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Upgrading And Refurbishing Apartments

Have you looked around for rundown apartments? Finding them is not difficult. Refurbishing an apartment property for big profits might be easier and less expensive than you might think. Investors who specialize in upgrading neglected and deteriorating apartments and houses, renovating them for sale or lease, make some of the highest profits in real estate.

There are also many larger houses that have been overlooked as investments because they are too large and poorly designed. These can be trimmed down to accommodate a family seeking more spacious quarters. By reducing the structure's surplus space, many sprawling houses can be made salable. It is also possible to buy a large house, remodel it to a duplex or more units (with zoning approval) and sell it for a good profit.

Some houses and apartments offer extra land. If you find one, study it carefully. It is sometimes possible to not only get your money back, but also make a profit on the sale of a remodeled house with a reduced amount of land (assuming the local zoning ordinances will so allow), while holding the additional land for long-term appreciation

or building another house or small apartment on it. One investor moved an existing structure from the middle of a large lot to one side, leaving room for a three-unit apartment after a split into two lots.

Benefits In "Rehabbing" Apartments And Houses

Low Front-Money Requirements. Less front money is required for many rehabilitation jobs than for comparable new construction, since the building shell is valuable and less material is required.

Maximum Use Of Work Crews. If the investor is a builder, he can buy or option buildings and start working on them during slack construction periods. In this way, he keeps construction crews busy for the maximum amount of time.

Cash Flow. A rehabilitated building can bring the investor a steady rental income providing cash flow and profits with tax shelter produced by depreciation deductions.

Quick Action. As the rehabber gains experience, a builder can complete work on an older ➤

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This publication is not a solicitation but is an information service from this office.

In This Issue

- Upgrading And Refurbishing Apartments
- Improvements On Leased Land
- Owners May Need A Lease Cancellation Clause
- Apartment Tenants Choose Amenities To Lower Rents
- Help With Investment Real Estate

When ideas in tax and other legal areas in this publication seem to fit your situation, it is recommended that you discuss them with your professional advisor before taking action.

Upgrading Apartments... (Continued)

building in less time than it takes to put up a comparable building from scratch. Usually, a rehabilitated building will produce more rentable space than a similar new structure because of modern building code requirements.

A Rental Portfolio. A portfolio of rehabilitated houses and apartments should produce a relatively high rate of return with only a limited risk. As they appreciate in value, periodic refinancing of the buildings is possible. In this way, the

investor can cash out part of the equity tax-free. Also, refinancing can produce substantial funds for new construction and rehabilitation projects. Later, when the buildings are sold, the gain will be taxed at favorable capital gains rates.

After the purchase, continue with the most professional actions by employing a professional real estate management company. ■

Improvements On Leased Land

Building apartments or other commercial buildings on leased land results in a separate ownership of that building and the owner of the land. The two owners, one of the land and one the improvement come together in one investment parcel. In this situation the landowner wants someone to develop the land but still wants to continue in ownership. The developer prefers to lease rather than buy the property.

One owner wants the security of owning the land with a good lease to the owner of the improvement. The owner of the building puts up less money since the ownership of land is not part of the expenses in the development.

Benefits To The Lessor

An example could be the developer of upscale homes who wants to keep the ownership of the land as an investment. The use of the land lease can widen his market by reducing the purchase price of the house. In certain parts of the country, the value of the land equals the value of the house. Leasing the land can cut the purchase price nearly in half. With this type of land lease, there is usually a provision for a rent increase halfway through the lease term in accordance with the results of a reappraisal of the land.

Benefits To The Lessee

The land lease results in the following benefits for a builder or developer:

- He/she can acquire a valuable parcel of land with very little cash investment.
- This leasehold that is acquired is an asset that can increase in value, and then could be used as security for a loan, or could be sold for a profit.
- The rental payments are fully deductible by the lessee.
- With a subordinated land lease, the lessee-developer gets the equivalent of a 100% loan on the land.

The Term of the Lease

Usually, a developer-lessee will attempt to get the longest possible term in the lease because the shorter-term land lease would have a smaller market for resale. A long-term land lease is generally a net lease under which the lessee pays the carrying costs, including real estate taxes.

When the land rental is a fixed amount, it is a percentage of the fair market value of the land when the lease is executed. This lease will often include a provision for reappraisal of the land at fixed intervals, with new adjustments in the rent. In

some cases, for instance with a shopping center, the landowner might demand a share of the percentage rentals over and above the fixed land rent. (Much of the income in the shopping center will come from percentage overages from the sub-lessees.)

Subordination Of The Lease

If the owner of the land will not subordinate the lease to a leasehold mortgage, the developer should get a reduction in rent because the unsubordination will cause his financing to be more expensive. Subordination could be the most important item in the terms of the lease. Even a short subordinated lease might be better than a longer unsubordinated lease, even though the longer lease is more salable.

The landowner may or may not allow his interest as owner-lessor to be subordinated to the interest of a leasehold mortgagee. When there is a subordination to the mortgage, the lender, in effect, gets a fee mortgage on the land rather than a leasehold mortgage.

When the lease is unsubordinated, the landowner-lessor has first rights over the lender in case the lessee-mortgagor should default. With these terms, the lessee could find that he cannot get a loan, or can get one only at a higher rate of interest. Without the subordination, the mortgage is, in effect, a second lien since the lessor's claim on the rents takes precedence over payments on the mortgage.

The objections of an owner to subordination of the lease could be as follows:

- He could lose the property if the lessee defaults on the leasehold mortgage.
- Subordination reduces his possibility of mortgaging his fee interest in the land, which would be a logical move for the lessor.

If the subordination is part of the terms, the landowner would record his right to receive any notice of default from the leasehold mortgagee and the right to cure the default. The expense would be reimbursed to the owner by adding the amount to the lessee's rent obligation. ■

Owners May Need A Lease Cancellation Clause

Whether a rental market is weak or strong, lease negotiations can be difficult when the landlord wants concessions that are different from the norm.

One situation that happens is when the owner of an office building or other commercial property intends to sell when market conditions improve, whether that occurs next year or five years from now. Another is the holder of vacant or under improved property who plans to develop it whenever market conditions justify. In the meantime, these properties must be leased to generate sufficient cash flow to pay operating costs and debt service. Such an owner will be amenable to giving significant concessions, including a low rental, provided the landlord can cancel the lease during the term.

An alternative to a long-term lease subject to cancellation is a series of short-term leases. However, a long-term lease subject to cancellation under specific conditions may be much more preferable to a tenant than a short-term lease that the landlord can refuse to renew for any reason. Here are some guidelines for drafting a fair cancellation clause:

The Guidelines

The option to cancel the lease by the landlord could easily lead to misunderstandings and lawsuits unless it is carefully drafted. Here are some important things to consider:

- **Definite Reason.** A landlord asking for the option to cancel in order to sell the property or demolish the improvements nevertheless may want the option clause in the lease to be unconditional. The need to specify a reason in the notice exercising the option could raise questions of good faith or improper exercise if, for example, a subsequent sale or demolition is delayed or postponed for a period. On the other hand, the tenant may insist that a reason be given; oral representation during negotiations will not themselves limit a cancellation option that is unconditional in the lease.
- **How the option is exercised.** One solution to the problem of an unconditional option is to make it exercisable only on actual sale of the premises. This would mean that possession could not be given at the closing of title and so be unacceptable to the buyer. The landlord will want the option exercisable at the time the

contract is signed (perhaps with the tenant to be entitled to remain until title is closed).

- **Notice to tenant.** The tenant will need a reasonable time to terminate its business and remove its property. The landlord will not want the notice period to be so long as to discourage a prospective buyer.
- **Reimbursement to tenant.** If the tenant will incur substantial costs to prepare or improve the premises for use, it may insist on reimbursement if the lease is canceled. A common formula is to amortize the up-front costs over the lease term, with reimbursement to equal the unamortized cost at the time of cancellation. (An alternative method is for the rent to be set initially at a low level, stepping up after periodic intervals.)

The lease should make clear when any such payment is to be made—at the time the notice of cancellation is given, at the time the tenant vacates, or at a subsequent time. Use of an escrow may be a solution to this issue.

- **The new landlord.** Suppose the original landlord sells the property to a buyer willing to take the property subject to the existing lease so no cancellation occurs. Does the new owner have the right of cancellation, or does it terminate on the sale? This should be made clear; if the option extends to the new landlord, it should also be clear as to whether the original or successor landlord is responsible for any payment due the tenant.
- **Right of first refusal.** The tenant may seek a right of first refusal in the event of a proposed sale accompanied by a cancellation of the lease. This would give the tenant the right to match the offer of a third party to buy the property. Landlords do not like rights of first refusal because they complicate efforts to sell; in this situation, it is unlikely that the tenant will insist on the right since the value of the property to a third party intending to develop it is likely to be substantially above the market value of the property under its current use.
- **Tenant's right to cancel.** The tenant may ask for a similar right to cancel the lease under certain conditions. While the landlord's cancellation option is fully valid without a corresponding right for the tenant, the landlord may be willing to make this concession in order to gain agreement ■

Apartment Tenants Choose Amenities To Lower Rents

Apartment living is a lifestyle decision for many tenants. Landlords might be advised to involve their tenants in the decision-making process in order to create and maintain desirable lifestyle living arrangements. One landlord, together with his management company polled tenants in a survey. They were surprised by the results.

They found that apartment tenants would rather have more car wash areas, longer pool hours, and a bigger club or recreation room on the premises instead of lower rent. The survey

found that tenants preferred that the landlord provide more and better amenities rather than making any changes in the rental arrangements.

Unexpected Results

Before the survey the landlord and management firm expected to see that tenants would want lower rent increases, bonuses or discounts for other changes more important.

In addition to the three most frequently mentioned amenities (car wash, pool hours, and rec room)—which the manager noted are the easiest for a landlord to give tenants—tenants also said they would appreciate having designated parking spaces, a barbecue or picnic area, tenant gardening, and permission to hold yard sales. ■

Help With Investment Real Estate

When you have searched for new real estate investment opportunities, with values that have been changing, you know that finding and evaluating them is becoming more sophisticated and complex. More investors are turning to real estate consultants as a means of providing a sounding board for their ideas as well as expertise in the planning and construction stages for their projects.

Today's investor in real estate must have a grasp of market conditions and potential that is usually beyond their own available time to attain. Investors need assurance about the true condition of the market. With increased competition, the market place is becoming more complicated.

Feasibility studies are essential for commercial

office, industrial, resort and hotel investors. With this kind of information, planning is better and there is less chance for error.

Real estate investing is not just looking for the structure and the land. It is investing in the type of property that you want at the price and terms that suit you at the time you want to make the purchase.

Our office is open and ready to assist you. We have been experts in property values in this area for a long while. We can help you with enough information so that you can make your own decisions on the value of property either in listing your present property for sale or in purchase of another. If you wish to consider structuring a tax deferred exchange into that next property, we can guide and aid you with that transaction.

Let us guide you in your investments. ■



A CCIM is a professional real estate practitioner with proven technical expertise in commercial property. A CCIM is a person truly committed to the fundamentals of effective commercial-investment brokerage. The CCIM has completed a full schedule of Post Graduate Level Courses in investments, taxation, development and marketing all types of commercial-investment properties. The designation of Certified Commercial-Investment Member is unquestionably the highest degree awarded in the commercial-investment real estate practice.

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