield if you prepay the loan prior to maturity. If there is a prepayment premium, then it may not be economically feasible to refinance your loan if interest rates drop.

Conclusion

Before you invest in commercial real estate, make sure that you evaluate the physical condition of the property, your ability to make needed renovations, and the financial strength of the tenants. You should also understand the lender's requirements if you intend to finance your purchase. These steps can help you avoid expensive surprises down the road.