

Commercial Real Estate  
Investing **101**

# A better way to invest in real estate.

## What is RealCrowd?

RealCrowd offers direct real estate investing opportunities to accredited investors. All properties that are offered are pre-vetted, institutional quality assets managed by the top real estate operators across the United States. A commercial real estate (CRE) investment is any property that produces rental income and is purchased with the anticipation of producing a profit. Apartment complexes, office buildings, industrial distribution facilities and retail properties are all commercial real estate investments.

Investing in commercial real estate has historically produced outstanding returns yet is a *nearly impossible barrier to entry market*, requiring very large amounts of capital; extensive knowledge of how to identify, underwrite and research opportunities; proper networks to access investment opportunities; and the wherewithal to commit a large amount of capital into a single investment. Until now.

## Why Read this eBook?

- This e-book is the culmination of nearly 20 years of experience and over \$3 billion of activity in office, industrial, retail, multi-family and development transactions.
- This ebook will help you formulate the answers to the following questions:
  - Why invest in commercial real estate?
  - What are the types of assets to consider purchasing and why?
  - How do I formulate my own commercial real estate investment strategy?

*Commercial Real Estate 101* is the first of many short and easy to follow eBooks published by RealCrowd with the intent of demystifying commercial real estate. The primary goal of the book is to give investors the knowledge to invest in, what we believe, is the greatest wealth creation asset class in the world - commercial real estate investments.

# Why commercial real estate?

## Real Estate: Quite Possibly The Best Asset Class

Commercial real estate is one of the most dynamic investment classes in the world. Commercial real estate is the only major asset class that produces high yields, significant equity buildup, can be efficiently leveraged for massive gains, has the security of a hard asset that you can see and touch (intrinsic value regardless of an income stream), and provides some of the best tax advantages.

## Real Estate: The Best All Around Asset Class

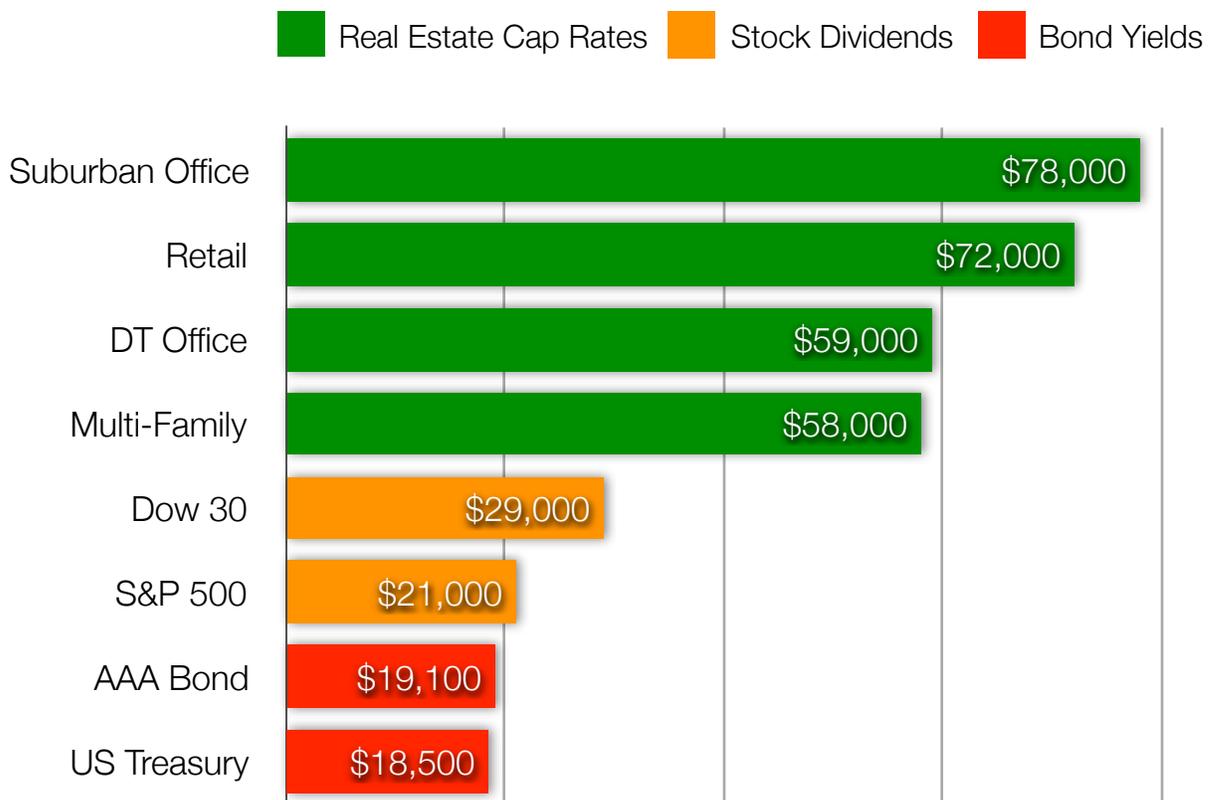


*"The major fortunes in America have been made in land."  
-John D. Rockefeller*

## Commercial Real Estate Produces Significantly More Income

One of the biggest advantages of Commercial Real Estate is the high annual cash return that it produces. In fact, **commercial real estate income stream can produce three times the average stock dividend yield and four times the average bond yield.** The chart below demonstrates the income each asset class produces based on a \$1 million investment.

### Annual Income Produced on a \$1 million investment



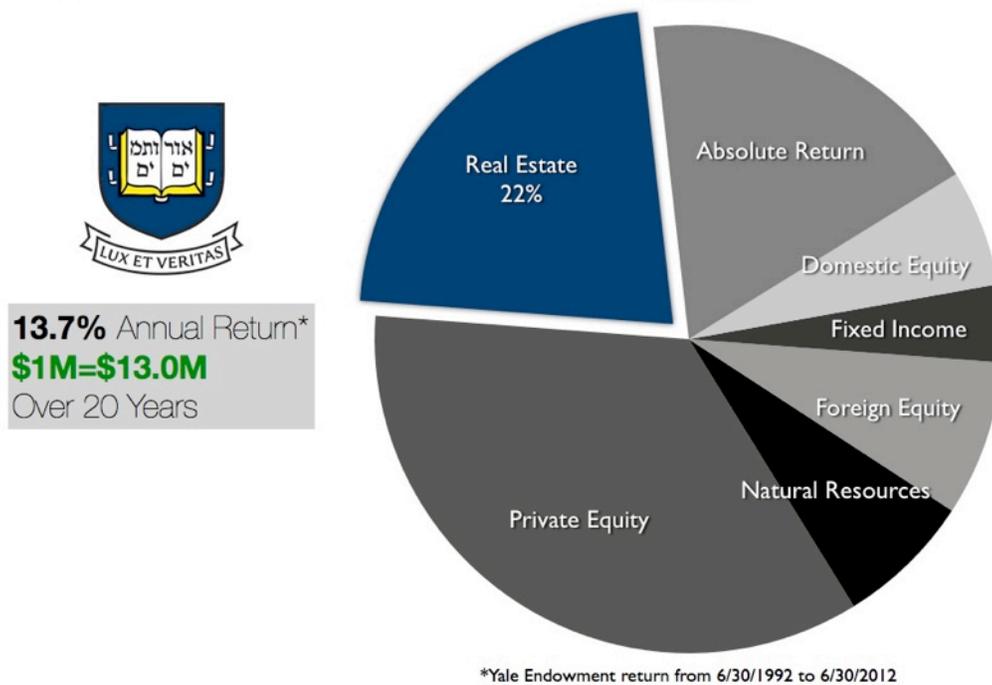
Average Cap Rate Source: Real Capital Analytics 2012 / Average Stock Dividend Q1 2013 / Average 10 Year Bond Yield Q1 2013

Investors use cap rates to measure returns. More detail on cap rates is provided in RealCrowd's Commercial Real Estate 201 eBook.

## Asset Allocation - A Key Role in Determining Results

It is recommended by leading experts that investors have 20% of their investment portfolio in income producing real estate. David Swenson, Chief Investment Officer of the Yale Endowment, a trustee of TIAA-CREF (a Fortune 100 financial services organization), and the author of *Unconventional Success: A Fundamental Approach to Personal Investment* created what is known as the Yale Model which has produced staggering returns of nearly 14% annually. The portfolio has 22% of its assets in income producing real estate investments and Yale is increasing that allocation further.

### Yale Endowment Asset Allocation=**22%** Real Estate



"Asset allocation decisions play a central role in determining investor results...approximately 90 percent of the variability of returns stems from asset allocation, leaving approximately 10 percent of the variability to be determined by security selection and market timing... *Careful investors play close attention to determination of asset class targets.*"

**David Swenson - CIO of the Yale Endowment**

## Commercial Real Estate: A Simplified Look...

Commercial Real Estate is a very simple investment vehicle. The basic premise of making money in real estate is simplified below:

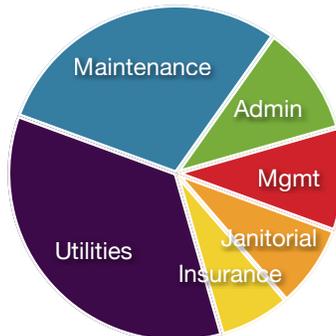
**Tenants Pay Rent**



Tenants pay rent, usually monthly. Revenue can also come from parking, signage, etc.

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**Building Expenses are Paid**



The real estate operator/property manager pays building expenses from the rental income.

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**Investors are Paid**



After expenses are paid, the remaining income is distributed to investors.

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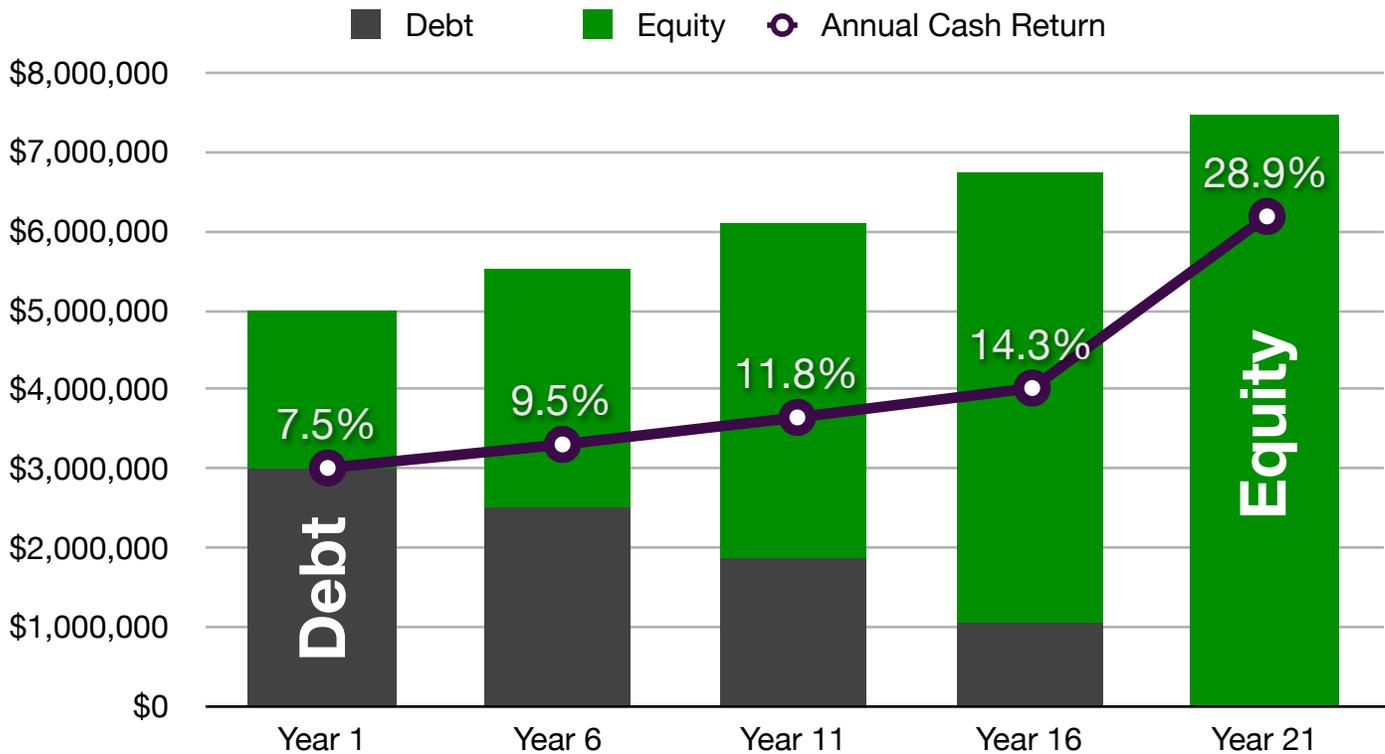
Upon sale of the property, equity is distributed back to investors.

## Real Estate's Amazing Long Term Income Benefit

Unlike other asset classes, commercial real estate is typically leveraged with financing. Sure you can purchase stocks on a margin account or commodities at a fraction of their price, but **only commercial real estate provides rental income that covers debt payments**. This makes commercial real estate an outstanding long-term investment class because as your tenants pay down the financing for you, equity is built up in the asset. Once you no longer have debt payments, your cash return instantly increases multiplying your cash flow multiple times over.

### Holding an Asset Through Loan Payoff Can Produce Massive Returns

<b>Annual Cash Return in Year 1</b>	7.5%
<b>Annual Cash Return AFTER Loan is Paid Off</b>	28.9%
<b>Increase in Annual Cash Return from Year 1</b>	<b>285%</b>
<b>Increase in Total Equity AFTER loan is Paid Off</b>	<b>273%</b>



Although this is a very simplified analysis, this shows the dramatic effect leverage can have on returns. Assumes a 20 year fully amortizing loan, a conservative 2% annual Net Operating Income increase, and 65% LTV.

## Magnify Your Equity Return Using Leverage

Real Estate also allows for magnified equity buildup on a shorter-term basis by using financing, which is illustrated below. If you were to purchase a \$10 million asset all cash and sell the asset in the future at \$11 million, you have made \$1 million profit, **a 10% return.**

However, if you were to purchase a \$10 million asset utilizing only \$1 million of your own money and financing the remaining (allowing the rental income to make the debt payments), then sell the asset, you have also made \$1 million profit, **however achieved a 100% return.**



### \$10M Cash Down and No Financing

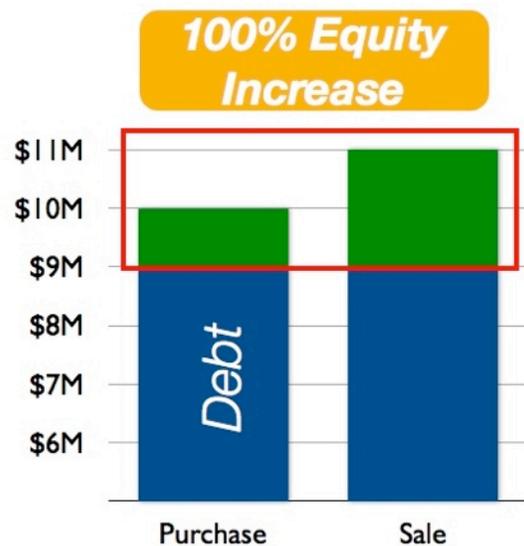
\$11M sale - \$10M purchase = \$1M profit

\$1M profit ÷ \$10M cash down = **10% return**

### \$1M Cash Down and \$9M Financing

\$11M sale - \$10M purchase = \$1M profit

\$1M profit ÷ \$1M cash down = **100% return**



Although this is a very simplified comparison, the analysis shows the dramatic effect leverage can have on returns.

## REITs Versus Direct Real Estate Ownership

Investing in a Real Estate Investment Trust (REIT) is a popular way to “diversify” into real estate. **However when you invest in a REIT you do not actually own real estate**, you own a share of stock in a company. The following are notable attributes of REIT investing:

- **High Fees** - A private REIT can charge up to 17% up front before your investment even touches the real estate. A recent REIT prospectus disclosed the following fees - *sales commissions=6.5%, dealer manager fee=3.5%, organization and offering expenses=2.42%, acquisition fees=1.75% and acquisition expenses=0.96%!!!* **For every \$100 you invested, less than \$85 actually went towards the real estate!** Additionally, a REIT is only required to distribute 90% of the income generated by its properties back to investors, significantly lowering overall returns.
- **Lower Average Returns** - The average publicly traded REIT dividend is 3.4%, significantly lower than average returns from direct commercial real estate ownership. Many individual properties can distribute a cash return ranging from 6% to 12% annually.
- **High Volatility** - Given that REIT shares are stocks traded in the stock exchange, they are subject to the high volatility and market shifts of the stock market as a whole.
- **Lack of Control** - The REIT structure is designed to provide an investment similar to what mutual funds provide for stock investing. Although there is a diversity of assets, there is also a lack of control over which assets are being purchased. Just as many investors have control of investing in individual stocks on platforms like E\*TRADE and Scottrade, they now have similar control over their commercial real estate portfolio through RealCrowd.
- **Less Transparency** - Although REITs have strict reporting guidelines, most investors know very little about the properties in a REIT portfolio. Direct real estate ownership increases the overall transparency of the investments.

If your primary objective is to participate in the numerous benefits that real estate has to offer discussed above, then a REIT does not achieve many of those goals.

# What asset class should I buy?

## There Are Multiple CRE Categories - Which Type Should I Buy?

Now that you know the benefits of commercial real estate investing, which assets should you consider? That answer is that it really depends on what your personal beliefs are about the real estate market. The founders of RealCrowd had the benefit of literally thousands of interactions with investors across the United States that purchased office, industrial, retail and multi-family properties and we have summarized investors' mindset for each asset class below.

Asset Category	Primary Mindset (Why buy this asset class?)
<b>Multi-Family (Apartment Complex)</b>	So long as there are people, there will be a need for housing. As the population grows, demand for housing will increase as well. Adjustments to inflation can be made annually through rental rate increases (except in rent controlled areas). The current generation prefers mobility and are not as apt to purchase a home and settle down, therefore will continue to rent.
<b>Office Buildings</b>	The United States economy will continually be moving away from manufacturing and agriculture to a service focused economy. The tech world thrives in offices and collaboration is key. More companies are opting to bring their workforce back into the offices versus letting them work from home (e.g. Yahoo).
<b>Industrial Buildings</b>	As eCommerce continues to grow, so will demand for industrial distribution buildings. Amazon.com, Zappos, and other online retailers are joined by smaller businesses that will drive demand for industrial buildings.
<b>Retail Properties</b>	People will always have a need and desire to go to a "bricks and mortar" retail establishment despite the advent of eCommerce. There is a social and even therapeutic aspect to shopping that will never be replaced by online shopping. Generally as the economy improves the retail sector can see the increase in demand immediately.

Obviously there are more reasons to purchase each asset class, but this should give you a good start to forming your own philosophy in investing in real estate. Many investors diversify their investments across all asset classes.

# What types of opportunities are there?

## Commercial Real Estate Investment Deal Types

Just like how there are different types of stocks such as growth stocks where shares are expected to grow at an above average rate, there are different types of opportunities in the commercial real estate investment world. Below is a summary of the types of CRE opportunities:

Deal Type	Property Attributes	Investor Opportunity
<b>Core</b>	Generally core assets are 85%-100% leased with a rental stream secured by long-term leases (over five years) - These assets are generally located in primary locations with strong market fundamentals - The assets are typically newer and require very little capital improvements.	These assets provide the highest level of income security - Generally they provide moderate appreciation and a lower yield.
<b>Core-Plus</b>	Generally, core-plus assets are leased between 70% and 85% - These assets offer the ability to lease up the remaining space to improve the income of the asset - They may also have below market rental rates and leases that expire shortly (within 1-3 years) - These assets can be located in primary and secondary markets and may require some capital improvements.	Core-plus assets provide an in-place income stream with the opportunity to increase the income in future years. These assets may have a lower in-place yield, but offer higher 'stabilized' yields as the asset gets leased up. Generally, an in-place yield could be 5% to 7% with the opportunity to increase it to 8% to 10%.
<b>Value Add</b>	Value Add assets are the "growth stocks" of the commercial real estate world. Generally, they are below 70% leased and may require physical improvements to be able to compete for new tenants. These assets are located in primary, secondary and tertiary markets.	Value Add assets provide the most upside when compared to core and core-plus assets. These assets produce lower initial returns between 0% and 4% initially, but can grow to 8% to 12% after the work has been completed.
<b>Development</b>	Land with the opportunity to develop commercial office, industrial, retail or multifamily.	Development opportunities can be risky depending on how they are structured. Having a tenant with a lease in place prior to construction (Build to Suit) provides significantly less risk than an asset without leases in place (speculative development).

# What is my investment strategy?

## Identifying your Investment Goal

Commercial Real Estate is an excellent long-term investment that matches very well with a variety of investment objectives. The following is a summary investment objectives by generation.

Generation	Investment Goals	Investments
<b>Baby Boomers</b>  <b>Born 1946-1964</b>	At retirement, obtaining the highest cash income without reducing your principal equity investment is paramount to ensuring an extended retirement income stream.	Commercial real estate provides significantly higher annual cash returns than stocks, bonds, treasuries and savings rates. Baby Boomers could consider well-leased multi or single tenant assets that provide higher cash on cash returns. Core and core-plus assets could be considered by Baby Boomers to maximize their income potential.
<b>Generation X or Echo Boomers</b>  <b>Born 1965-1979</b>	Generation X has time to build up equity in commercial real estate. Generally, this generation has saved for their retirement through a company 401K plan which is often limited to pre-chosen mutual funds with lackluster performance. Generation X could consider other retirement plan options, including a self directed IRA, checkbook IRA, or Solo 401K plan which would allow them to have significantly greater flexibility to invest in asset classes other than mutual funds.	The longer-term time horizon to build up a retirement portfolio and lower liquidity of commercial real estate plays well into considering using real estate as a retirement vehicle for this generation of investors. Core, core-plus, value add and development assets could be considered by this generation with the intent of owning the real estate long term and paying off the debt to produce maximum cash flow at retirement.
<b>Generation Y or Millennials</b>  <b>Born 1980-2000</b>	Generation Y has very similar investment objectives as Generation X, which is building up maximum equity in the early years, which will produce the highest income at retirement.	Generation Y has the ability to consider the entire menu of real estate, core, core-plus, value add and development.

"There have been few things in my life which have had a more genial effect on my mind than the possession of a piece of land."  
-Harriet Martineau

# Commercial Real Estate 201

## Thank You

Thank you for your interest in commercial real estate investment at RealCrowd. We value our investors and are committed to offering the highest quality investments with the best real estate operators across the United States.

## If You Are Interested in Learning More

Please email us at [CRE201@realcrowd.com](mailto:CRE201@realcrowd.com) to obtain the CRE 201 ebook. The ebook will provide answers to the following questions:

- What factors affect real estate values?
- How do I value commercial real estate?
- How do I run a simple cash flow analysis? (Computing the Net Operating Income)
- What is a capitalization rate and how is that determined?
- How do I determine if the asset is located in a quality location?
- What should I be looking for in a quality real estate operator?

*Again, please email us to obtain your copy of CRE 201 ebook.*



# CRE Terms & Definitions

## Absorption

Absorption is the way commercial real estate investors gauge tenant demand and is measured in square footage. Total absorption is the total new square footage leased by tenants. For example, if a building had 20,000 square feet of new leases in 2013, its total absorption is simply 20,000. The more relevant metric to view is net absorption which is the total new square footage leased minus the total square footage of tenants that no longer occupy their suites in a given time period. If a building had 20,000 square feet of new leases in 2013 and 5,000 square feet of tenants leaving, its positive net absorption is simply 15,000 square feet. Absorption can be measured by building or by entire markets.

## Capitalization Rate (Cap Rate)

The cap rate is the percentage of funds you paid for the building that comes back to you annually (not taking financing into consideration). As an example, if you purchased a building for \$1,000,000 that returned \$60,000 annually, your cap rate is simply 6%. The calculation is  $\$ \text{ NOI} \div \$ \text{ Price} = \text{Cap Rate } \%$

## Cash-on-Cash Return

The cash-on-cash return is the percentage of funds you invested in the building that comes back to you annually after making financing payments. Your cash-on-cash return is often higher than your cap rate if favorable financing is put in place.

## Contract Rent

Contract rent is the current rent being paid by the tenant according to their lease. Contract rents are measured by square footage in commercial real estate. For example, if an office tenant is paying \$21,000 a year for 1,000 square feet of space, their contract rent is \$21.00 per square foot per year. Contract rents may also be quoted monthly.

## Market Rent

Market rent is the rental rate that a specific location could achieve if it were available to lease today. Like the contract rent, market rent is quoted per square foot. Investors compare market rent to contract rent to see if there is an opportunity to increase rental rates once a suite becomes available.

## Net Operating Income (NOI)

The net operating income is the total rental income from all of the tenants, parking revenue, and other revenues minus operating expenses (taxes, insurance, management, maintenance, utilities). The net operating income is one of the first metrics and investor will review/verify because the cash return to investors is paid from the net operating income. Net operating income does not take into consideration financing nor does it include capital improvement costs.

### Occupancy

Occupancy is the percentage of occupied suites in a commercial real estate property or market. For example, if a 100,000 square foot building is leased and occupied by 95,000 square feet of tenants, the building's occupancy is simply 95%. Occupancy can be measured in buildings and in entire markets.

### Vacancy

Vacancy is the percentage of unoccupied suites in a commercial real estate property or market. For example, if a 100,000 square foot building is leased and occupied by 95,000 square feet of tenants, the building's vacancy is 5%. Like occupancy, vacancy can be measured in buildings and in entire markets.

