OWNOUROWN

The Commercial Real Estate Primer

Commercial real estate has historically been one of the most proven pathways to wealth creation in this country and has created more millionaires and billionaires than any other asset class; and the vast majority of the "millionaire next door" types owe the bulk of their wealth to commercial real estate.

Historically, commercial real estate has been an asset class that the wealthy and well connected benefited from. Own Our Own is on a mission to change that by making it accessible to virtually anyone who wants to invest in one of the most stable and time-tested investment types.

The first step to creating wealth in commercial real estate, or any asset class for that matter, is by building a strong foundation of knowledge that you can then act on.

This is a comprehensive intro to commercial real estate written in plain English and intended to demystify jargon and break down barriers to understanding commercial real estate, so that everyone can have access to the greatest wealth creating resource that exists.

PART I

What is Commercial Real Estate?

There are two primary categories of real estate - residential and commercial. Residential is pretty straight forward; it's the housing structures we live in. And on the face of it, commercial real estate is equally straight forward; it's real estate used in commerce. Sounds simple, but commercial real estate is much broader than residential.

What Is Commercial Real Estate (CRE)?

Commercial real estate ("CRE") refers to property used for business-related purposes (retail stores, gyms) or as workspaces (office buildings), as opposed to living spaces. (Multi-family rental properties are residences for the tenants, but considered commercial real estate for the owner/landlord.)

Commercial real estate is usually leased to tenants for them to conduct their own commercial activities. There are several categories of commercial real estate, as everything ranging from restaurants and barber shops to shopping centers and retirement homes are considered CRE.

Key Takeaways

- Commercial real estate is property used for business or income-generating purposes
- The classes of commercial real estate include: office; industrial; retail multi-family, hotels, land and special purpose. Many investors consider office, industrial, multifamily and and retail to be the primary categories. ***(In part 2 we explain each category in detail)***
- Commercial real estate is typically leased, and provides rental income as well as the potential for capital appreciation.
- Investing in CRE is typically more capital intensive and entails more complexity than residential real estate.
- Private equity funds, publicly traded real estate investment trusts (REITs), crowdfunding platforms, and private syndications are some of the ways that individuals can invest in commercial real estate.

PART II

THE CORE ASSET CLASSES

Commercial real estate is a fairly broad term. As with most things, understanding the lingo in the real estate world is half the battle. And it's an absolute must if you want to go deep into the space. So our assignment with this article is to teach you some of the foundational language of real estate.

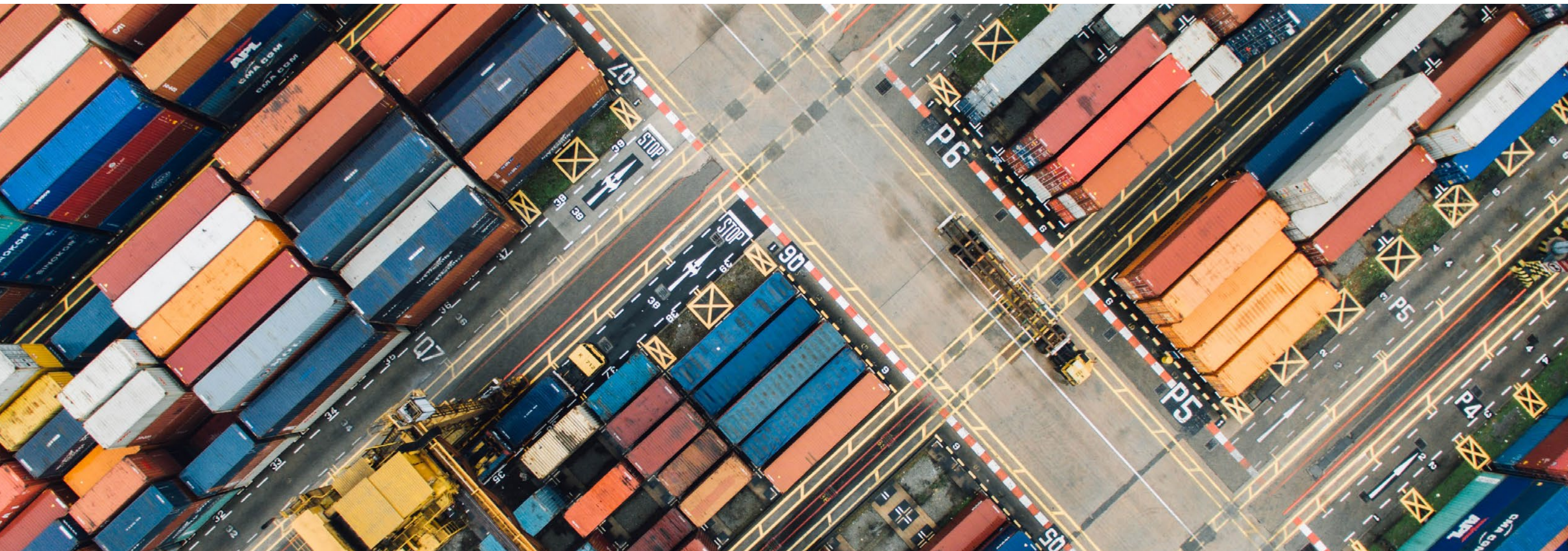
What are the main categories, or "asset classes", of commercial real estate?

Many commercial real estate professionals refer to the core asset classes in commercial real estate as the "four basic food groups": industrial, multifamily, office and retail.

Each of these asset classes can be further subdivided. As you'll see, multifamily is further divided into "garden", "midrise" and "highrise" apartments. Additionally, there are property types that we would consider to be primary asset classes outside of "four basic food groups"; specifically hotels, land and special purpose.

Finally, every property type can be placed on a quality spectrum – typically from A to C, although we sometimes see people in the industry use D. And the meaning is straight forward. A properties are best in class and the further out on the spectrum you go, the greater the drop off in quality.

We define and explain some of the main real estate property types in this primer.



The Core Asset Classes:

Office

Classification. Offices are typically placed into one of the following: Class A, B, or C. However, these categories are not rigid and very dependent on the location. A Class A property would have pristine location in addition to physical construction. B could include a Class A level construction, but may be located somewhere less ideal. C would then include everything that does not fall into one of the above.

Central Business District (CBD). These are found in the traditional "downtown" area of large metropolitan cities. Typically highrise, these are the types of properties one normally thinks about when picturing office spaces, such as in those found in places like New York and Los Angeles.

Suburban office buildings. This includes offices, usually mid rise buildings, of approximately 80,000 - 400,000 sq ft. These buildings are found outside of larger metropolitan centers. In addition to this, some suburbs will have several different buildings pieced together on one larger overarching property.

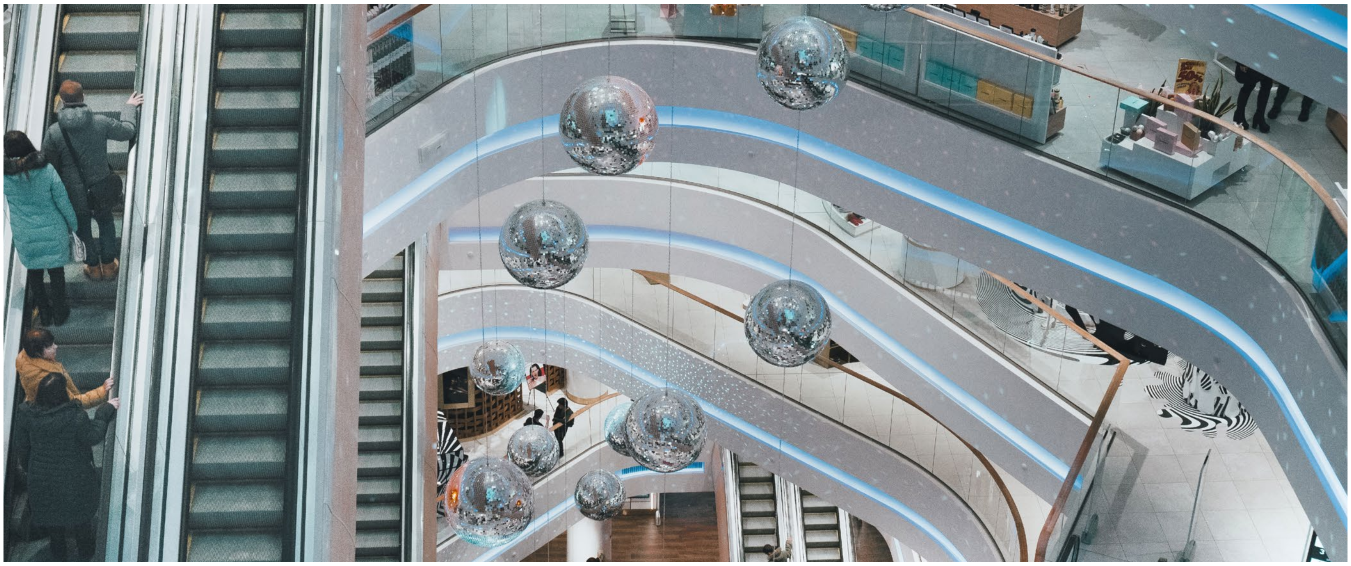
Industrial

Heavy manufacturing. Something that would typically fall under this category is an automotive factory. These types of facilities need extensive resources to operate and are very bespoke to individual tenants. As a result, they can not change hands with relative ease.

Light Assembly. Unlike heavy manufacturing, these spaces are not as reliant on heavy machinery. An example of this would be something such as a facility for books or educational supplies. These spaces are significantly more flexible than the above mentioned.

Flex warehouse. The primary characteristic of these spaces is their flexibility, and often times these warehouses will contain both office and industrial space on-site.

Bulk Warehouse. Typically quite large, these spaces are spaces usually reserved for large scale distribution of products. An example of this would be a regional distribution center for a blue chip Fortune 500 company.



Retail

Strip Center. These spaces can often be found on the non-CBD region of a large metropolitan area, or in suburban towns. They do not necessarily require an anchor tenant, and are small with parking space typically limited in scale. Examples of tenants in strip centers are family restaurants, mailing centers (like a UPS), or ice cream shops.

Community Retail Center. Typically anywhere from 100,000-400,000 sq ft, these centers have one or more anchor tenants, along with several smaller supporting tenants to fill out the property. Examples of anchor tenants would be grocery stores such as a Kroger or Whole Foods. Parking space is usually larger at community retail centers as well.

Power Center. Power centers are distinguished by the presence of several large scale anchor tenants, typically supercenters such as a Target or Walmart, with each taking anywhere from 50,000-150,000+ sq ft. Included typically in these centers are “out parcels” in the parking lot area where a bank or other retail tenant may have a location.

Regional Mall. These are large scale shopping centers with multiple retail tenants on site. Shopping malls and outlet malls are included in this category.

Multifamily

Garden Apartments. Usually found on the outskirts of urban areas or in suburbs, these apartments are low rise (under 5 stories) with parking typically on site on the ground level.

Midrise Apartments. Typically between 5-10 stories, with 20 - 120 or so units. In addition, elevator service would be found on site.

Highrise Apartments. Typically found in large metro areas, with hundreds of units, these are the condos standard to cities such as Chicago or Manhattan and other global cities.

Hotels

Full service hotels. This includes major name hotels, such as a JW Marriott in downtown Los Angeles. Hotels in this category would include all services, gym, maid services, etc. These hotels are the standard for business travel in large metropolitan areas.

Extended stay hotels. These are for longer stays, and are more home-like in nature. Some additional features would be larger rooms, kitchens, and more expansive living areas.

Land

Greenfield Land. This would include land that has not been developed on, such as a dairy farm.

Infill Land. Land, within a metropolitan area, that has been developed but has been rendered vacant would be considered infill land.

Brownfield Land. This would be land that has previously been used for agricultural purposes, but is now available for re use. Typical of brownfield land is some form of defection in the land.

Special-Purpose

While we have touched on all the standard, typical forms of commercial real estate, there are other forms that do not fall into the aforementioned categories. These can be considered “Special Purpose”. Examples of these would include something like a mini-golf course, or maybe a water park.

THE FOUR WAYS TO MAKE MONEY IN REAL ESTATE

Real estate has always been one of the more popular asset classes for investors. It is appealing to investors for a number of reasons; but primarily because it's tangible and we all have an intuitive understanding of what real estate is because we interact with it on a daily basis.

If you ask the average investor how someone can make money in real estate, they'll more than likely respond with either ***cash flow*** or ***appreciation***, but there are actually ***four*** ways for real estate investors to make money in any deal. And while not every investment will provide each of the four in equal measure, every income property has the potential to provide you with as many as four different types of returns.

We define and explain each of these four returns in detail.

Cash Flow

When you buy a real estate investment property you should remember you are really buying it's income stream, or cash flow. Cash flow is basically what remains after you subtract your monthly expenses from your income.

- ***Cash in - Cash out***
  - *Example:* Total cash inflow for the month is $10,000 — monthly expenses of $8,000 = $2,000 (positive cash flow)
- ***Positive*** *cash flow:* When you earned more money than you spent
- ***Negative*** *cash flow:* When you have spent more money than you have earned

Appreciation

Appreciation is the benefit you receive when you sell your property for greater than what you paid. And for the most part, real estate tends to appreciate over time. Appreciation is driven by a number of factors, but the core driver is increased demand for the property, or the area around the property.

- ***Appreciation = Sale price - Purchase price***

Loan Amortization

Loan amortization is when the amount you owe on your mortgage decreases as payments are made. And as your debt decreases, your equity increases. So your tenants are effectively buying your property for you over time.

- ***Loan amortization = Debt service - Interest paid***

Tax Shelter

Owning real estate comes with great tax benefits. If you have an investment property you are allowed to deduct depreciation of the building and any additional capital investments which will reduce your taxable income. So, even though your investment may be increasing in value over time the IRS allows you to deduct the useful life of your property over time. You can also shelter cash flow using like-kind exchanges.

- ***1031 Exchange:*** may allow you to defer taxes on sale indefinitely

(Remember to always consult with a tax advisor to ensure you are receiving full tax benefits.)

PART IV

These are the four broad investment strategies in real estate. They're visually depicted here as a linear spectrum. As you progress from left to the right on this spectrum, your risk and return are increasing. This is a simplification of the world, but it is conceptually and directionally correct. Below, we define and contextualize the four strategies and map them to target returns for each strategy below.

CORE → CORE PLUS → VALUE ADD → OPPORTUNISTIC

I. Core

- Conservative, lower risk
- This is a steady income play, think of a "dividend stock", or more akin to a corporate bond
    - You can expect to clip a steady coupon and low probability that you'll sustain any loss in principal
- Best real estate in the best markets
- Turnkey in that not much work is required
- Low leverage used in these transactions as returns are lower: 45-50% LTV
- Modest returns: 6 – 8%

II. Core Plus

- Low to moderate risk
- Income and some growth
- Either older properties in the best markets, or best properties in second tier markets
- Maybe some repairs or maintenance
- Fairly low leverage
- Fairly low leverage: 45 – 60% LTV
- Moderate returns: 8 – 10%

	CORE	CORE PLUS	VALUE ADD	OPPORTUNISTIC
Total Return	6 – 8 %	8 – 10 %	12 – 15 %	20% +
Return Composition	Income	Income + Appreciation	Income + Appreciation	Appreciation
Risk Level	Low	Low – Moderate	Moderate – High	Highest

Low Risk ⟷ High Risk

III. Value Add

- Moderate to higher risk
- Focused on appreciation, typically moderate to little cash flow initially
- You do some work to achieve your returns
  - Make repairs to units
  - Significant lease up
  - Improve operations
- Higher leverage: 60 – 75%
- Higher returns: 12 – 15%

V. Opportunistic

- Most aggressive, highest risk
- Execution driven
    - Ground up development, intensive redevelopment, complete re-tenant strategy
- Very little to no cash flow at inception, but potential for most growth in cash flow and most appreciation
- Highest leverage: 70% +
- Highest returns: 20% +

There may be some overlap at the fringes of these strategies, but this is more or less what the real estate world consists of, and your returns are a direct function of the risk you're taking.

Within reason, risk is an agnostic term. It's neither good nor bad, as long as you fully understand the risks inherent in your investment, and you're being fairly compensated for it.

Commercial real estate is both deep and wide, conceptually, which makes it a very dynamic discipline. But almost none of it is incredibly complex, and all of it can be understood and mastered by someone committed to consistently putting in the work to learn.

This primer is a high-level overview that's meant to help the reader establish a baseline understanding of the industry and the language that defines it. This is a first in a series of primers from the Own Our Own Investor Education team that will move from beginner to expert in sequence.

It doesn't make sense for everyone to be a professional real estate investor, but it does make sense for everyone to understand and invest in some real estate. With enough grit, determination, and work, anyone and everyone can be the real estate-millionaire next door. Now you are on your way.

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