Baby Boomers: Time to Invest in Commercial Real Estate for Retirement Income

By David V. Tran

2008 marks the first year when 78 million baby-boomers born between 1946 to 1964 start retiring. This is the first time in the US history that there are so many people who will be eligible for AARP membership. So how will this affect you when it's your turn to retire? And what should you do now? Since it has never happened before, you don't have the benefits of learning from history. Let's look at the big picture from 40,000 feet:

1. Uncle Sam is currently spending about $1.30 for every tax dollar he collects. As of March 2008, the US national debt has skyrocketed to over $9.38 trillion dollars or about $30,894 per citizen. The borrowing pace has also accelerated as he added $2.38 trillion dollars more debt just less than 4 years and the budget deficit for 2008 could widen to over $500B. The Government Accountability Office (GAO) warned this kind of fiscal policy is simply unsustainable!

2. Per Michael Astrue, Commissioner of Social Security Administration, Uncle Sam will begin paying more benefits to retirees than he collects from active workers starting in 2017! The situation for the Medicare Trust fund which pays for hospital benefits is even worse. Per David Walker, the former US Comptroller Director, the Medicare Trust Fund will pay out more than it collect starting in 2008. This is because Americans are living longer while having fewer children. The baby boom generation just compounds the problem. So there are fewer young workers paying taxes to support the retirees. Government spending on health care alone could double by 2017 to more than 2 trillion dollars a year as a result of baby boom generation retiring and rising costs of drugs & medical expenses. As a consequence, the reserves for the Medicare trust fund will be depleted by 2019!

3. On top of that, the US has a huge appetite for imports. The trade deficit reached $708 Billion dollars in 2007. It has been rapidly increasing since 1997 when the figure was only $108 Billion. So more and more of our capital is sent to the Middle East and China to pay for our addiction to oil and imports. Per the Wall Street Journal (WSJ), the US has spent $10B since 2000 to expand railroad infrastructure and planned to invest another $12B. It's not an accident the US is expanding its railroads the first time in nearly a century. One of the primary reasons is to haul more cheap Asian imports to heartland cities.

The aging of the baby boomers is probably the most urgent issue facing the US in the 21st century. To tackle the problem, the government will have to spend more and more money that it does not have. To put it simply, the problems are so big and a financial train wreck is inevitable. The question is not if but rather when the tipping point triggering an unprecedented financial crisis will happen. So it's not a surprise that only 18% of US workers in 2008 are confident they will have enough money for a comfortable retirement per Employee Benefit Research Institute. To make sure you will be least impacted by what is about to come, you need a personal plan to address the issue.

If you work for Corporate America, you probably participate in the 401K plan which invests mostly in stocks/mutual funds and bonds. While 401k is a convenient retirement plan for many, it may not be the solution for everyone. Some people prefer to own more tangible real estates with limited supplies that they have total control and most likely will not reinstate financial results years later! Most if not all financial experts agree that as you get older, you should reduce your investment in the stock market due to its volatility. In addition, the stock market is often promoted & considered as a best investment in the long term. However, the WSJ summarized it all on its March 26, 2008 issue "By one broad measure, the stock market has made no progress over the past nine years." So where should you move

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your investment to? This article discusses about an alternative plan to 401K and for a lack of better name the “equity-of-my-home-is-my-retirement-investment-plan”. It is intended to introduce a new paradigm in retirement investment that is not promoted by Fidelity.

There are several reasons why commercial real estate investment is a strong candidate:

1. It is a fairly stable investment. This is an important factor as investors want to make sure their equity is also preserved throughout their retirement years. Unlike stocks, real estate investment is not sensitive to market fluctuation. Commercial real estate investment will shield people from going through the emotional roller coaster as the stock value widely fluctuates sometimes within a very short time. The stock of the Bear Stearns, the fifth biggest investment bank in the US is an example. J.P. Morgan Chase & Co. offered $2 a share for what was traded at $150/share in March 2007 with a book value of $84/share and Lehman Brothers reiterated its $110 price target just 3 days earlier! It sparked soul searching questions about the true, not book, not market, value of stocks & mutual funds. You don’t see this kind of dramatic volatility in commercial real estate!

2. It generates strong cash flow after paying all expenses and mortgage. To those who invest for retirement purposes, this is another important criteria. In order to retire with dignity you need cold hard cash. Your social security check which was never intended to be your only source of retirement income will most likely not sufficient. The maximum benefit for a 65 years old person in 2008 is only $2185/month provided you have maximized your contribution every year after you turned 21 (you can estimate your social security benefit check on www.ssa.gov/OACT/quickcalc). For those who are still working for Corporate America, this cash flow gives you a second source of income just in case. The simple truth is you are the company’s most important asset until you get the pink slip. Besides, your gray hair is often a liability! To achieve strong cash flow, investors often look for properties where “cap rate” is higher than the interest of the loan. This means you also make a profit on the money you borrow! Texas is an area where many commercial properties offer 8-9% cap rate and it is a good place to invest for strong income. Commercial properties are like a golden goose that keeps laying eggs. You can just eat the eggs, i.e. cash flow, without slaughtering the goose, i.e. your equity, for meat.

3. It is an excellent hedge against inflation. As gas approaches 4 dollars per gallon, you will have to pay more on almost everything. In addition, the US dollar is falling against most foreign currencies so imports will cost more (is there anything made in the US any more?) All these things cause inflation to go up at least in the foreseeable future. Commercial properties tend to hold values very well for two reasons: strong cash flow and limited supplies. Besides, the leases often have an annual rent increase so you should have a raise every year. As the rent increases, the property value is more likely to remain the same or to go up.

4. It gives you a wide range of landlord responsibilities options from purely passive to active. Some single-tenant properties, e.g. restaurants or pharmacies offer 20 years absolute triple-net lease with no landlord responsibilities whatsoever. This means you don’t have to worry about looking for a new tenant for a long time. The tenants maintain your property in first-class condition & pay for all property taxes while all you have to do is cash the rent check and pay the mortgage. This kind of property is ideal when you just don’t want to do anything.

5. It also offers potential for appreciation while allows you to depreciate for income tax purposes. This may increase dramatically the overall return of the investment. It is a more prudent investment than residential real estate investment. Due to strong cash flow, you don’t have to gamble on appreciation to make money and thus are less likely to invest on pure speculation. If the property appreciates in value then your investment return is much better. However, if it does not appreciate rapidly and thus you don’t get rich quick, your rental income is more than enough to cover the loan payment & expenses. As a result, your property is less likely to be foreclosed. So it’s not an accident that the default rate for commercial properties is only 4/10 of 1%, at least five to ten times lower than that of residential rental properties. Of course real estate properties are more difficult to sell compared to 401k shares. This actually encourages you to hold the properties for long term investment and discourages you to sell prematurely.

Below is a case to illustrate these principles:

The Smiths (name changed to protect privacy) had their own business and lived in a very expensive neighborhood in the San Francisco Bay Area. They planned to sell their business and retired in the next 2-3 years. They still wanted to maintain current life style. Over the years, they had invested in real estate and had quite a bit of equities in several residential properties. However, they figured out these residential properties would not generate enough cash flow for them to retire comfortably. They decided to exchange these properties for ones with more income. They sold one of the properties and netted about $1M. While the Smiths were looking for properties with high rental income, they wanted to make sure the investment also preserved their equity. This meant they would need to invest in a stable and growing area. They chose to do a 1031 tax-deferred exchange for a $2.825M Italian restaurant located in front of a mall in the fast growing Atlanta metro. The financial information showed the tenant was doing very well and expected to do well in the future due to its highly-visible and irreplaceable location. They applied for $1.8M 5-year fixed-rate 30-year amortization loan at 6.95% interest rate. The property generated $19,000 of net rental income a month after expenses (8% cap) while the mortgage payment was $11,915. So each month, the Smiths net over $7000 of cash flow --several times more than the expected amount of their social security checks. The tenant signs a 20 years absolute triple-net lease in which there are no landlord responsibilities. Since the lease had a 2% annual rent increase, the Smiths could expect to get even more cash flow in the future.

Conclusion: The turbulent stock market in 2008 and the subprime crisis are a late wake up call to reevaluate the emphasis on investment for growth & appreciation to investment for income. Investing in commercial real estate is a good alternative solution to generate a strong & stable stream of retirement income for baby boomers while preserving your equity. However, it is not a plan for everyone as it requires a large sum of down payment. It’s time to take action now before everyone jumps into the bandwagon.