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Jeff Hassannia, proud junkyard landlord.

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Going Commercial

THE RESIDENTIAL MARKET IS FALLING. BUT NOT ALL PROPERTY IS CURSED. CONSIDER BUYING AN OFFICE BUILDING INSTEAD. BY DOROTHY POMERANTZ

JEFF H. HASSANNIA BOUGHT HIS first investment property when he was 18: a tiny $50,000 two-bedroom house outside of Portland, Ore. That investment led to a lucrative side career as a landlord. Over the next 15 years Hassannia, who is also an engineer, bought and sold six homes, ending up with a $1.2 million portfolio.

But three years ago Hassannia noticed housing prices were going up faster than rental income. His call was a bit early, but his instinct was right: This was trouble. "I decided to get out," he says.

Not out of real estate, just the housing end of it. He moved into the commercial market. Hassannia put $227,000 down on a $650,000 2.3-acre junkyard in Redmond, Ore. that had an auto-wrecking shop on the property. While this might not be a glamorous holding, his tenant faithfully sends him a check each month for $3,500, more than enough to cover his mortgage. The land is in a growing part of Redmond; a Wal-Mart just opened a few blocks away and a Home Depot is slated to open soon.

His property is zoned commercial, so he can develop an office or classier building, in keeping with the upgraded surroundings. When the junkyard's lease is up next year he can decide whether to renew it at a higher rent or to sell the land to a developer.

Last year Hassannia, 37, ditched his final residential property, a condo in Los Angeles. His portfolio now consists of five commercial properties worth $5 million.

Commercial real estate falls into different segments with their own demands and economics. For individuals the most popular assets are apartments, small offices, strip malls and warehouses. So far the real estate crash hasn't been felt in commercial property. And 2007 appears to show only a slight deceleration in commercial rent increases from 2006.

Apartments, where the pace of increases is in line to slacken from 5% to 4%, have benefited from still high home prices and tightening mortgage-lending standards. Offices (up a percentage point to 10%) have seen continued robust demand for space thus far. Shopping centers, which play host to day-to-day

necessities—drugstores, hair salons, laundries—are down 0.5%. (The big malls, owned by powerful players like real estate investment trusts, are finding meager advances in same-store sales at their department stores and boutiques.) Warehouses, their growth pace off only half a point to 4%, are still much in demand.

Over the past 12 months commercial real estate has returned an average 13% (property appreciation plus rental income), says commercial brokerage house Marcus & Millichap. That bests the 8.4% total return from the S&P 500 and far outstrips the circa 3% return on single-family homes, which are falling in price but provide rental value to homeowners.

Commercial property can get killed in a recession (who knows when that's coming) but over the long haul rewards owners with appreciation in line with the standard 5% annual growth in rental income. Net income (rent after expenses) should run at least 6.5% of a property's value.

Regardless of the megatrends, Harvey E. Green, chief executive of Marcus & Millichap, notes that ways always exist to wring better returns from a property. You can improve building management to stop waste, sign up higher-paying tenants and renovate to attract more of them.

As with the residential market, credit for buying commercial property has tightened. Gone are the days of interest-only mortgages. You'll have to put down 30% of the cost of the building and amortize your loan. A high down payment could be a blessing in disguise; it reduces the risk that you'll run up a loss that can't be deducted on your tax return because of antishelter legislation.

GOING IT ALONE

FORMER MECHANIC CHARLES JONES owns six commercial properties around Louisville, Ky., including an 11,000-square-foot self-storage center and a small metalworking factory. Last year one of his tenants, who ran a small grocery store, sent him the keys and a note saying he could no longer run the place. In order to keep money coming in, Jones stepped in to run the store himself while he looked for another tenant. He figured the store would lease out more easily if occupied.

The point: Being a commercial landlord can be as much of a headache as running any other business. Be prepared.

Be prepared, especially, to spend a lot of time looking for an investment and checking it out. Is the tenant in financial straits? Is there chemical waste under the parking lot? Is the zoning about to change in a way that would wreck your resale value?

Don't be too avid to do a so-called Section 1031 exchange, a swap of one investment property for another that enables you to postpone the capital gain tax on the property you're giving up. This would be a fine idea except for five things: 1) Middlemen's fees can eat up a chunk of the supposed tax saving. Remember, the tax you owe is only on your profit from the first property, while the fees are going to be a percentage of the whole transaction. 2) You're not avoiding tax, only deferring it. 3) The federal rate on most of your appreciation is only 15% now. When you pay tax down the road the rate is probably going to be higher. 4) The tight deadlines written into the tax rules may induce you to overpay for the new property. 5) Some 1031 escrow agents lose the money entrusted to them.

IF YOU WANT TO BE A COMMERCIAL LANDLORD, ASK YOURSELF:

- Do you want to invest on your own or in a group?
- How much work do you want to put into your property?
- Is a 1031 exchange worthwhile, or will the delayed tax benefits be eaten up by fees?
- Would you make more money buying a publicly traded REIT?

All that said, the tax-deferred swap could make sense if you have a single investment property that you want to trade in for a diversified pool and you like the people running the pool.

GOING WITH A GROUP

YOU CAN FORM A POOL OF BUYERS with people you know. David Rifkind, a managing director at real estate financier George Smith Partners, says that in addition to thinking about all the financial risks inherent in a real estate deal, you also have to think about the personality risks. "Make sure you're investing with people you know and trust and that everyone's interests are aligned," says Rifkind. A perfect partnership debate: Should you pay for a costly new boiler this winter, or wait and risk the old one breaking down?

You may want to buy into a professionally managed pool, whose managers collect fees for buying, managing and selling. Some pools are limited partnerships, some are "tenancies in common."

Partnerships tend to be illiquid; if you want to sell your share you need the consent of a managing partner. (The partnership agreement spells out an exit strategy for heirs of dead partners.) If the partnership is professionally run it is called a syndicated deal. Brian Shirken, head of Columbus Pacific Properties, says that upfront fees should be low (less than 2%) and that a reputable syndicator will have his own money in the investment and collect his profit on the back end.

Tenancies in common are to partnerships roughly what apartment condos are to apartment co-ops. That is, fellow TIC investors have less say in how you dispose of your unit. But still, if you want out before the agreed termination date you have to find a buyer. TICs normally last only five to ten years. If you go with a TIC, protect yourself by holding it through a limited liability corporation you control.

There are plenty of companies that manage large TICs, such as Fort Properties out of Los Angeles, which has $415 million in properties under management. If you are planning to sell an investment property, you can swap your way into a Fort Properties pool via Section 1031. The minimum investment at Fort is usually $500,000.

TIC funds come with steep fees. Fort Properties marks up the equity shares it sells by 10%. It doesn't manage the properties; it farms out that work and bills the investors. Typical fee for finding tenants, keeping the gardens trimmed and hiring repairmen for the elevators: 3% of the rent.

The most hands-off way to invest in commercial real estate is through a publicly traded real estate investment trust, where the shares are totally liquid and pay a dividend. So far this year REIT total returns are a negative 3.5%. Still, they pay an average dividend yield of 4% and tend to keep up with the stock market over long periods. And a REIT will never send you the keys to the business in the mail. F

Homeowners Houschang and Dorte Pakpour: enticing potential buyers with more than just ocean views.

The Case For Seller Financing

WANT TO SELL YOUR HOUSE AT A NICE PRICE? SELLER FINANCING MAY HELP—IF YOU KNOW WHAT YOU'RE DOING. BY CARRIE COOLIDGE

IN EARLY OCTOBER, WHEN DORTE and Houschang Pakpour put their Mediterranean-style villa in Laguna Beach, Calif. on the market, they put a little extra bait on the hook. In the glossy sales brochure touting the ocean and canyon views, European gardens and cathedral ceilings, the Pakpours noted that seller financing was available. "I'm willing to work with a serious buyer," says Houschang Pakpour, 62, a piano restorer and antique dealer. "I figured I would just be putting the money in an interest-