FINANCIAL ADVISORY

Properties That I Like to Avoid (Part 1 of 2)

BY CHRISTOPHER MILLER, MBA
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Recently, I made reference to a past article that detailed investment properties that I like to avoid, and why. An investor then called and asked me some questions about that column. Upon searching my archives, I realized that it has been many years since I've addressed this topic. Additionally; after several more years in the business and reviewing hundreds of additional properties, I have some more information to add. Therefore, I felt it was time to take another look at properties that I like to avoid.

This month, we will take a look at two asset classes that, during my 20 years in the investment real estate business, I've learned to avoid. Often; a class of real estate will have a characteristic that differentiates it from other types of properties. Sometimes this characteristic will add an significant degree of risk.

MULTI-TENANT RETAIL PROPERTIES

We are all familiar with multi-tenant retail properties. This large category covers everything from the 10-unit strip center that surrounds your local grocery store all the way to the large mall where you last bought some clothes.

The feature I dislike the most about these properties is that they tend to have high tenant turnover costs. If "Suzy's Beauty Parlor" goes out of business, the landlord will need to pay a real estate broker a leasing commission to find a new tenant. The landlord will typically then need to give the new business a "tenant improvement allowance," since it will take some construction to turn a former beauty salon into, say, a sandwich shop. Then, sometimes, that sandwich shop will fail quickly, and the landlord needs to pay all those expenses all over again.

Multi-tenant retail is a unique category due to the way landlords depend on their larger, or "anchor" tenants to draw customers to the center, and to give business to their smaller, or "in-line" tenants. If you think back to your local mall; the stores like Macy's, JC Penny's, Nordstrom and Sears are anchor tenants. If the mall near you has had an anchor tenant "go dark," or close, you probably noticed that a lot of the in-line tenants in that "leg" of the mall have closed too. Similarly, if

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the grocery store in a strip shopping center closes, the Hallmark, Barber and donut shop often closes, too. (I've seen it happen.) This means that; not only does the landlord need to come up with money to fill that anchor space, they'll need to come up with money to replace many in-line tenants, as well.

MULTI-TENANT OFFICE BUILDINGS

While tenants in office buildings usually aren't dependent on one another business, and one closing doesn't tend to cause the dreaded retail "vacancy domino effects," multi-tenant office buildings do share the high turnover costs that multi-tenant retail is burdened with. If the small law firm on the 2nd floor moves away, this won't affect the loan brokerage on the 5th floor – but those leasing commissions and tenant improvement costs will still need to be paid.

Unlike retail properties – where a tenant is less likely to move from a location that generates healthy sales – offices can really be located anywhere. If a competing property down the street offers your tenant a discount on rent AND offers to pay all moving expenses; it is likely you'll now have a vacancy to fill.

Office buildings don't typically see the type of tenant diversity that retail centers do. In retail centers, this really happens naturally out of necessity. After all, 5 sandwich shops in your neighborhood grocery center probably wouldn't work very well. This potential lack of tenant diversity can leave landlords exposed to certain economic trends. For example: when the last recession hit Orange County, California; the majority of small loan brokerages that popped up around town went out of business, contributing to huge vacancies in many buildings.

The two types of properties discussed this month are on my "try to avoid" list due to their high potential operating costs. Surely there are investors that do well in these categories, right? Yes – there certainly are. These investors tend to be very well capitalized – writing a $2 million check every so often for tenant improvements or property renovations isn't a problem for them. I prefer real estate investments that don't need such large capital infusions periodically – and I think that my clients do, too.

As I mentioned earlier, a recent conversation with an investor reminded me that I've never done a comprehensive article on properties that I like to avoid. This month's article is part 1 of a 2 part series devoted to the topic. Next month we'll review some more properties that I don't like and we will talk about some exceptions because, as I like to say, good deals can be found anywhere.

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FINANCIAL ADVISORY

Properties That I Like to Avoid (Part 2 of 3)

BY CHRISTOPHER MILLER, MBA
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I originally planned this month's article as the conclusion of a 2-part series. After spending some time writing, I discovered that I have much more to say about Properties that I Prefer to Avoid. Therefore, this month's installment will be part 2 of an extended 3-part series.

During my years in the real estate industry, I have experienced many different types of real estate investments and recognized the ones that work best for me and for my investors. I like to share this information with my readers through my monthly articles. Last month, I talked about multi-tenant retail and multi-tenant office properties: two product types that I will avoid almost without exception. (I say almost because, as I like to say, sometimes great deals can be found anywhere.) This month I will explore two more asset classes that fit this description, as well.

ENERGY PRODUCTION

Fifteen years ago, some energy exploration companies realized that the like-kind term, as used in the IRS' code concerning the 1031 exchange, is broad. Rather than like-kind mandating apartments for apartments and parking lots for parking lots, the term instead means investment real property for other investment real property. Since the IRS had previously ruled that energy leases and royalty rights were real property that qualified for exchanges, these asset managers entered the 1031 market and began showing their products to investors.

The business plan was simple: Investors would buy producing oil and gas wells, enjoy monthly income from them, then plan to sell them at a profit in the future. In reality, however, things didn't quite work this way. To see why, let's explore how oil (and natural gas) wells work.

First, a petroleum explorer will spend a lot of money leasing the rights to drill for oil in a particular spot from the mineral interest owner, then by drilling one or more wells. If the well is successful and "strikes" oil and/or gas, the explorer becomes an operator, and begins pumping out the petroleum products to sell at market. Or – he could just sell this "proven well" to an investor looking for cash flow. In this case, the income-producing asset is a "pool" of petroleum products in the ground.

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Since the asset is a pool of products, this oil well likely, in the absence of a 10X increase in oil prices, will never be worth as much as the day it was completed. This is because that asset – the pool in the ground – grows smaller as that energy is harvested. If you buy an oil well today, and half of the oil is gone 10 years from now; what will your well's value look like? It will probably be less than what you paid for it. For this reason, I like to avoid buying producing energy wells as investments.

I did, in the past, participate in energy royalty interests in the past where we, the investors, experienced success. As royalty owners, we would be the ones leasing to companies who then take the risk of drilling and pay us a percentage of whatever they find. My preferred manager for royalties, however, decided to leave the retail business to focus on chasing billion-dollar endowment funds as clients. The companies that were left in this space, in my opinion, were too small – offering "mom and pop stuff" – to warrant consideration. Since I dislike producing wells as investments and still haven't found a royalties investment provider that I am happy with, I no longer deal in energy investments for 1031 Exchanges.

HOTELS

Although I have been successful with hotels in the past, (from finding a great deal), this asset class is one I like to avoid. You probably remember when, during the last recession, almost every hotel in the country was in financial trouble and scores of foreclosures – even on luxury hotels like the St. Regis in Dana Point, (Foreclosed in 2009.[1] Now known as the Monarch Beach Resort[2]), which was If you think further back, you will recall that the same thing happened when the travel market was depressed following the September 11, 2001 terror attacks. My observation is that hotels will suffer serious financial difficulties ever time there is a recession.

But how are big companies like Hilton and Marriott still in business? That's a good question – the answer is that these companies don't own most of their hotels – franchisees do. So – similar to your local Subway sandwich shop, a businessman can purchase a Hilton franchise and open his own hotel. If that property is foreclosed upon, the franchisee suffers the financial ruin of foreclosure. Hilton probably comes out even better, actually – as a franchisee with a better financial condition can then purchase the property and continue sending their fees to the home office.

IS IT A REAL ESTATE INVESTMENT, OR AND OPERATING BUSINESS?

Investors need to remember that hotels or oil wells are an operating business, while rental properties are a more passive activity. Operating businesses have much more overhead: labor will be their largest one. This is why a company that suffers a 15% reduction in business will often go out of business: their income suddenly doesn't cover their costs. If we're buying apartments as investments, a 15% reduction would certainly hurt, but wouldn't necessarily cause a collapse if the properties are not overly leveraged to begin with.

As I mentioned earlier, this series was extended for one more month because I had much more to say about more types of properties that I prefer to avoid. Next month, we will conclude this series with a few more asset classes that, I believe, warrant extra caution in your due diligence process. If you have any questions, my toll-free office number is (877) 313-1868.

1 Source: Los Angeles Times, April 7, 2010, "St. Regis Monarch Beach Gets New Owner." Vincent, Roger and Reckard, E. Scott.

2 Source: Orange County Register, April 7, 2016, "Goodbye, St. Regis: Luxury Resort Will Have a New Name June 1." Madans, Hannah

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This month, we'll read the third and final part of my "Properties that I Like to Avoid" series. I took a break from this series last month to talk about the benefits of using leverage to buy investment real estate because – who wants to focus on stuff they don't like for 3 months in a row?

In this article, I'll discuss two more classes of properties that I have learned to dislike. I feel that the risk/reward potential for these two types is skewed too heavily towards the risk side – with not enough reward potential left over for investors.

STUDENT HOUSING

Student housing, by its very nature, is often overvalued. Remember that investment properties are valued based on the amount of income that they generate. Apartments leased exclusively to students tend to charge rent that is much higher than, say, a comparable property that is not located near a college. Investors then, in turn, pay more for such a property than they would for that comparable property with lower rents. The big risk when buying student housing is – can the landlord continue to receive those higher rents? If enough students can not be recruited to fill the units, residents from the surrounding neighborhoods must be found to do so. They likely will not, or can not, pay the inflated rents that students are charged, however. How much will the property's bottom line suffer if this happens?

My favorite example when discussing student housing is my alma mater, the University of Southern California. When I arrived on campus in 1995, I didn't know anybody there so I asked the University to set me up with some roommates on campus. I ended up sharing a USC-owned, on-campus apartment with 3 guys from the marching band for a semester before I made some friends and struck out on my own. This apartment had 2 bedrooms and one bathroom. Each of us paid $660 per month to live there, so USC was collecting $2,640 per month from a two-bedroom, one bath apartment – in 1995!

Since then, USC has seen a huge increase in student housing development. Private developers have built luxury apartment complexes in the immediate area – most notably in place of the car lots that used to dot Figueroa Street. The university itself has opened three large new dormitories in the last 2 years that have added almost 1,800 beds

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to the market. The housing shortage that USC exploited in order to charge such high rents isn't quite so bad anymore.

By looking around on the USC website, I was able to find that rent for that same unit is now $1,000 per month from each resident. While that may sound like good money today, those handy with a financial calculator can see that, over the last 23 years, the rent on that unit has increased by only 1.82% per year. Since USC doesn't have a mortgage to pay on that property, this may not hurt them too badly. An individual investor, however, could suffer greatly from such low rent growth. An individual investor likely has a mortgage to pay, insurance bills and other expenses to pay before he collects his cash flow. While his mortgage payments (with a fixed rate loan) are capped, his costs will very likely rise faster than that 1.82%. Here in California, property taxes will go up 2% per year. How have your other expenses risen?

VACANT LAND

With income-producing properties, rising income can drive rising property values. If you own vacant land, then, will the value rise in the future? The answer to this question is less certain. It is certain that vacant land will produce negative cash flows for you in the form of property taxes. A vacant land investor will purchase the land, pay the annual expenses, and wait for another investor to buy the land from them – hopefully at a higher price.

I often say that real estate is a fantastic way to get rich slowly. The best chance we have to earn a large capital gain in real estate is to buy something and hold it for at least several years. A vacant land investor will need to pay those expenses for that longer hold period. Wouldn't it make more sense to buy something that pays you income today while you wait to sell at a profit?

ARE THESE INVESTMENTS ALWAYS BAD?

Just as no asset class is a "guaranteed win," no asset class can entirely be considered a "guaranteed loss." As I always say, good deals exist everywhere: they are just found less often in certain spots. While I have personally had success investing in many of the asset classes mentioned in this series, I have had some failures in them, too. (In the case of hotels, I have had both.) As always, do your due diligence when considering a purchase. In my opinion, the asset classes mentioned in this series warrant a much harder look before you buy. If you have any questions, call me at (877) 313-1868.

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