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## PERSONAL PROPERTY

# Property Play

*A primer for investors who are considering commercial real estate to build up their nest eggs*

By KEMBA J. DUNHAM

**A**FTER HIS MOTHER died a few years ago, Mark Larson "realized mortality" and came to a big decision. He wanted to amass enough wealth to leave something behind for his children.

So, he and his brother started investing—but not in stocks or mutual funds. Instead, they began buying properties like office buildings and retail space.

"With the stock market, you're investing in faith," says the 56-year-old Mr. Larson, national director of the private-capital investment group at real-estate services firm Grubb & Ellis Co. "But with commercial real estate, you can quantify the location, quantify the rent, and drive by and look at it every Saturday to make sure it's still there."

More investors are following Mr. Larson's logic as they think about retirement. They're looking to build nest eggs that could last 30 or even 40 years—and commercial real estate seems like a stable investment compared to stocks.

For one thing, commercial real estate delivers regular income—whether from rent checks or dividends from a real-estate investment trust, or REIT. And the sector has traditionally kept pace with inflation and provided "sufficient risk-adjusted returns," says Grant Conness, a financial adviser at 1031 Alternatives Group, a division of Costa Financial Securities Inc. in Hollywood, Fla.

Indeed, while the residential housing market is struggling, commercial real estate is showing solid fundamentals in many markets—with occupancies high,

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increasing rent growth and supply under control.

On top of that, commercial real estate has gotten increasingly sophisticated and transparent as an investment vehicle in the past 20 years. In part, that's because of the emergence of the market for REITs. These publicly traded companies invest in real estate and pay out 90% of their income as dividends to shareholders.

Here's a look at some of the ways to invest in commercial property—starting with some important caveats.

### Get Some Help

Investors who want to consider commercial real estate as an investment shouldn't try to go it alone. Many experts recommend finding a broker who can analyze regional markets, how the various commercial property types are performing in those markets and the kind of rents these assets can capture at any given time.

It's also important to work with an expert to figure out what kind of investment would make you feel most comfortable. For instance, an older property that needs renovation may be a riskier bet than a newer one that doesn't need much work, says Harvey Green, chief executive of Marcus & Millichap Real Estate Investment Services, an investment real-estate broker in Encino, Calif. Unless you can find tenants to pay higher rent—and cover the costs of renovation—you may not be able to get a good enough return on your investment. Another example would be a strip shopping center with no anchor tenants, which has a much higher risk level than a neighborhood center with a grocery-store or drug-store anchor tenant, adds Mr. Green.

Finally, bear in mind that commercial

real estate, like other types of real estate, can go down in any particular location, says Michael Kitces, director of financial planning at Pinnacle Advisory Group, in Columbia, Md. The local economy might slow down, big area employers might cut lots of workers and the government might raise taxes.

Now let's look at some ways to buy property.

### Direct Ownership

The basic choice in property investing is whether you'll invest directly in a property or do it through a third-party vehicle. Buying a property directly offers a couple of big advantages. You can deduct part of the purchase cost of the building from your taxes for many years. And if the property goes up in value, you don't have to share the gains with any partners.

This approach also means you can do a "1031 exchange." This allows you to defer, or sometimes avoid, paying capital-gains taxes when selling the property, if you plan to use the money to buy another property of equal or greater value. "As long as the investor keeps moving into another investment, they virtually never have to pay the tax on their gain," says Marsha Sloten, a Las Vegas-based commercial real-estate broker.

Still, the thought of managing tenants and dealing with building upkeep might scare off many baby boomers who are gearing up for retirement and are looking for a hassle-free investment. So, many people hire a management company to deal with those headaches. Typically, local management companies charge anywhere from 5% to 10% of the gross rent, depending on the duties they perform. Larger commercial companies might charge between 4% and 6%.

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When hiring a management company, check out its references and see how well it is regarded locally. For instance, interview local vendors that have worked with the company, such as plumbers, painters or carpenters.

### **Sponsored Investment Properties**

Investors who don't have the money or inclination to go it alone can turn to sponsors, who buy commercial properties on behalf of small investors for a fee. In most cases, you don't have to seek out a sponsor; they typically market investment products directly to financial advisers, who in turn present them to their clients as options.

To figure out if a sponsor is trustworthy, you can check court or state records to see if the sponsor has had any problems. You can also ask for references from investors who have done business with the sponsor.

Kraig Kast, chief executive at Atherton Trust, a provider of trustee and wealth-management services in Redwood Shores, Calif., offers another piece of advice: "I would invest small—\$30,000 to \$250,000—then if the results are there, invest more over a period of time with that sponsor."

There are a number of ways of investing with a sponsor. One is tenants-in-common, or TIC, ownership. A TIC typically involves a group of investors who each buys a fractional interest in a commercial property, such as an office building. The investors receive the benefits of ownership—rental income and profit on any future sale—but leave the

day-to-day details to professional managers.

"TIC properties are usually buildings that most small to midsize investors couldn't otherwise afford to purchase on their own," says Mr. Conness of 1031 Alternatives Group. Experts say qualified individuals can invest in a TIC with as little as \$100,000.

One drawback of the TIC is that once you invest, you're probably locked in until the property is sold. You could sell your fractional share, but there's a limited market for such a purchase.

Smaller investors can also team up with other investors to form a limited partnership. Usually, there's a general partner who puts the partnership together with the help of an attorney, and gets paid a fee for managing the property and a share of the profits, says Lou Weller, a principal at Deloitte Tax LLP in San Francisco.

What's the main distinction between the two options? The big difference is that you can exchange into or out of a TIC interest in a 1031 exchange. But in an LP, the limited partnership can't exchange its interest in such a fashion. Also, in a TIC structure, investors each get a deed to their share of the property. But with a limited partnership, the property title is held by the LP entity.

This leads to differences in the legal consequences, says Mr. Weller. If someone owns a TIC interest directly, he or she can be sued directly. But the LP structure itself limits legal exposure of the limited partners.

A third type of sponsored investment vehicle is the REIT. If you're put off by the recent volatility in actively traded REITs, you might consider public, non-traded REITs. These offer all the benefits of regular REITs—such as monthly distributions—but they don't trade actively, so they're often much more stable. (A REIT's monthly distributions often are about the same as income from TIC or LP offerings.)

### **Triple Net-Lease Properties**

Finally, there are "triple net-lease properties," which you can buy as an individual investor or as part of a group. In these deals—typically used for retail, office and industrial properties leased to a single tenant—the lessee handles expenses such as taxes, insurance and maintenance.

The appeal for tenants is that they typically get a long-term lease—sometimes 30 years—with limited increases in rent. The advantage for owners is that all they have to do is pick up the check from the mailbox, says Grubb & Ellis's Mr. Larson. And because the tenant usually holds a long-term lease, owners feel they can count on the income for years. Mr. Conness adds, "The ability to relate to a well-known tenant like Walgreen's gives many investors some piece of mind."

A caveat: Because of the long leases, net-lease properties can be very illiquid. "Be cautious about tying your money up in an investment vehicle that is not liquid if there's a risk you'll need the money sooner rather than later," says Mr. Kitces of Pinnacle Advisory Group. ■■■