eFunding, Inc. 1340 Tully Road, Suite 306-307 — San Jose, CA 95122-3055 — (408) 288-5500— (408) 288-5533(F)- © eFunding, Inc. 2007

eFUNDING COMMERCIAL REAL ESTATE INVESTMENTS

NEWSLETTER

WWW.EFUNDINGCOM.COM

MARCH 2007 VOLUME 3 ISSUE 3

Strategy for Shopping Center Investment in California

By David Tran

Investing in shopping centers in California presents a real challenge for many investors. Most shopping centers in the state offer very low if not the lowest cap rate in the nation, e.g. 4-6% range. As a result, the cash flow is weak compare to shopping centers in other states. Investors will also need more money for a down payment, e.g. 40-70% of the purchase price to qualify for a loan. The upside is that the vacancy rate for retail properties in the state is among the lowest in all 50 states. For example, the retail vacancy rate in San Jose is only about 4%, the second lowest in all major metro areas (Oakland has the lowest vacancy). This means the income stream should be very stable. So, as an investor, if you don't achieve strong cash flow, you must look for property with strong potential for appreciation to achieve better investment returns. To accomplish this, you could:

1. Sell the property at a lower cap rate. If you purchased a shopping center at a higher cap rate 5-10 years ago then you will be able to capture strong appreciation. However, if you purchased the property recently at a low cap rate already, it's not possible to reduce the cap rate much lower. So this approach probably won't work.
2. Increase the rental income. Most NNN leases have a fixed 3% annual rent increase. Assuming the market cap rate remains the same, this will only equate into an unimpressive 3% annual appreciation, unless you want to achieve appreciation in different ways.

Property Analysis

The goal to increase the rental income begins with the analysis of your purchase. While most retail properties in California offer 4-6% cap rate, many properties charge tenants below market rent due to

1. Poor property management and/or simply ignorance about market rent. Some property owners choose to manage their own properties to save expenses. However, they are among the worst property manager if the collected rent is used to measure their performance. They often are not aware of the market rent and so they often lease to the first tenant to ensure the unit is occupied quickly.
2. Very long term leases signed when the rent was low.

So the key is to identify properties with below market rents and a low price per square foot. These properties will provide you with upside potentials. However, the market rents often have a wide range. For example retail space in San Jose commands between $2-5/SF a month. It's not easy to determine if the tenants of the property pay below market rent. The following are some properties that have low upside potential that we may want to screen out:

1. Big-box properties with anchor tenants, e.g. Wal-Mart, Target, or Safeway. These big national tenants often sign long term lease with low rent due to its creditworthiness and large rental space. Once the lease is signed, the rent is locked in for 20-30 years. So it's almost impossible to drastically increase the income within a short time. As a matter of fact, many big-box retail properties in California are listed at below replacement cost. This is because they have long term leases with below market rent. They are on the market for a long time and yet is not sold because the cap is low, e.g. 4%. The prospect for higher income is sometimes 15-20 years away when the lease expires.
2. Retail centers with very high price per square foot, e.g. more than $800/SF. You will need to charge the tenant $4/SF a month plus NNN to achieve 6% cap. This is almost the highest rent in the market so it's hard to push it up even higher.
3. Retail centers with long term options AND fixed 3-4% annual rent increase instead of being adjusted to market rent. You should pay attention to this little detail in the lease as it may have major impact on the rent you collected. The problem is the appreciation is often higher than 3-4% annually in California. So if rent is not adjusted to the new fair market rent at the beginning of a new lease option, the rent is most likely below market rent and it may not sell at the highest market price.

On the other hand, if you see multi-tenant shopping centers offered at 4-5%

David V. Tran, ext-201
Sr. Investment Advisor/Broker

Shu Young, ext-203
Investment Advisor/Broker

Lionel Madamba
Investment Advisor/Broker

cap but priced at only $200-300/ SF it's very likely the property has below market rent. This kind of property will offer strong potential for appreciation. Once you see this property, you should also see if the property is:

1. Adjacent to an anchored tenant. Business owners prefer to be near an anchored tenant as this anchored tenant will bring in more traffic to the center. The business owners are willing to pay higher rent for this location.
2. A multi-tenant strip with small units. In general the rent is higher for small units, e.g. 1000 SF than for larger 4-5000SF because there are more tenants looking for 1000 SF units.
3. On a major artery or near the freeway. More traffic and convenience are always good for business.
4. In a stable or growing area with higher household income. When the local residents have higher disposable income, they will spend more time and money for good and services offered in the retail centers.
5. Located in an area with low vacancy rate and high rents. Ideally, you want a property lease that will expire within 1-5 years. This will allow you to adjust to the higher market rent quickly.

Sometimes it helps to see problems as opportunities. For example:

1. Most investors don't like retail strip with gross leases. However, if you can convert these gross leases into NNN you will be able to get strong appreciation.
2. Most investors don't like a shopping center with high vacancy. However, you may be able to buy at a low price. If you can turn around and improve the occupancy rate quickly, you will be able to realize good appreciation.

Property Management

Once you purchase a property, you will need a good property manager to help increase the rent. The property manager is a key partner to implement your investment strategy. In order to increase the rent substantially, e.g. 30-50% more compared to the rent in the previous lease, the property manager must demonstrate to the tenants that the new market rent is a fair market rent. Otherwise, the tenants may make a wrong decision and move out. This involves research to determine fair market rent and providing comparables to the tenants. So as a fair business person, you want to make sure the property manager has an incentive to do the extra work. One way to accomplish this is to compensate the property manager a certain percentage of the appreciation when the property is sold in addition to the typical 4-5% property management fees. This is a win-win for both the property manager and landlord when the property appreciates in value due to higher net operating income. Otherwise with a typical 4% fee in a property management contract, you will likely receive a 3-4% rent increase when the lease is renewed. Both you and the property manager lose when this happens.

Of course, some tenants with marginal profits won't be able to afford the higher rent and will move out. The property manager will have to evaluate the financial and business strengths of all the tenants and identify potential move-out's. She will plan accordingly to find replacement tenants to minimize income disruption.

Prior to a substantial rent increase, you may want to make cosmetic changes to the center to give it a new look. You may want to consider the following:

1. Re-paint the center.
2. Re-surface and paint the parking lot.
3. Ensure the air conditioners and heaters are in working condition.
4. Fix any leaks in the roof.

When the tenants see these improvements, they may convince themselves that it's too risky to move the business to another lower rent location.

Favorable Financing

You can also improve cash flow by obtaining financing with favorable terms from unconventional sources, e.g. insurance companies or conduit lenders instead of typical commercial lenders. While you have to pay higher loan fees and closing costs, the long term savings in interest payment are substantial. This should lower your interest rate from about 6.75% to 5.8% with no defeasance for multi-tenant shopping centers.

Conclusion

The commercial real estate market in California is very different due to its very low cap rate. To achieve strong investment return, you will need to be a creative business person with this so-called passive investment. By choosing the right property with below market rent, hiring a highly-motivated property manager, and selecting low-interest financing, you will achieve strong cash flow and robust appreciation within a relative short time.