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Commercial investment real estate: Factors to be considered by a potential investor

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For real estate professionals who lived through the market disasters of the late 1980s and early 1990s, the present turmoil in the real estate, financial, and equity markets may seem far less severe than the media would have us believe. However, the present economic woes are quite real. We are facing strong recessionary trends characterized by increasing unemployment, tightening credit underwriting standards, contraction in the retail and hospitality sectors, uncontrolled energy costs, and a weak dollar.

Is this an environment in which it makes sense to purchase commercial investment real estate? While there may be no simple answer to this question, we are convinced that the following factors must be considered by any potential investor.

Real Estate and Other Equities: It is a simple fact that, over time, real estate investments have performed far better than stocks and bonds. To be sure, real property is far less liquid than stocks and bonds, and real property also incurs costs related to management and maintenance. However, these things are true and in both good economic times and bad. Thus, if one's goal is long term investment, not speculation, the financial tenor of the times does not alter the fact that investment real estate is a proven winner.

Hunting for Bargains: Television advertisements for The Christmas Tree Shops ask rhetorically "Don't you just love a bargain?" There is no arguing with that claim that everyone does! Surely, in the present market, there is an impression that values have softened and the time should be right for finding a "good buy." However, from an investment standpoint, a given property cannot be viewed as a bargain simply because it seems inexpensive. Real estate investing must, in the first instance, fulfill certain economic criteria for the investor. Financial and physical data for the property must yield some assurance that anticipated rates of return on capital are likely to be achieved. Only then, may a bargain be viewed as such.

In truth, given the low interest rates that have prevailed in the recent past, a great many prime investment properties are being held at relatively low carrying costs. As a result, modestly priced high quality investment properties are not plentiful in the current marketplace. Prime commercial investment property is not yet being "dumped." However, some observers of the financing markets contend that many low interest rate short-term notes on commercial properties will come due between now and 2010. The result could be an expanding inventory of such properties in the marketplace. Thus, the conditions for a buyers' market may well be in the pipeline.

The Role of 1031's: The special provision of the federal tax code that allows tax deferred reinvestment of profits from real estate sales in so-called "like kind" exchanges creates a marked advantage for real estate investing. Because they are using pre-taxed funds, 1031 investors often are willing to accept lower cash on cash returns. By using pre-taxed funds to increase their down payments, real estate investors can hedge their risk in high quality properties that are under-performing because of the general, market environment. Larger down payments reduce cash on cash return while increasing cash flow, thus enabling investors to operate in the black while waiting out a soft market. The ultimate rewards in both value appreciation and stronger cash flows are reaped when the market recovers. If you are in a position to do a 1031 exchange, the present weak economic conditions represent an opportunity.

Buying Best of Breed: As the economic guru Jim Cramer proclaims nightly on his television program, always buy "best of breed." The greatest apparent bargains are rarely that. The highest quality investment property, capable of yielding both value appreciation and sustained growth in cash flow will never be given away in the market place. The challenge lies in finding best of breed properties that can be acquired at a reasonable discount below their typical market value. So, is it a sensible time to buy commercial investment property? The answer is "yes," only if : Properties are evaluated by conventional economic criteria, All things being equal, the properties being purchased can be seen as among the best of breed for their market, and the investor has the courage to buy while others are selling or simply sitting on their cash. Finally, the ability to use the 1031 tax code mechanism allows the investor to transcend normal cash flow and loan to value criteria in making acquisitions. If you are comfortable with any or all of these buying criteria, the present soft economy may mean that your time to invest is at hand.

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