COMMERCIAL REAL ESTATE

What is the single most important part of a commercial investment?

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Contributing Columnist

Many of you reading at home own a business.

Your business address — if it's not a spare bedroom or a corner of the garage — typically is found at a manufacturing building, a suite of offices or a retail storefront.

You either lease or own that location.

If it's a lease, you have a landlord and that landlord — the commercial real estate investor — is the subject of today's column.

Landlords come in all shapes and sizes. Some own very few buildings and have invested their own savings in a commercial real estate enterprise. Others are funded by Wall Street or a pension fund and are extremely bureaucratic.

Regardless of a landlord's holdings, his source of funding or sophistication, the one thing all of them share is their reliance on a property's net income. The income stream — rent minus operating expenses, or net income — provides their return on investment.

I believe the income stream is the most important part of a commercial real estate investment — otherwise, you don't have an investment. You just own an empty building.

A commercial real estate investor considers many aspects of his investment.

The stability of the income stream. Is rent paid by several tenants or one? If an investor owns a 10,000-square-foot building with 10 tenants and one tenant moves out — nine rent payers remain. That's manageable. Conversely, if the 10,000-square-foot space has one occupant, the income is dependent on the health of that tenant. If business ebbs, a costly vacancy may occur. Also, when do the leases expire? A short-term lease — less than three years — creates a potential transition much quicker than a 10-year lease.

Is the income stream above or below the current market? Rents have sky rocketed within the last few months. If a lease was signed two years ago, chances are the rent may be below the market rents today. This is good news if the buildings go dark and you must replace the tenant. You're bound to get more rent. However, if we experience a dip, you may find yourself owning a building with an unsustainable rent, which could be quite costly if your tenant vacates.

What sort of return does the income stream provide? Generally, the net income provides a nice return on the money invested — typically 4-6 percent.

Here's a simple example: Net income is $10,000 per month or $120,000 per year. If this $120,000 per year provides a 5 percent return, the building is worth $2.4 million. Your return may be drastically different. Let's say you bought the building 10 years ago and paid $1.5 million. The same $120,000 in annual net rents yield you an 8 percent return.

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