

COMMERCIAL REAL ESTATE

Property Types



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Introduction

Crowdfunding offers a number of ways to diversify within the larger asset class of real estate generally. Investors can, for example, become lenders whose loans are secured by a property (“first trust deed” investing), or take an ownership position (“buy and hold” investing) so they can participate in a property’s potential appreciation. Investors can also diversify among different kinds of properties—and commercial real estate has several sub-classes of property types that an investor should be familiar with.

COMMERCIAL PROPERTY ASSETS CAN BE ALLOCATED AMONG FOUR MAJOR PROPERTY TYPES:

- > **Apartments/Multi-Family**
- > **Office**
- > **Retail**
- > **Industrial**

Other property types in the commercial sector include **self-storage facilities, healthcare properties, hotel/lodging accommodations, and senior living centers**. In this introduction, we’ll focus on the four primary property types.

MULTI-FAMILY

Multi-family residential buildings vary by location (urban or suburban) and size of structure (high-rise or garden apartments). Economic drivers of apartment buildings include demographic trends, home ownership, household formation rates, and local employment growth. Leases are typically short-term (one to two years), and adjust quickly to market conditions. Larger apartment buildings are only minimally affected by any single vacancy. Multi-family properties are generally considered to be one of the more defensive investment types within commercial real estate, though they are still subject to competitive pressures from newer construction.

OFFICE

Office buildings range from large multi-tenant structures in city business districts to single-tenant buildings (like a hospital’s medical office building). Rents and valuations are influenced by employment growth and a region’s economic focus (e.g. finance and high-tech centers typically need more office space). Individualized tenant improvements are usually not very involved, but credit quality of tenants is key; re-leases of office space typically require some lead time to consummate. Office properties often have longer-term leases that can lag behind current market lease rates, so that significant “step-ups” (or “step-downs”) of rental rates may occur when leases expire. Because these buildings are often leased to businesses, the tenants often demand special features in the leases, including rights of first refusal to rent contiguous space, signage rights, or even building purchase options.



RETAIL

The retail sector includes everything from smaller neighborhood shopping centers (encompassing, for example, a small grocery, pharmacy and a few restaurants or clothing stores) to large “super-regional” malls that have entertainment activities and can draw shoppers from a great distance. In the remainder of the spectrum are community shopping centers, fashion or specialty malls, outlet malls, and “power” centers with a “category-dominating” anchor tenant like Home Depot or Wal-Mart. Retail properties are most broadly influenced by the state of the national economy generally, especially such indicators as employment growth and consumer confidence levels. More local factors include the property location and its traffic flow; population demographics; and local household incomes and buying patterns. One unique feature of retail store leases is that they frequently contain a base rent payment plus a “percentage rent” payment based on the tenant’s gross sales figures. Leases also often have long terms; as with office buildings, this means that after a while lease rates may lag current market rates, and step-ups may need to wait until lease expirations. New tenants may also demand more in the way of space improvements that contribute to the “look and feel” of their business.

INDUSTRIAL

Industrial properties include manufacturing facilities, warehouses, distribution centers, and research & development space. Manufacturing and R&D properties tend to be build-to-suit buildings that can be difficult to “re-tenant” without extensive modifications, while warehouses and distribution centers can be more generic buildings. Industrial properties are also influenced less by local job growth than by larger economic drivers such as global trade growth (imports and exports) and corporate inventory levels. As with office buildings and retail centers, industrial property leases tend to have long terms, so that over time lease rates can fall behind “market.” Perhaps most importantly, industrial properties tend to be occupied by a single tenant, adding lack of diversity as another level of risk to this property type.

The various commercial property types must each be evaluated differently. The influence of regional economic considerations, market supply and demand, lease terms, tenant credit, and any “pass-throughs” of operating costs on a commercial property varies significantly depending on what type of property is being discussed. Because of this variation, prudent investors should consider diversifying across several of the major property types in order to reduce their overall investment risk. We explore some of the primary property types in more detail in the following chapters.





Multi-Family Housing

The multi-family sector is considered one of the most “defensive” areas of real estate.

Apartment buildings tend to be less prone to economic cycles, since everyone needs a place to live, even when a drooping economy might cause significant vacancies in other types of commercial space. Crowdfunding allows investors access to larger multi-family complexes that offer even more stability, since individual vacancies in those properties have a lesser impact on the overall rent roll than do vacancies in smaller complexes.

Apartment buildings represent almost 25% of the total U.S. commercial real estate market.

They can vary by location (urban or suburban), by the mix of units (e.g., studio, one bedroom, or two-bedroom), and by the type of structure (high-rise or garden apartments). Garden apartments (usually two- or three-story buildings with more open space) often have a more favorable building-to-land ratio for purposes of the depreciation deduction. They also sometimes exhibit more price elasticity, meaning that rent reductions or increases are more likely to affect demand; high-rise apartments tend to be more expensive at the outset, and thus pricing is often less of an issue.

Like other areas of commercial real estate, apartment buildings can be classified by quality level.

“Class A” structures are generally newer buildings in better market locations. Amenities may include workout facilities, deluxe lobbies, and doormen, and the rents are reflective of these features. Class B structures are usually somewhat older buildings in locations that are less upscale, with a more limited range of amenities. Class C buildings tend to be the older buildings in the market area, usually with lower- and middle-income residents.



Apartment demand comes from a number of sources, including demographic trends, home ownership and household formation rates, and local employment growth. Newly married couples and young adults moving out on their own are likely to initially rent an apartment. Demand is also driven by relocations of existing households to new areas. Also, many people who could conceivably buy a home still choose to wait until they are better able to bear the financial burden of a monthly mortgage payment.

Apartment leases are typically short-term—one to two years. At first, this might seem to be a disadvantage, but a shorter lease has several advantages. For instance, a shorter-term lease is an attractive feature to renters not wanting to make a long-term commitment, so it is typically easier to find tenants to fill vacancies relative to longer-term leases. It also means that multi-family properties can adjust quickly to market conditions, either to quickly implement rent increases in a “hot” market or, if the demand environment is not so great, to offer short-term rent incentives in order to minimize the vacancy rate. Market rents depend on local median incomes as well as the cost and availability of home or condominiums to purchase as an alternative to renting an apartment.

As with other commercial properties, apartment complexes require competent property management if cash flow is to be maximized. The tasks of rent collection, tenant relations, maintenance schedules, security, bookkeeping, and showing and renting space are all jobs that need to be done successfully to assure that the expected revenue will be achieved. The management function has only grown in importance in recent years; the shift of more real estate ownership to institutions that require strong reporting, and a significant increase in both litigation and regulation, all call for managers to increase their levels of documentation.

Since apartment buildings share many features with single-family homes, this type of investment is often more familiar to many investors. The cash flows derived from multi-family complexes are usually relatively steady, assuming that the property is correctly managed. Crowdfunding allows investors access to larger multi-family complexes that offer even greater stability. Assuming the proper due diligence has been done in initially valuing the property, a well maintained and favorably located apartment complex represents one of the least risky forms of real estate investment.





Due Diligence on Multi-Family Housing

Crowdfunding of real estate can provide investors with increased access to large commercial properties of various types, and apartment complexes can be one of the least risky forms of real estate investment. Here, we discuss some of the due diligence that investors need to undertake in evaluating these multi-family opportunities.

Cash Flow.

As a general rule, the value of any income property is a function of the cash flow it generates. Sometimes investors are willing to pay very high prices (low capitalization rates) because they expect significant ongoing increases in the cash flow of a property, or because the value of the land offers a separate source of value. This is not usually true of apartment buildings; cash flow typically grows over time, but physical and functional obsolescence, and sometimes local rent controls, usually cause cash flow growth expectations to remain modest.

Location.

The area or community in which an apartment complex is located is of prime importance. The regional economic drivers and employment levels are important, but a more detailed study of the particular neighborhood of the property is also essential. Is the area already a desirable area to live, or at least seeing an upswing in perceived appeal? Are other neighborhood demographics, like the age distribution and average household size, favorable to apartments? Local economic activity is also important. Are new jobs likely to be created nearby, or are nearby base industries on the decline? Access to transportation is also valuable – are freeways or light-rail lines nearby to provide access to downtown areas or other employment centers?



Physical Plant.

As with any property, the physical state of the property must be assessed to evaluate deferred maintenance items that can materially affect the operation and value of the apartment building. A prospective owner should evaluate the plant's foundation, roof, heating and air conditioning systems, electrical, plumbing, elevators, and the building's "envelope" (the windows and walls). Expected future repairs or improvements should be analyzed with an anticipated timeline and the associated costs, in order both to better negotiate the purchase price of the property and to perform appropriate financial planning for the investment.

Competing Supply.

Construction cycles occasionally result in an over-supply of apartment buildings and other commercial properties. An analysis of new construction permits and other housing statistics can provide a feel for whether the property is in a relatively stable market or one where competing properties are shortly due to come on-line. Construction is also affected by local or regional restrictions such as zoning, building codes, and environmental impact studies and fees. Over the long run, such restrictions may cause local apartment building price appreciation to be greater than in other areas.

Vacancy Rates.

Currently, complexes with more than 7-8% vacancy rates tend to be either in an unfavorable market area or in need of renovation or other re-positioning. Sometimes, however, such adverse figures are simply due to poor management. Apartment buildings are management-intensive, and tenant relations, proper maintenance, and the showing and renting of space are key components of the property manager's responsibilities. A review of current and historical occupancy rates, both for the property and for comparable properties in the area, can give an investor a better understanding of a property's potential competitiveness.

Value-Add Opportunities.

Sometimes a smartly chosen remodeling project can markedly boost the attractiveness (and rental rates) of a property. A re-fashioned façade, or the remodeling of kitchens and baths as units become vacant, can oftentimes justify higher rental rates and increased cash flow. Apartment buildings are also often in a position to generate ancillary sources of income. Coin-operated laundry facilities (using energy-efficient equipment) and vending machines are some of the best sources. Parking spaces can often be charged for separately, and are usually not subject to rent control regulations. Mini-warehouse facilities and furniture rental arrangements, among other things, can also add to a property's top line.

A key aspect of any passive investment is to also perform due diligence on a project's sponsor. Operators with a track record and a solid understanding of the local market are often well positioned to update poorly performing properties and run them more efficiently.





Retail Properties

Retail properties represent more than 25% of all investment-grade commercial real estate in the United States. Consumer spending represents nearly two-thirds of the domestic economy, and the U.S. has more retail space per capita than any other country. Although internet sales have had an impact on some retail sectors (notably electronics and books) by moving some of the related business online, in some sectors online retailers have begun opening up traditional physical stores. Preferential sales tax treatment previously given to internet-based retailers has now ended. The vast majority of consumer purchases still take place in physical stores, and studies show that most consumers prefer the “touch and feel” aspect of shopping -- indicating that physical retail centers will likely remain the dominant means of consumer purchasing in most sectors for the foreseeable future.

The retail sector includes everything from smaller neighborhood shopping centers (encompassing, for example, a small grocery, pharmacy and a few restaurants or clothing stores) to large “super-regional” malls that have entertainment activities and can draw shoppers from a great distance. In the remainder of the spectrum are community shopping centers, fashion or specialty malls, outlet malls, and “power” centers with a “category-dominating” anchor tenants.

Special Economics.

Retail properties have their own set of growth drivers, on both macro- and micro-economic levels. The sector is most broadly influenced by the state of the national economy generally, especially such indicators as employment growth and consumer confidence levels. More locally, the many important factors include the property location and its traffic flow, population demographics, local household incomes, and buying patterns.



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Shopping center operators must work not only to keep their properties fresh to attract consumers, but also to stay abreast of their tenants' own competitive pressures. A retail property may not only be at risk of physical obsolescence (an aging facility may need a major structural overhaul), but also of becoming obsolete competitively (for example, if a significant tenant is suffering in the face of larger or more fashionable rivals). A property's layout can also become a functional disadvantage; popular retail formats can change, and the configuration of existing store sizes may no longer satisfy modern tastes.

Unique Rental Characteristics.

In the retail world many tenant leases are of the triple net lease type, where some or all of the responsibility for paying the property's pro rata real estate taxes, insurance, and maintenance is shifted to the tenant. These arrangements have their own special due diligence considerations.

Most shopping centers have larger “anchor” tenants that are a major draw of consumer traffic to the center generally. For neighborhood centers, a typical anchor store might be a Safeway, CVS or Walgreens; for larger malls, perhaps a department store like Macy's, Target, or Nordstrom. Because these tenants serve to draw much of the center's traffic, they often get special incentives on the rent—they generally pay based on a percentage of their sales, and sometimes only over some threshold amount. Smaller “in-line” or specialty tenants are often responsible for the bulk of the overall rent roll—a price they are willing to pay because the anchor tenant is perceived to be driving much of the customer traffic to the center.

Many tenants will also be required to pay “percentage rent” based on their sales volumes. The idea behind percentage rent is that the structure acts to align the interests of the landlord and tenant; the landlord has an incentive to maximize the tenant's prosperity, since the landlord shares in the tenant's success by gaining increased rents if the tenant enjoys better sales. Usually, landlords and tenants will negotiate a threshold or “base” sales amount; if the tenant store's sales are below that threshold, it will pay only the base rent, but if the sales are above that figure additional percentage rent will apply. Percentage rents are typically in the range of 4–8% of the tenant's sales over the agreed “breakpoint” threshold amount.

Because tenants establishing a retail business (or branch store) have their own set of start-up expenses—and sometimes require particular improvements to a space—they often negotiate leases of relatively long terms, usually also with renewal options. While these leases will still typically have escalation clauses tied to the consumer price index or some other rent increase schedule tied to inflation, their longer term gives the tenant some assurance that its business will have adequate time to establish itself. For property managers, such leases bring some security, but also a degree of risk; the rents under longer-term leases can, over time, begin to lag current market rates. A landlord may have to wait quite a while before being able to take advantage of any step-up of space's rent to a level more in line with market rates.



Another factor with retail leases is the brokerage commission that typically applies. Unlike with residential properties, where a manager either handles rentals to prospective tenants directly (or retains a management company to do so), retail properties typically require specialist professionals to broker leases between prospective tenants and landlords. These brokers have contacts with large retail chains and other sources of potential tenants and can be very useful to a landlord's efforts to fully lease a center. Their fees, however, are typically paid by the landlord, and their commission rates are generally based on the aggregate base rent figure. The landlord must thus negotiate with brokers as to whether all of their commission is due up front, or whether their fees can be paid on an "as collected" basis over the term of the lease.

Another feature of retail rental negotiations is the issue of how to handle any necessary improvements to a retail space. Plumbing fixes, repainting, and other basic "habitability" repairs are clearly the landlord's responsibility. Often, however, a tenant may want specific improvements that contribute to the "look and feel" of its business. If such improvements may not be readily usable by a subsequent tenant, a landlord might resist paying for them. Usually both sides bring money to the construction issue, but leases vary widely as to how the costs of tenant improvements are shared.

Retail Property Sub-Market: Triple Net Leases

A triple net lease (NNN) is a lease agreement on a property where the tenant or lessee is responsible for paying all of the three "net" expenses – real estate taxes, insurance, and all maintenance – in addition to any other fees covered by the lease agreement such as rent and utilities. Typically, this structure is seen with single-tenant retail properties leased to tenants with high credit ratings (e.g. single building with Walgreens as only tenant). The most common corporate credit tenants for triple net leases are discount stores, fast food restaurants, auto parts outlets, and pharmacies.



From an investor's perspective, investing in a triple net lease can often have the following benefits:

Predictable, long-term revenue stream.

Triple net leases are often structured as long term lease agreements, and it is not unusual to see 10-25 year terms. Investors also receive the rent "net" after the expenses are paid by the tenant, which creates a predictable income stream that is not impacted by future increases in operating expenses and capital expenditures, some of which can be large and many times unexpected.



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Protection against inflation.

Along with the high degree of income security that comes with a triple net lease, investors should also expect to see additional rent increases over time built into the leases, which provide a hedge against inflation.

Little or no property management responsibilities.

In a true triple net lease, the tenant takes control of the building, alleviating virtually all of the day-to-day management responsibilities.

Reliable, reputable tenants.

Often, large national tenants will elect to conserve their capital and instead of purchasing their own properties, they will execute long-term triple net leases. Freeing up this capital enables these companies to invest more in the other critical aspects of their own businesses, which could include acquisitions, paying down debt, or simply diverting capital to more productive capacities. While an investment-grade credit rating does not indicate a risk-free investment, investors can often benefit from the large stable of reputable corporate tenants that typically operate using triple net leases.

Due Diligence on Retail Properties

We've seen how a retail property can be somewhat cyclical and is influenced by the state of the economy, especially such indicators as employment growth and consumer confidence levels. Valuation remains a property-specific matter, though, and we'll now discuss some of the key aspects of due diligence on retail properties and the primary factors driving their valuation.



Physical Plant.

As with any property, the physical state of the retail center must be assessed to evaluate deferred maintenance items that can materially affect the operation and value of a property. Depending on whether the property is of the triple net lease variety (and thus whether the tenants might be responsible for some of the building maintenance), a prospective retail property owner should evaluate the plant's foundation, roof, heating and air conditioning systems, electrical, plumbing, elevators, and the building's "envelope" (the windows and walls). Expected future repairs or improvements should be analyzed with an anticipated timeline and the associated costs, in order to both better negotiate the purchase price of the property and to perform appropriate financial planning for the investment.



Tenant Quality.

An inquiry more specific to retail property concerns the quality of the tenants that occupy the shopping center. Investors generally hope to see some “credit” tenants – stores that are part of a large national chain with access to public credit markets. The more prominent of these will have an investment-grade credit rating from a major rating agency, which rating can be anywhere from “BBB” to “A.” Retail properties that are dominated by “noncredit” tenants would be deemed of a somewhat lesser quality property class, perhaps as Class B or Class C.

Lease Terms/Renewals.

We earlier discussed how retail property leases can be of relatively long duration, since stores need to have some time to get their businesses established. Investors should review not only the current rent roll but also the various lease terms of the tenants, and get an understanding of the timing of any upcoming renewals. The market rent rates of similar properties in the area should be studied in order to assess whether the leases coming up for renewal currently have lower (or higher) rents than other similarly situated properties. Some centers may offer a “value-add” opportunity if the current rentals are perceived to have been mismanaged and the rent roll might be increased with a changed tenant mix or other repositioning of the property.

Market Area.

Factors affecting the general marketability of a retail property include the property location and nearby traffic flow, the area’s population demographics, local household incomes, and buying patterns. The average number of people driving (or walking) past the center on any given day is a key metric in evaluating a retail center. Convenience of access can also be an issue; if in a heavy traffic area, are there exit ramps or turn lanes that ease the approach to the center’s parking lot (and is the parking lot of sufficient size)? It is also important to understand the local population (and whether it is growing), and to know the average local age and income level. This is key in understanding the center’s customer base and in assessing whether the center’s existing retailers are an appropriate “fit” for that population.

Competition.

The success of the center may also depend on the local competitive environment. If similar retail businesses operate nearby, they may operate to “cannibalize” the sales of the stores in the shopping center if the total market capacity is becoming saturated. It is also essential that the center not have an internal mix of businesses that might unnecessarily compete with each other. Fashionable new entrants can also disrupt the center’s business; if an older, smaller grocery store anchors a shopping center and a shiny new Whole Foods store opens nearby, then the older grocery store tenant could become competitively obsolete and the center’s overall sales may drop off as a result.





Office Buildings

Office buildings range from large multi-tenant structures in city business districts to single-tenant buildings that might be built to suit a specific lessee. These buildings are, of course, subject to market forces affecting supply and demand just like other types of commercial space. However, the economic drivers for office space are sometimes different than those for other real estate investments.

Rents and valuations for offices are primarily influenced not just by employment growth but also by a region's economic focus. Office buildings are especially influenced by specific types of employment — namely, sectors with very high proportions of office use. These economic segments are generally those that utilize service and professional employees such as attorneys, accountants, engineers, insurance personnel, real estate brokers and related service providers (like title and escrow providers), and people working in banking, financial services, consulting, medical, dental, and pharmaceutical fields.

Office buildings are interesting indicators of how land-use patterns and submarkets develop within urban areas. Like retailers, business firms utilizing office space look at the real estate and land from which they sell or market their services as just another input in the production of their client services that are sold from a location. Business users view real estate as a factor that affects operating expenses and revenues; rent, space requirements, the number of employees, and revenues are viewed in the context of how various locations might maximize profit. Does the building really contribute to their business, by (for example) allowing them to advertise openly?

This viewpoint explains why the vast majority of real estate used by business firms is leased and not owned, even though many buildings may carry the name of a major corporation on their exteriors. Most tenants find leasing to be more cost-effective than owning, especially when their space requirements are less than the quantity of space they would have to purchase in order to get a building in their desired location. A large commitment of capital to purchase a large building takes away from the business's



ability to use those funds in its main area of focus and instead puts it in “the real estate business,” involving the know-how needed to collect rents, maintain, and insure the space. Even if a business can occupy an entire building, it might still choose to lease because owning would reduce its operating flexibility; if the company decided to leave a metropolitan area and consolidate (or expand) in a different location, it might have to sell the entire property. This could take a considerable amount of time and tie up personnel and capital, whereas a lease would have allowed it to move upon the lease expiration date—or it could have simply negotiated a release from the landlord.

Office space tends to be leased for three- to seven-year terms, with tenants often having the option to renew leases for additional terms. Rents vary by locations within office properties, and owners may charge premium rents for higher floors (with unobstructed views), building corners, and spaces contiguous with elevator banks. Tenants often demand special features in the leases, including rights of first refusal to rent contiguous space, signage rights, or even building purchase options. Office properties often have longer-term leases that can lag current market lease rates, so that “step-ups” (or step-downs) of rental rates are not infrequent when leases expire.

Despite the longer lease periods, office buildings have their own set of risks. Economic downturns can affect commercial real estate—including office buildings—more than residential buildings, and businesses can go bankrupt even while people continue to need housing. (After the dot-com crash, for example, Silicon Valley rents dropped in some properties by more than 30%.) For this reason, the credit quality of tenants is key; re-leases of office space can often require significant lead time to complete. Because of these issues, cash-flow oriented investors try to focus on office buildings with multiple tenants, so that no single tenant vacancy jeopardizes the entire property investment.

Building owners must also stay abreast of competitive pressure. A desirable office space is usually defined by whether it is “a good place to work” – which can encompass the convenience and other defining features of the surrounding neighborhood in addition to the state of the building itself. Accessibility of public transport, nice design and interior finishings, the vitality of the neighborhood during working hours, and value-added services such as parking, wireless broadband infrastructure, and security all are increasingly important features of office properties.

Investments in office building properties can be profitable, but they have their own distinct risk/return profile. Higher returns can be available, but these are offset by increased vacancy risks and competitive challenges. Multi-tenant buildings offer a certain level of safety, and long-term leases with high-credit tenants are also attractive to investors. Office buildings can fill a distinct place along the risk/return spectrum for commercial real estate, and for that reason should be considered by many investors seeking to diversify their real estate portfolio.





Hotels and Lodging

The ownership and management of lodging facilities has undergone many changes. A sector that began with entrepreneurs who owned and managed individual properties has come to be dominated by national and international chains. The most recent trend is for many major hotel chains to develop and manage properties for outside investors, rather than owning the properties themselves.

The hotel sector can be divided into a number of segments:

- **Deluxe:** Four Seasons, Ritz Carlton, Wyndam Luxury Resorts
- **Luxury:** Sheraton, Hilton, Westin
- **Upscale:** Crowne Plaza, Doubletree, Embassy Suites
- **Midscale:** Holiday Inn, Best Western, Comfort Suites
- **Economy:** Rodeway Inn, Econo Lodge, Motel 6
- **Extended Stay:** Summerfield, Homewood Suites, Extended Stay America

Luxury and upscale hotels tended to be more resilient in the aftermath of the recent recession, perhaps because they cater primarily to business travelers. Midscale hotels with food and beverage services constitute a very large segment of the overall market, while economy hotels are more favored by seniors and others traveling on a limited budget. Extended-stay hotels have larger, apartment-style guestrooms and typically service relocated employees and engineers assigned to a building project.

The lodging industry is closely tied to national – or even worldwide – economic conditions.

Prosperous times mean increased room and occupancy rates, but a faltering economy causes both leisure and business travelers to stay home or at least spend less. New construction is also a factor – in



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the late 1980s, oversupply caused a period of stagnation for the industry as a whole, even though the economy was doing well. The degree of this correlation with general economic strength is stronger than with other real estate asset classes. Demand for tourism services is particularly sensitive to both price competition and non-predictable shocks like terrorism, political unrest and natural disasters. At the same time, the supply side of the industry can be quite “sticky” – new hotel construction requires large-scale capital investment and a long-term investment horizon, leaving the industry sometimes slow to respond to demand increases requiring a short-term response.

Hotel economics depend on both occupancy rates and room revenues, so an important industry yardstick is RevPAR (REVENUE Per Available Room). This metric is calculated by multiplying a hotel’s average daily room rate by its occupancy rate, or by dividing a hotel’s total guestroom revenue by the room count and number of days.

Example: \$80 average room rate X 70% occupancy rate = RevPAR = \$56

Following the 2008-10 recession, hoteliers at first sacrificed room prices in order to increase their occupancy rates; more recently, though, room rates have increased significantly. An industry survey recently forecast RevPAR as growing between 5-6% over the next few years, which would be at the high end of average figures over the last 30 years or so.

Another recent trend is the lack of supply scheduled to come on-line over the next few years.

Concerns about Europe, among other things, held back new construction financing during the last few years, and the supply pipeline now appears to be below the long-term average – leading many industry observers to conclude that fundamentals will remain strong through at least 2017.

The hotel industry thus appears to have stabilized and entered into what looks to be an improving environment over the next five years or so.

Hotel values are now regaining the values last reached in 2006, so that owners who were previously “underwater” have now returned to the market, and the number of hotel transactions is up significantly – more than 50% over comparable periods in 2012, according to Jones Lang LaSalle, a major industry player. Other observers project an average 40% increase in hotel values through 2016, largely because of an expected continued improvement in the fundamentals of the segment.

Hotels are more cyclical than other real estate asset classes, but the recent dynamics of the sector have made it attractive to many investors. Much-improved demand, along with a projected shortfall in supply, makes it an interesting play on future economic recovery. The industry has recovered to normal levels and solid recent performance, along with upward-trending occupancy rates and room revenues, make it an exciting segment of commercial real estate.





Self Storage Facilities

Self-storage businesses offer space-strapped customers a secure place in which to store things they don't need right now, but can't bring themselves to throw away. These facilities have become big business; nearly 1 in 10 American households use one of about 50,000 self-storage facilities in the country. The sector has generated more than \$22 billion in annual U.S. revenues and rentable space now totals more than three times the size of Manhattan. Popular television shows like "Storage Wars" and "Auction Hunters" have grown out of the phenomenon.

The business model is unusual for commercial real estate. Self-storage facilities can be in unglamorous locations – noisy roads or the outskirts of town are fine. Tenants pay little or no security deposit, and are free to leave at a moment's notice. Nevertheless, it's a sector that has recently seen robust performance and growth that was slowed only slightly during the recent recession.

Economic Drivers.

Two primary factors influence the business. First, people continue to acquire things that can't be consumed – furniture, toys, numerous knick-knacks – and, for various reasons, they are hesitant to, or can't yet, throw these items out. The recent recession hurt the sector only slightly; displaced homeowners often moved to apartments or smaller homes and still needed to store excess household items. Second, despite the short-term nature of the rental contracts, people are reluctant to finally deal with – and throw out, or at least clean out – the items they've placed in storage. Stored stuff is like a bank deposit – it usually stays where it is. Estimates are that one-third of storage space is filled with items that have been there for over three years.

Rapid Adaptability.

Because the tenant base at these facilities is large, owners are protected from the long-term vacancies that can sometimes occur in other commercial real estate categories. The short-term nature of the rentals also allows owners to quickly react to market conditions.



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Stable Cash Flow.

People use self-storage for many different reasons, including household downsizes, renovations, relocations, military posts, and for holding business records. Some of these motives become more prevalent during economic downturns, lending a counter-cyclical feature to the sector. Moreover, because people are slow to leave these facilities once they've rented space, turnover is less of an issue than the short-term contracts might lead one to expect. Finally, the large number of rentable spaces in most facilities also means that owners are not vulnerable to large swings in vacancy rates.

Moderate Management Chores.

Self-storage facilities are relatively low-maintenance; a clean sweep after a tenant has vacated and the space is ready for the next renter, and there is typically no need for tenant improvements or leasing commissions. Until the recent recession, operators rarely had to do much marketing; that has now changed, and knowledge of internet marketing techniques is becoming a big factor. A manager usually needs to be on-site during the day to handle new leases, and security guards, alarms, or cameras are usually employed during evening hours.

Competitive Factors.

Like other real estate asset classes, self-storage facilities can be classed as Class A, Class B, and Class C properties. Location and the physical condition of the building remain primary factors in this assessment, with the population inside of a few-mile radius serving as the target demographic. Development of new properties has been extremely limited over the past five years, aiding the recent pricing stability for existing properties. Owners have, however, begun to compete on the basis of other enhancements, including:

- Electronic access control, with proximity cards or even biometric scanners
- Climate-control features or "green" eco-friendly units
- Web marketing or mobile apps that allow for online unit reservation and bill-paying

Fragmented Market.

Nearly 80% of self-storage properties remain in the hands of small, independent investors. The sector's solid past performance has begun to capture the attention of large institutional investors. Larger properties in particular are increasingly the subject of interest from institutional buyers, including the larger self-storage companies that run themselves as real estate investment trusts (REITs).

The investment community has recently taken notice of self-storage as a viable commercial real estate asset class and the underlying dynamics continue to fuel the sector's success. It may not last forever, but with solid recent past performance and upward trending occupancies and rental rates, self-storage is currently a real estate rising star.



Feel free contact us here at Realty Mogul with any questions or comments you may have concerning different commercial real estate property types or real estate crowdfunding in general.

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