

Banishing Buyer's Remorse

When business owners become building owners, they often save — and even make — money

by Karen Dera and Karen Burkhardt

Small- and midsize-business owners dive steadily and stealthily into the local commercial real estate market, creating little splash. But beneath the surface, their undercurrents are pulling the building market on a curious course.

Much like the residential real estate market, the commercial real estate market has been subject to low interest rates, and entrepreneurs are applying the same financial scrutiny to the buy-versus-lease decision that they apply to home-buying decisions.

"Typically, it will cost a user less money in the long run to own their building," says Becki Roberts, vice president of small business administration and commercial lending for Sonoma National Bank. "The advantages are realized in several areas: They have control of their own space, there are no leases to negotiate, and they are able to make improvements to the spaces that are investments in their own asset."

Greg Watson, Rose Lester and John O'Brien may not have much in

common when it comes to their business niche; what they do have in common is the recent purchase of a commercial building or condominium after leasing for several years.

Greg Watson purchased a 40,000-square-foot building off Interstate 80 on Longview Avenue in Sacramento. In June 2004, his 175 employees and two related companies, Watson Roofing and Watson Services, moved in.

"With the growth of our business and need for more space, we just outgrew where we were," says Watson, who is sole owner of both businesses. "Prospects look bright for future growth, so it was time to think hard about where we will be for the next 10 to 15 years." Most compelling for Watson was that he could control his own property and now has considerable flexibility in what he does with it.

Rose Lester, president of Lester Consulting, closed escrow last month on a 3,000-square-foot commercial condo with six offices and a reception area on University Avenue for her strategic planning, fundraising and

communications firm. "Buying was less expensive, and it will allow me to keep my client fees more competitive," she says.

Attorney John O'Brien purchased a 2,500-square-foot commercial condo for his law firm, John O'Brien & Associates, in the recently completed Liberty Center I in Elk Grove. "It is something that I always wanted to do, as it's an appreciating asset and you just can't go wrong with California real estate in the last few years," says O'Brien.

Why Buy?

"In today's low-interest market, the small-business owner's monthly loan payments are often less than what their monthly lease payments would be, and at the end of the day they own the building," says John Shelby, senior vice president of Five Star Bank. Shelby facilitated an SBA loan that allowed Rose Lester to make the leap into ownership.

"Many business owners are buying larger buildings, moving into a

Advice From New Building Owners

John O'Brien: "The first step is to get over the sticker shock when you go to price a building. Even the 10 percent needed for an SBA loan is a large amount. That can be substantial and may be hard for a startup company. You need to be stable, know where you're at and where you are going so you can plan ahead. But when you run the numbers with today's interest rates, I think the purchase is a no-brainer."

"It may also take a long time from conception to actually moving your furniture," says O'Brien. "And there may be more delays if you've purchased before the groundbreaking of the building. Construction may take longer than planned, usually with justifiable purposes. When I was planning to move into my condo, I had to hold over my current lease longer than I anticipated because the project wasn't

completed when I had planned it to be. Whatever your time estimates are, double them."

Rose Lester: "Do your homework and use a good broker and attorney. Using professionals throughout the process will save you some of the headaches — not all of them, but certainly the most critical ones. A good attorney can point out your liabilities and a good broker can assess if you are buying under, over or at market price so you will know the real value going into it."

Greg Watson: "Location is important. Have a business plan and know what you want before you go looking. Make sure it's going to make financial sense. I plan to grow my business and have been anticipating this move and had been searching for the right place."

Photo: Bill Mahon



Attorney John O'Brien and consultant Rose Lester recently purchased commercial condos after leasing for several years.

portion of the space and subleasing the remaining space. Not only are they buying property at low interest rates, but they also are realizing income from their subtenant," says Shelby.

But having tenants in the same building can take time from what you do best: running your business. "The problem with buying a whole building with the idea of subleasing part of it is that, whatever your business, you are now also in the business of being a property manager, and there are higher risks associated with that," says O'Brien, a personal injury attorney. "On the upside, you have a bigger building, with possibly more appreciation."

Colliers International Vice President of Research Garrick Brown writes in a year-end office market report that "The big investment story of 2004 is the continued scarcity of buildings available for sale; quality office investments remain few and far between, and

demand for these properties is so great that off-market sales have almost become the norm." (Off-market means the buildings are sold even before they are listed and sometimes even before the developer breaks ground.)

The Commercial Condo Craze

Paul Frank of PDF Development is one of the few developers building commercial condos. He has several developments in Elk Grove and will soon break ground on a 90,000-square-foot office building called Liberty Center II.

"Many will ask me, 'Why didn't you tell me about that project?' They would have liked to buy in," says Frank. He just completed Liberty Center I, the 50,000-square-foot office condo project on East Stockton Boulevard into which O'Brien recently moved. "This is the first Class A building I've done in this market,"

says Frank. His company partly occupies the building; the remaining condos were sold before the building was complete.

O'Brien bought his Liberty Center I condo off-market. "This concept makes so much sense," says O'Brien. "I belong to the association of condo owners in this building. Guests walking in have no idea that it's anything different than a Class A office building that we could be renting from a big multimillion-dollar business owner."

Frank says commercial condos are more complicated to pull together than freestanding projects because of the legal and operating structure of the owner association, which collects fees that cover management, utilities, landscaping, insurance and garbage.

Scott Bennett, a sales and leasing adviser for Grubb & Ellis Commercial Real Estate, facilitates sales for Catlin Properties' 70,000-square-foot Class A

condo-construction project in Folsom. "In Sacramento, condos are popular, but they are the exception, not the rule," says Bennett. "Several developers such as Catlin Properties and Mark III Builders have freestanding office projects all over the place." Freestanding buildings for small businesses range between 3,500

and 6,000 square feet, dimensions that Bennett says give developers the most success in selling their projects. The cost for these buildings is between \$200 and \$250 per square foot. Though there are some still available, Bennett says most are sold before construction is completed.

Funding

Kevin Rappleye, Bank of the West vice president of SBA lending, helped Greg Watson turn an SBA loan into a secure investment for his rapidly expanding roofing company. The SBA has two loan programs available for the purchase of commercial real estate: the SBA 504 and 7A loans. With each, the business owner may put as little as 10 percent down for the purchase of commercial real estate.

Rappleye paints this financial picture: "If a person buys a 5,000-square-foot building for \$1 million, it's about \$200 per square foot. If he's currently leasing a building for \$1.60 per square foot, that's \$8,000 per month rent for their 5,000-square-foot building."

Rappleye continues. "Now, if he buys the building with an SBA loan that allows 10 percent down on a \$900,000 loan at 6.5 percent interest, he'll pay a little less than \$6,100 for the same 5,000 square feet," he says. "So, do you want to pay someone else \$8,000 a month to lease the building, or pay \$6,100 a month to own it?"

The previous example is figured on a floating rate, and payment will vary with interest rates. Fixed financing is available at less than \$7,000 per month, still less than the lease rate. "It's true that the owner is then responsible for the taxes and repairs," says Rappleye, "but there are also tax advantages — depreciation rates and interest expense deductions."

The Market

In a 2004 fourth quarter report published by Cornish & Carey Commercial, office vacancy rates were at 15.4 percent and industrial vacancy rates were at 13.5 percent. John Frisch, a Cornish & Carey vice president, says a vacancy rate greater than 14 percent indicates a strong tenant market, whereas vacancy rates less than 10 percent indicate a strong landlord market.

"High commercial real estate prices are a concern, especially when considered with the high vacancy rates," says Frisch. "But if an investor buys good real estate even under these conditions and can maintain during downturns and cor-

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rections — which occur every seven to 10 years — the buyer will eventually benefit. But I worry when people think these prices will keep going up exponentially.”

It seems that the homebuilding and home-buying wave in Sacramento goes hand in hand with the commercial

building-buying craze. “This is the first time I have seen such a close link between high — and going higher — commercial real estate prices and what’s happening in residential real estate,” says Frisch. “But what’s more interesting is that commercial real estate is selling at very high prices at

the same time that building vacancies are high — so the leasing market is weak, [while] the selling market is hot.”

Five Star Bank’s Shelby seconds that motion. “It’s all about supply and demand. For the small owner-user buildings, the demand is still strong, and supply is trying to catch up.”

Advice From Bankers

John Shelby, Five Star Bank: “The first thing potential buyers should do is meet with their banker prior to entering into a purchase contract to pre-qualify for a loan program and dollar amount so that the buyer knows exactly what their buying parameters will be.

“Probably the biggest pitfall in the loan process is business owners wanting to buy more building than they can afford. They should stick to what they do best and not try to become real estate speculators. My advice to the business owner is to have a specific strategy in place. How long do you plan on staying in this location? Are you going to retire soon? Some loans may be very attractive to get into, but are very costly to escape.”

Becki Roberts, Sonoma National Bank: “When a company is experiencing rapid growth, they may not be able to afford a building big enough to meet their future needs. Therefore, it would be better for them to wait and purchase in the future. Also, if location is a key factor for a business and they are unable to purchase a building in that particular area, they may need to wait until a suitable building becomes available.”

Kevin Rappleye, Bank of the West: “As to whether buying is still a good idea if rates rise, in the 15 years I’ve been doing these loans, I’ve never had anyone come back and say they wish they hadn’t bought their property. This has held true whether the prime rate was 10 percent [in the early ’90s] as well as when it was 4 percent [in early 2000].”

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