AQUILA COMMERCIAL

COMMERCIAL REAL ESTATE INVESTING 101

CHRIS PERRY, SIOR
Principal
perry@aquilacommercial.com

JOE SIMMONS
Senior Vice President
jsimmons@aquilacommercial.com

TABLE OF CONTENTS

Advantages of Investing in

COMMERCIAL REAL ESTATE

- Provides investment diversification
- Can produce high investor yields
- Security of a hard asset that you can see and touch
- Provides some of the best tax advantages
- Ability to borrow a significant amount of the price of the acquisition. Each monthly mortgage payment results in paying down the loan (tenant rent helps pay off the loan)

Risks Associated with Investing in

COMMERCIAL REAL ESTATE

- Leverage increases risk (highly levered property – if rents decrease – Big Problem)
- Much more illiquid than other asset classes
- Property values can be influenced greatly by real estate cycles + macro economic cycles

REAL ESTATE TERMS

BALLOON PAYMENT:
The final payment of the balance due on a partially amortized loan.

BASIS:
The total amount paid for a property, including equity capital and the amount of debt incurred.

CAPITALIZATION RATE:
Is the rate of return on a real estate investment property based on the income that the property is expected to generate and is expressed as net operating income divided by current market value. Also referred to as "Cap Rate".

REAL ESTATE TERMS

CASH FLOW:

The net cash received in any period, taking into account net operating income, debt service, capital expenses, loan proceeds, sale revenues, and any other sources and uses of cash.

DEPRECIATION:

The loss of utility and value of a property (tax benefit).

INTERNAL RATE OF RETURN (IRR):

Is the percentage rate earned on each dollar invested for each period it is invested. It represents a way of measuring the return on an investment over the entire investment period.

LOAN-TO-VALUE RATIO:

The amount of money borrowed in relation to the total market value of a property. Expressed as the loan amount divided by the property value.

REAL ESTATE TERMS

DEBT COVERAGE RATIO:

Ratio of net operating income to annual debt service. Expressed as net operating income divided by annual debt service.

MARKET VALUE:

The most probable price that a property would bring in a competitive and open market under fair sale conditions. Market value also refers to an estimate of this price.

NET PRESENT VALUE:

The sum of all future cash flows discounted to present value and netted against the initial investment.

REAL ESTATE TERMS

CORE:

Lower Risk/Lower Return. The properties utilize lower leverage and tend to generate predictable cash flow. They are typically positioned in strong tier 1 markets, and are easily financed. Lower probability of sustaining loss of investment on core properties, but this also means the potential for outsized returns is also on the lower end.

CORE-PLUS:

Moderate Risk/Moderate Return. Similar to the core properties, core-plus properties generally have few to no issues with securing financing, and are well located and typically have a strong tenant base. The difference is found in a limited elevation of risk and potential for increase NOI, like upcoming lease rollover or light value-add opportunity.

REAL ESTATE TERMS

VALUE ADD:

Medium Risk/Medium-to-High Return. This type of investment is characterized by the opportunity to improve the investment in some way. Typically by improving it's the property physically or increasing the operational efficiency, this will improve the cash flow and returns.

DEVELOPMENT:

Higher Risk/Higher Return. What this entails depends on the specific property, but range from ground-up development to redevelopment of existing structures. The potential for outsized returns here is very high, but accordingly the risk is highest as well.

INVESTMENT VEHICLES

- Limited Partnership
- REITs
- Private Equity Funds
- TIC Investment
- §1031 Exchange

LIMITED PARTNERSHIP (LP)

- A Limited partnership must have at least one GP and a least one LP (limited liability corporations, LLC's treated like LP's)
- Passive Investor
- No involvement in operations
- No liability
- Typical waterfall structure
  - Limited Partners get preferential return on equity and then profit split with sponsor.
- Potential Obligation for future capital calls

PRIVATE EQUITY FUNDS

- An asset class consisting of equity and debt investments in the different property markets allowing multiple investors to pool their funds
- Investor makes monetary commitment over period of time
- Commitment may be called over time or up front
- Generally asset management fee and possible disposition fees involved
- Provides diversification in product types and geographical areas
- Terms of funds vary, but usually 5 – 10 years
- Many require Accredited Investors – Investors that are financially sophisticated per SEC

TIC INVESTMENTS

- Investment by the taxpayer in real estate which is co-owned with other investors
- Since the taxpayer holds deed to real estate as a tenant in common, the investment qualifies under the like-kind rules of §1031
- Typically made in projects such as apartment houses, shopping centers, office buildings, etc.
- Can provide a secure investment with a predictable rate of return on their investment
- Illiquid

§1031 EXCHANGE

- Allows investors to sell a property, to reinvest the proceeds in a new property and to defer all capital gain taxes.
- As the below example demonstrates, exchanges protect investors from capital gain taxes as well as facilitating significant portfolio growth and increased return on investment.
- **Example:**
    - An investor has a $200,000 capital gain and incurs a tax liability of approximately $70,000 in combined taxes (depreciation recapture, federal and state capital gain taxes) when the property is sold. Only $130,000 remains to reinvest in another property.
    - Assuming a 25% down payment and a 75% loan-to-value ratio, the seller would only be able to purchase a $520,000 new property.
    - If the same investor chose to exchange, however, he or she would be able to reinvest the entire $200,000 of equity in the purchase of $800,000 in real estate, assuming the same down payment and loan-to-value ratios.

REITS

- A REIT is a type of security that invests in real estate through property or mortgages and often trades on major exchanges like a stock
- REITs provide investors with an extremely liquid stake in real estate
- They receive special tax considerations and typically offer high dividend yields. Must pay 90% of taxable income out as SH dividends
- It is an investment vehicle for real estate that is comparable to a mutual fund, allowing both small and large investors to acquire ownership commercial properties such as apartment complexes, hospitals, office buildings, timber land, warehouses, hotels and shopping malls

KEYS TO IDENTIFYING & ACQUIRING ATTRACTIVE ASSETS

Physical Characteristics

- Functional
- Well Located
- Newer or opportunity to re-develop

Underwriting

- Below Replacement Cost
- Today's rents + modest rent growth
- Value-add opportunities

Deal Characteristics

- Distressed / Motivated Seller
- Unique Circumstances:
  - Tenant in tow
  - Inability to re-finance