

# Real Estate *advisor*

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# Creative concessions get the deal done

**M**any sellers set a price they want for a property based on what they initially paid for the property, or to recover the cost of building improvements. Though willing to compromise to a certain extent, they may hold out for their “bottom line” price to the point where it appears non-negotiable.

But buyers can still find ways to wrap up a deal through creative concessions. Such transactions allow the seller to feel like he or she got the asking price while giving the buyer the desired reduction in the effective cost of the purchase. Here’s how it’s done.

## Ask for repairs or improvements

Begin your quest for concessions by asking the seller to correct any health and safety problems with the potential investment, such as asbestos cleanup or electrical infrastructure repairs discovered during inspection. Roof

repairs, new paint and carpet replacement are all subject to negotiation. Also fair game are office build-outs or custom leasehold improvements, such as ventilation systems and signage.

*Your options are bound only by your own imagination — the secret is figuring out what each side values.*

If the seller has agreed to patch the roof but you know you’ll need to replace it soon anyway, consider forgoing the repairs and ask the seller to remove that cost from the purchase price. Another option would be to ask the seller to include furniture or equipment (such as a forklift or loading ramps) with the building. Be selective when asking for concessions, however. Buyers who nickel and dime risk turning off potential sellers.



## Request seller financing

Another tried-and-true tactic for effectively lowering the purchase price involves below-market seller financing. Ask a seller who insists on a specific asking price to lend part or all of the financing at below-market interest rates. By going this route, you may save more than if the seller sold it to you at your initial offer.

Also consider lease-to-own or installment contract options. These were common in the 1980s when high interest rates limited the amounts buyers could borrow. Now they’re regaining popularity in the tight lending climate.

Sellers also can benefit from installment sales, because they can defer much of the capital gains tax liability. Instead, taxes are extended over a period of years as payments are received. The possibility that capital gains rates could go up after 2010, however, may make installment sales less attractive to sellers today.

### Figure out what matters

Flexibility and creativity are key to closing a deal these days. Your options are bound only by your own imagination — the secret is figuring out what each side values. For example, a cash-starved seller might concede on price or offer a credit for the buyer's closing costs for a quick closing date.

Also be prepared to accommodate the seller's need for an Internal Revenue Code Section 1031 (like-kind) exchange, which allows a business or investor to defer capital gains (or losses) due upon sale.

It may take the seller time to locate a like-kind property that fits Sec. 1031 requirements. But tax incentives can be a powerful bargaining tool.

Also consider asking the real estate agents involved in the transaction to lower their commissions. Some might refuse on principle, but others recognize that lower commissions are better than forgone commissions.

### Be open minded

Setting your own "bottom line" also can be a dangerous strategy. While the bottom line is supposed to keep you from losing or spending more than you can afford, it can also impede or prevent a deal.

So it's important to be open minded. In reality, you can't know what your bottom line is in advance.

## Winning negotiation strategies

The key to winning at the negotiation table is to memorize the rules of success, and then stick to them. Start by keeping your options open. Buyers who have other alternatives and are willing to walk if the deal isn't right stand a much better chance of remaining in the driver's seat during negotiations.

Be sure to keep your emotions firmly in check. Do you absolutely love the property? Don't let the seller know it. Keep looking for other properties even as you close in on a deal — and make the seller aware that you have other options. Target properties based on their unique physical attributes, your required rate of return, and your borrowing capacity — not your emotional attachment.

Savvy buyers know their market, stay atop comparable listings and recent sales, and understand valuation basics, including how to evaluate a rent roll. They also get to know the seller personally and explore what the seller wants from the sale — or can offer the buyer, including improvements, financing and other creative alternatives.

Then experienced buyers look at the cards on the table and evaluate whether to hold or fold. A financial professional can help guide this decision. You don't want to waste time on unrealistic sellers or properties that fail to meet your investment criteria for size, location, physical specifications and zoning.

Only when you see the proposed deal — complete with terms and ramifications — can you decide if it's in your best interest.

### Deal or no deal

Given the right incentive, especially in the tenor of today's real estate market, many sellers will make necessary concessions. If someone simply won't budge, recognize that you're negotiating with an unmotivated seller, and move on.

Remember that, no matter what you do, some deals simply can't be made. If the numbers don't work or the profit potential isn't there, walk away from the table. And be sure to seek expert advice — especially if you find yourself in the valley of indecision. Professional real estate and financial advisors can pay for themselves many times over during a deal. ■

# Conduit loans: Down but not out

In these times of tight credit markets, it's good to examine every financing option available. One option is a commercial mortgage-backed securities (CMBS) loan, also known as a conduit loan.

A CMBS is a bond in which interest and principal received from a pool of mortgage loans are *passed through* to the bondholders. If properly structured and administered, the trust that holds the underlying loans doesn't pay tax. Rather, income is taxed once at the bondholder level.

Let's take a look at how a conduit loan can help you fund your next development project.

## How they work

Residential and multifamily mortgage-backed securities (MBS) are issued by government-chartered enterprises such as the Federal National Mortgage Association (FNMA or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac).

*Conduit loans are nonrecourse, which means borrowers aren't required to sign personal guarantees.*

But many conduit loans are issued through private institutions, including banks, investment banks and construction companies. They're referred to as private-label or nonagency MBS.



The companies that offer these securities and the commercial loans that back them are known as conduits because the interest and principal from the loans pass through them to the bondholders.

Because conduit lenders can spread financial risk across a pool of mortgages, they're able to offer fixed rates that are generally below those of other commercial loans and flexible payment schedules. Moreover, conduit loans are nonrecourse, which means borrowers aren't required to sign personal guarantees.

## What they can't do

The terms of a conduit loan are designated by a pooling and servicing agreement (PSA). Lenders regard PSAs as written in concrete, because, in many cases, they make certain promises to the investors who buy the CMBS your loan will back. And those promises, which become the conditions of your PSA, often must hold for the life of the CMBS.

That means it can be next to impossible to make changes to the terms of your loan or the property securing it. For example, investors may be promised payments on a regular schedule, eliminating the possibility of prepaying the loan for a designated period. Prepayment penalties can amount to as much as the value of 12 months of interest payments.

If you do want to pay off the loan early, you'll probably have to *defease* the loan, meaning you'll have to buy and post Treasury bonds (or a cash equivalent) equal to your remaining payments. Most conduit loans are subject to a lockout period, which prevents loan defeasance in the first two to five years of debt service.

Other conditions of the PSA might dictate such issues as corporate structure and governance. You also may be prevented from making physical changes to your property — for instance, building an addition or making significant modifications. Lenders include conditions related to property changes because altering an asset securing the CMBS — your

property — can result in a tax code violation for the whole mortgage pool.

### **Are conduit loans a good fit for you?**

CMBS loans haven't escaped the effects of the credit market crisis. In fact, new conduit loan issuance is at its lowest level since 1995, according to the Urban Land Institute. Many conduit loans and CDOs have been downgraded because of recent changes in the rating system for structured asset-based securities, as well as increases in CMBS loan refinancings and defaults. Like all bank funds, conduit financing is more scarce and its terms are often less flexible than during its heyday from 2005 through 2007 — but it's still a viable alternative for healthy, diligent borrowers.

Although conduit loans may not be right for every development, they're still worth a second look if you can live within certain constraints. And the benefits they offer — low fixed rates and flexible payment schedules — are hard to beat, if you qualify in today's tight lending environment. Work with your financial advisor to see if a conduit loan is right for you. ■

## **Preventive maintenance programs pay off**

**A**s the economy inches toward recovery, it's tempting to postpone (or forgo) building and equipment maintenance to save money. But this strategy is likely to backfire over the long run. Poorly maintained equipment is a safety hazard, but fixing minor problems early also is often cheaper than dealing with major repairs and replacements later.

Successful property managers and owners stay atop fixed assets repairs and maintenance. They know the location, condition, and replacement

cost of what's on hand. They also schedule routine (and impromptu) maintenance, manage warranty issues, and stock essential replacement parts. Here are five steps to a strong preventive maintenance program.

### **1. Take inventory of equipment and structural components**

Inventory all equipment on the property, including elevators, HVAC systems, heating systems, pumps and motors. Also include structural components, such as roofs and supports.



Describe each item fully, with information on the manufacturer, operating procedures (if applicable), location within the property, details of purchase and existing warranties. The inventory should also state where to obtain parts and service.

## 2. Outline maintenance tasks

Determine the types of inspections and preventive maintenance that should be performed on each piece of equipment and structural component and how frequently they should be done.

For equipment items, develop a schedule that outlines when each item needs to be cleaned, lubricated, serviced or overhauled. In addition, list spare parts that should be kept on hand. For structural items, include a to-do list for periodic inspections related to painting, patching or similar maintenance issues.

## 3. Calculate the cost

The property manager should estimate how much time, labor and money the program will require. Cost estimates should be realistic in terms of both the budget and level of work involved. For example, many older buildings still use aging air conditioning systems that are expensive to operate and maintain. You can reduce monthly utility bills on such buildings by replacing the system. Moreover, your maintenance staff could then spend valuable time elsewhere.

The building owner could also benefit from a tax credit for energy-saving equipment, together

with Section 179 expensing or other increased depreciation writeoffs, in the event of an equipment upgrade. But be sure to evaluate whether the financial benefits of the upgrade, over the long term, outweigh the costs.

## 4. Develop a schedule and appropriate forms

Some maintenance items must be checked daily, while others may be inspected less often. The property manager, in conjunction with the maintenance supervisor, should develop a realistic schedule for each task. Create checklists to facilitate daily, weekly, monthly or seasonal reports as needed. Also devise a system for issuing work orders and monitoring task completion.

## 5. Keep adequate records

Maintaining accurate records will help you determine whether time, money — or both — can be saved by performing certain maintenance activities less frequently, or whether certain items should be inspected more often. Good records can also help you verify whether maintenance personnel are performing needed tasks.

*The property manager should estimate how much time, labor and money the program will require.*

## Eventual payoff

While an efficient preventive maintenance program may not result in immediate cost savings, it will eventually result in increased efficiencies and a healthier bottom line. Equipment will likely last longer, deferring replacement costs. Major equipment breakdowns (which are often more costly than preventive maintenance would have been) will be less frequent.

Like the tortoise in the race against the legendary hare, preventive maintenance may not progress quickly at first, but with proper planning, “slow but steady” pays off in the end. ■

# Ask the Advisor

## How can I reduce the use of asphalt paving?

**A**lthough many communities will always prefer pavement to gravel roads, asphalt pavement isn't considered to be very "green." While pavement is necessary for busy roads and the national highway system, there's a growing awareness of the negative ecological impact triggered by too much asphalt. But you, as a developer, can help curb the proliferation of asphalt paving.

Not only can environmentally friendly paving projects enhance your reputation, but they also can save you money on materials and labor.

### The problem with asphalt

The asphalt creation process is a source of air pollution, generating fumes that have had adverse health effects on workers exposed to them. Asphalt is also made from oil, a nonrenewable resource. Large asphalt parking lots contribute to stormwater management issues in cities. When rainwater isn't allowed to soak into the ground, crucial sources of groundwater can't be replenished.

Moreover, due to the large concentration of asphalt, large cities can be hotter than outlying areas in the summer. This "heat island effect," as it's called, can increase air conditioning costs and may contribute to global warming.

### Planning is key

Skimping on pavement width or depth will cause roads to prematurely deteriorate and possibly violate building codes and contractual agreements. Instead, developers should plan their paving projects *smarter*. For example, consider "cluster developments," where buildings are centered in open space (rather than each in the center of its own lot). This type of development can significantly reduce the amount of pavement needed for parking. Many developers also are creating walkable communities to help reduce the environmental impact of overpaving.

In addition, some municipalities are creating zoning laws that specify the percentage of paving allowed per acre. Creative planning also can encourage walking, biking or public transit. For example, zoning for mixed-use developments that include retail, office and residential areas makes it possible to live and work within walkable neighborhoods and town centers. Zoning laws also can establish roadway, streetscape and public space criteria to ensure new projects include walking and bicycle trails. Such laws could set street-width limits that offer traffic islands planted with greenery (rather than paved).

### It's a joint effort

Although smarter pavement planning requires a unified effort by policy makers, citizens and developers alike, the environmentally friendly results — and potential cost savings — are well worth the effort. With careful forethought and ongoing project management, you can significantly reduce the environmental impact of asphalt on your projects, which, in turn, may make a huge impact in your corner of the world. ■





**In the real estate industry, the numbers are big and so are the risks. Poor timing, bad advice, even small oversights can have substantial consequences. Whether you're a developer or an investor, Elliott Davis' Real Estate Practice helps keep your business grounded.**

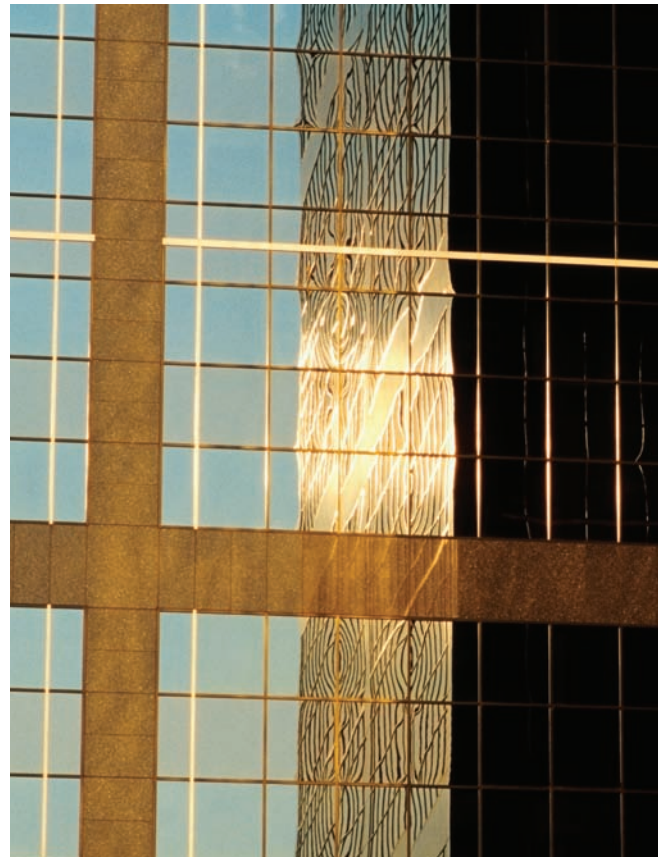
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