INTRODUCTION TO CRE101

COMMERCIAL REAL ESTATE INVESTING

CRE101 is an essential primer on the world of commercial real estate investing, answering basic questions investors commonly have, as well as furnishing key terms and definitions, for example:

What is “Net Operating Income”? How does real estate compare to other asset classes? What is the difference between direct and indirect real estate investing? Is there an easy way to determine my investment strategy? Why even invest in commercial real estate?

Drawing from these basics, readers will be ready to proceed into more advanced topics introduced in the followup to CRE101, RealCrowd’s Valuation Series. As such, it’s the first of many steps in becoming a more informed, capable—and profitable—investor. Enjoy!

Sign up today
**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.

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### Why Commercial Real Estate Compared to Stocks, Bonds, and Cash/Savings

<table>
<thead>
<tr>
<th></th>
<th>Real Estate</th>
<th>Stocks</th>
<th>Bonds</th>
<th>Cash/Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>High Cash Return</strong></td>
<td>✔</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Equity Buildup</strong></td>
<td>✔</td>
<td>✔</td>
<td>❌</td>
<td></td>
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<tr>
<td><strong>Leverage</strong></td>
<td>✔</td>
<td></td>
<td>❌</td>
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<tr>
<td><strong>Hard Asset</strong></td>
<td>✔</td>
<td>❌</td>
<td>❌</td>
<td></td>
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<tr>
<td><strong>Tax Advantage</strong></td>
<td>✔</td>
<td>❌</td>
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</tbody>
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*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**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Annual Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suburban Office</td>
<td>$78,000</td>
</tr>
<tr>
<td>Retail</td>
<td>$72,000</td>
</tr>
<tr>
<td>DT Office</td>
<td>$59,000</td>
</tr>
<tr>
<td>Multi-Family</td>
<td>$58,000</td>
</tr>
<tr>
<td>DOW 30</td>
<td>$29,000</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>$21,000</td>
</tr>
<tr>
<td>AAA Bond</td>
<td>$19,100</td>
</tr>
<tr>
<td>US Treasury</td>
<td>$18,500</td>
</tr>
</tbody>
</table>

**CAP RATE**

The cap rate is the net operation income divided by the purchase price.

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Average Cap Rate Source: Real Capital Analytics 2012 / Average Stock Dividend Q1 2013 / Average 10 Year Bond Yield Q1 2013
Asset allocation decisions play a central role in determining investor results...approximately 90% 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

SIGN UP TODAY
Asset Allocation - A Key Role in Determining Results

It is recommended by leading experts that investors have a portion 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.

YALE ENDOWMENT ASSET ALLOCATION = 22% REAL ESTATE

13.7% Annual Return*
$1M = $13.0M Over 20 Years

*Yale Endowment return from 6/30/1992 to 6/30/2012
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.

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

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

UPON SALE OF THE PROPERTY, EQUITY IS DISTRIBUTED BACK TO INVESTORS ALONG WITH ANY PROFITS FROM THE SALE.
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.

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.

<table>
<thead>
<tr>
<th>$10M Cash Down &amp; No Financing</th>
<th>$1M Cash Down &amp; $9M Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>$11M sale - $10M purchase = $1M profit</td>
<td>$11M sale - $10M purchase = $1M profit</td>
</tr>
<tr>
<td>$1M profit ÷ $10M cash down = 10% return</td>
<td>$1M profit ÷ $1M cash down = 100% return</td>
</tr>
</tbody>
</table>

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.
**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 have summarized investors’ mindset for each asset class to the right.

<table>
<thead>
<tr>
<th>Asset Category</th>
<th>Primary Mindset (Why buy this asset class?)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MULTI-FAMILY</strong> <em>(Apartment Complex)</em></td>
<td>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.</td>
</tr>
<tr>
<td><strong>OFFICE BUILDINGS</strong></td>
<td>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).</td>
</tr>
<tr>
<td><strong>INDUSTRIAL BUILDINGS</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>RETAIL PROPERTIES</strong></td>
<td>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.</td>
</tr>
</tbody>
</table>
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. A summary of the types of CRE opportunities are listed in the chart on the right.

<table>
<thead>
<tr>
<th>Deal Type</th>
<th>Property Attributes</th>
<th>Investor Opportunity</th>
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<tbody>
<tr>
<td>CORE</td>
<td>Generally core assets are 90%-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.</td>
<td>These assets provide the highest level of income security - Generally they provide moderate appreciation and a lower yield.</td>
</tr>
<tr>
<td>CORE-PLUS</td>
<td>Generally, core-plus assets are leased between 75% and 90% - 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.</td>
<td>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%.</td>
</tr>
<tr>
<td>VALUE ADD</td>
<td>Value Add assets are the “growth stocks” of the commercial real estate world. Generally, they are below 75% leased and may require physical improvements to be able to compete for new tenants. These assets are located in primary, secondary and tertiary markets.</td>
<td>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.</td>
</tr>
<tr>
<td>DEVELOPMENT</td>
<td>Land with the opportunity to develop commercial office, industrial, retail or multifamily.</td>
<td>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),</td>
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### 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.

<table>
<thead>
<tr>
<th>Generation</th>
<th>Investment Goals</th>
<th>Investments</th>
</tr>
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<tbody>
<tr>
<td>BABY BOOMERS (Born 1946-1964)</td>
<td>At retirement, obtaining the highest cash income without reducing your principal equity investment is paramount to ensuring an extended retirement income stream.</td>
<td>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.</td>
</tr>
<tr>
<td>GENERATION X OR ECHO BOOMERS (Born 1965-1979)</td>
<td>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.</td>
<td>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.</td>
</tr>
<tr>
<td>GENERATION Y OR MILLENNIALS (Born 1980-2000)</td>
<td>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.</td>
<td>Generation Y has the ability to consider the entire menu of real estate, core, core-plus, value add and development.</td>
</tr>
</tbody>
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*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
**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 $\text{NOI} ÷ \text{Price} = \text{Cap Rate} \%$

**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.

**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.

**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.
CONCLUSION TO CRE101

WHAT’S NEXT?

Now that you have the broad fundamentals, an understanding of the basic “hows and whys” of commercial real estate investing, and a few key terms at your disposal, you’re ready to move up the line to more advanced topics.

CRE201: Start With Risk is the first entry in RealCrowd’s Valuation Series and your next step in learning how to assess the real estate market and investment opportunities.

Specifically, it will teach you how to think about risk and return—a pair of concepts foundational to the analysis of real estate assets—and cover the following topics:

• Risk/return profiles of CRE investment strategies
• Factors affecting real estate values
• Assessing the value of a CRE asset
• Quicksnap analysis of multiple opportunities

Please email us at CRE201@realcrowd.com to obtain the CRE201 ebook and to continue becoming a more informed commercial real estate investor.