SMALL BUSINESS OWNER'S GUIDE TO BUYING

COMMERCIAL REAL ESTATE

America's SBDC Tennessee Small Business Development Centers

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Greetings:

Middle Tennessee State University's Tennessee Small Business Development Center (TSBDC) program is the premier provider in Tennessee of business technical assistance and training. Our business development services are provided through a network of 20 locations across the state all in an effort to enhance economic development for our state while growing our small businesses.

This publication is provided by the TSBDC for your use to enhance your understanding of the subject matter and thereby increasing your business development opportunities. For further information regarding additional resources, our training calendar or to schedule an appointment with a business counselor, go to www.tsbdc.org

Regards,

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Tennessee State University

Tennessee Technological University Service/Upper Cumberland Development District

The University of Tennessee, Martin

Volunteer State Community College

If you're sold on buying Commercial Real Estate, here's your plan.

Take a moment to sit back and reflect. You've grown your small business with a lot of hard work, time and dedication, and now you're ready to take it to the next level. Or perhaps you're standing on the ground floor of a new endeavor. In either scenario, you're at an important threshold, ready to take the crucial step of purchasing commercial real estate.

Even if you've bought a home or two, make no mistake about it: buying commercial real estate takes longer and requires more research and planning. You will need to be tenacious and organized. You'll need the expertise of professionals to prove that your business profits can pay for the real estate loan – and that positive cash flow will not be interrupted.

What makes real estate "commercial?" Any property you use to grow, expand or support your business qualifies. Some examples are:

- Retail locations • Warehouses • Office buildings
- Manufacturing facilities • Shopping centers • Hotels
- Apartment complexes with at least 4 units • Commercial condos
- Land for commercial construction

The Good News

Many business owners rent whatever space is necessary to operate, so why is purchasing Commercial Real Estate/CRE a good idea?

- By building equity in your CRE, its value may increase because of inflation, and because the principal balance of the loan is decreasing.
- You'll enjoy the tax benefits of depreciation that offsets income.
- You'll have the freedom to manage and customize your own space without restrictions from a property owner or landlord.

If the building or facility you purchase has space that can be leased to other businesses, that income can greatly supplement your cash flow. In addition, tax laws benefit entrepreneurs who invest in commercial real estate because it promotes commerce, elevates surrounding property values and could increase employment. Additions and improvements also add value.

So let the process begin! This easy-to-follow guide will explain it in simple terms, in logical order and in full support of the entrepreneurial spirit.

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Gather Your Team

You've made the decision to buy commercial real estate, so how do you begin? First, realize that, although you're good at what you do, negotiating the worlds of real estate, law, accounting, leasing and insurance – especially when your money is on the line – requires sharp knowledge and experienced perspective. Your "team" should include a commercial real estate broker, an attorney, an accountant, an insurance agent, a business advisor, and a lender.

Choose your team wisely, considering not just their track records, but also their working styles. Asking friends, business contacts and local chambers of commerce for recommendations is a good idea, but do your homework before contracting with anyone.

Find a Good Real Estate Broker

It's preferable to work with a realtor who specializes in commercial rather than residential real estate. A commercial expert will not only make finding a suitable property easier, but will also offer valuable advice, insight and experience.

Don't just consider someone's resumé or track record. It's wise to make sure that your broker is a good fit for you, since the two of you will be working closely. Temperament, personality and working style should be factored in, too, before you sign a contract.

Once a real estate broker knows the size, usage, zoning and condition of the property you're looking for, he or she will search the market, showing you qualifying properties. At the Closing, the seller typically pays the commission earned by the broker. The usual fee is 5%-10% of the sale price, although laws vary by state, and the rate can be negotiated before the broker agreement is signed. Brokers earn their commission by:

- Finding real estate that fits your needs, within your price range.
- Knowing how the real estate can be financed. Most lenders require a 20- to 30% down payment, with the remainder of the loan financed for 15 or 20 years (which results in affordable monthly payments) with a three to five-year balloon. A "balloon" means that, at the end of five years, the remainder of the principal balance of the loan is due.
- Facilitating all negotiations between buyers and sellers.
- Providing business plan documents, including current leases (if the real estate has tenants) and the income ("rent roll") they provide.
- Researching the costs associated with the real estate, including operating expenses such as utilities and tax information.
- Gathering old environmental studies and appraisals, even though the lender will order new ones. (Some "old" information is valuable in this process.)

The Legal Team

1 The Buyer's Attorney

- Prepares formal offers.
- Reviews zoning, environmental reports, titles, survey and licenses that will be included with the purchase.
- Looks at the lender's commitment letter and/or term sheet, which outline terms, conditions, rates and covenants. This letter typically has a time limit, so returning a signed copy to the lender is crucial.
- Holds the "good faith" deposit, a nominal amount agreed on by the buyer and seller. The deposit can be "hard" (non-refundable) or "soft" (refundable).
- May or may not be present at the Closing. Ask the lender to send all documents to your attorney before the Closing, and feel comfortable that they have been reviewed and explained to you.

2 The Lender's Attorney

- Drafts the loan documents to be reviewed and signed by you. This will happen only after the lender receives your signed commitment letter.
- Checks for any liens on the real estate or other assets you're using to secure the loan. This insures that the lender has the first lien on all collateral.

3 The Seller's Attorney

- Develops the final Purchase and Sales agreement, which must be signed prior to presenting the loan request to the lender.
- Creates the Bill of Sale, which is signed at the Closing.
- Facilitates the transfer of any licenses or easements with all legal documents necessary. If licenses have to be transferred, ask for enough time in the P&S agreement. Transfers must be final at the Closing.
- Usually does not attend the Closing. If, however, the seller cannot be there, the seller's attorney can attend as a representative.

Add a Good Certified Public Accountant

Lenders will typically require a CPA (Certified Public Accountant) to prepare your financial statements. Your accountant will assist in analyzing the property you're buying by reviewing past financials. Financial projections, which include new real estate costs and mortgage payments, will be solidified. In addition to these numbers, lenders also require both personal and business tax returns for the past three years from anyone who will own more than 20% of the real estate. These returns must be re-signed in blue ink to confirm they are correct, and that they match the ones you filed with the IRS. Lender often require detailed personal financial statements.

Find an Insurance Agent or Broker

Your lender will require property and casualty insurance on the real estate you're purchasing, as well as on any assets taken as collateral. You have the option to choose your own insurance agent, so look for one who specializes in commercial real estate. Show the agent a copy of the commitment letter to be sure you receive the right kind and amount of insurance, which must be equal to the loan amount.

Buyers who will hold a 20% or more ownership in the property are sometimes required to carry life insurance as well – a guarantee that the loan will be paid if they should die. If a loan has three guarantors, three insurance policies would each cover one third of the loan amount. If the owner/borrower dies, the lender is paid the remaining loan amount from the insurance payout and anything in excess goes to the borrower's beneficiary.

Hire a Good Business Advisor

Many times, it's wise to pay for the perspective of a knowledgeable business consultant (also called a commercial loan broker) who sees the financing process with clarity and can offer solid perspective and advice. Professional advisors have experience putting together business plans and loan presentations, as well as constructing financial projections. You should negotiate a fee up front with your consultant, usually an hourly rate for a minimum amount of hours. In addition, there is usually a "success" fee or commission of .75% to 2% of the loan amount. This number has nothing to do with the rates, terms or covenants of the loan, and is paid by the borrower at the Closing.

Get Real with Your Real Estate Purchase

Even those who have bought commercial real estate in the past would agree that each facet of the process requires careful analysis. Here are some things to ask yourself:

- Is the property the right size?
- Is the building or land the right type?
- Are all the necessary utilities in place?
- Is there parking, a loading dock, or access for the disabled?
- Is it close to highways, airports and rail lines?
- If it's important to be close to your market, how does the property's location rate?
- Is it OSHA (Occupational Safety and Health Administration) approved? They set and enforce health and safety rules for employers.
- Will the property comply with zoning laws?
- Do any licenses need to be transferred with the sale? For example, if you were buying a restaurant, the license to serve food would need to be transferred. Research into licenses will be done by the lender, and should also be conducted by both the buyer's and seller's attorneys. Keep in mind that license transfers take time, so the issue should be brought up early on, in the offer letter (page 11) and the Purchase & Sale Agreement (page 19).
- Do any easements need to be transferred? An easement allows someone access to your land. For example, an easement for utilities allows an employee or representative of a utility company to pass through your property for repairs or maintenance.
- Pay attention to zoning laws for the new purpose of the property. If you are buying an old farm that will become an antique store, be sure zoning will allow it.
- Utilities – or the lack of them – should be considered. For example, if you're buying a small manufacturing facility, be sure its power supply is up to current standards.

Idea

Create two separate companies:

1. Operating Company
2. Holding Company

You may be the owner of both companies. The Holding Company owns the real estate and leases the commercial space to the Operating Company. The Operating Company pays rent to the Holding Company. A "triple net" lease is common which means the Operating Company directly pays real estate taxes, hazard insurance and repairs/maintenance for the Holding Company. Why do this? There are tax benefits, plus a lawsuit against the operating company will not affect the real estate holding company. You also have the ability to sell the business but keep the real estate.

How Do You Arrive at a Value for Real Estate?

Numbers can be demystified by using several valuation methods (page 7). In order to complete these calculations, you must have a copy of the current property tax bill. Ask the seller for it, or you can go to the municipal office that records property transactions, which are public record. It is a good idea to run the numbers on other recently sold properties in the area, too.

Three Appraisal Methods

An overview of the basic computations for analyzing the value of real estate

1 Capitalization/Cap Rate

This method arrives at a value based on what the real estate generates in lease and rental revenues, minus expenses. Each property will have a different cap rate. Investors and lenders want higher cap rates if the property has problems including a depreciating value. Investors and lenders will accept lower cap rates if the commercial property is in good condition, in the right location, with no major problems, and a low vacancy rate. The appraiser bases the analysis on what an investor would expect for a similar investment.

2 Comparison

This method of determining a property's value compares it to properties that are the same size and condition, in the same vicinity. This method is somewhat difficult, since there are so many types of real estate – everything from horse stables to skyscrapers. In this method, the land and building are separately valued according to square footage.

3 Replacement

This appraisal method is based on what it would cost to reproduce the same real estate. Costs might include things like land preparation, utility installation, building type and location. Appraisers typically break down costs per square foot. For example, the cost per square foot may be $50 for a storage facility and $75 for a retail store. This method of valuation is affected by the age of the building(s) and the amount depreciated over the years. The appraiser will be aware of, and research these numbers.

$48,000	Annual Rental Income
– $33,000	Less Total Expenses
$15,000	Net Operating Income
x 10	Cap Rate
$150,000	**Real Estate Value**

	What it represents	Number we're using as an example	Your number
A	Size of the land being purchased	9,000 sq. ft.	
B	Size of the building being purchased	5,000 sq. ft.	
C	Tax assessed value of the land	$100,000	
D	Tax assessed value of the building	$200,000	
E	Total tax assessment of land and buildings	$300,000	
F	Percentage of taxes allotted to the land	33.3%	
G	Percentage of taxes allotted to the building	66.7%	
H	Purchase price of the land	($165,000) (33.3%)	
I	Purchase price of the building	($335,000) (66.7%)	
J	Total sale price	$500,000 (100%)	
K	Purchase price value of one foot of the land (H divided by A)	$18.33	
L	Purchase price value of one foot of the building's floor space (I divided by B)	$67.00	
M	Total area of land and building	14,000 sq. ft.	
N	Average purchase price of one sq. ft. of land and building (J divided by M)	$35.71	

Landing a Lender and a Loan

When searching for a lender, you need to find one that not only offers commercial loans, but is open to the type of financing you seek. There are many internal reasons for a lender's decision, so it's wise to ask up front whether your loan request would be considered. Suppose you're seeking a loan to open a restaurant. Even if everything you bring to the table looks good, a lender may already have too many restaurant loans and will not be interested in yours.

One way to pay a smaller down payment is through an SBA/Small Business Administration guaranteed loan offered by most lenders (page 9). You may also consider your state's department of economic development, which offers business loan programs with low interest rates and/or property tax breaks.

In addition to your loan presentation, you may also be asked to fill out the lender's own loan application. If a loan guarantee from the Small Business Administration is required, you must also complete an SBA application.

Your loan presentation will be reviewed along with your personal and business credit. Regardless of their decision, lenders will usually not return your submission; so make at least one complete copy to keep for yourself.

Applying for a Commercial Loan

In order to apply for a commercial loan, you will be required to pay a down payment (page 11) and to submit a complete business plan (page 12). Your business plan includes the loan request and projected financial statements, usually for the next 12 months. This shows the lender that you have the money to pay the real estate loan, while maintaining profitability and positive cash flow.

Show how much money you have and where it is coming from. If there are investors, you must provide detailed information about the money they are investing. Indicate how much money you are requesting from the lender, and how it will be used (such as renovating, upgrading or customizing the property). Include itemized expenses, backed up with written estimates, contracts or other documents that show amounts.

How Will The Loan Be Used?

Lenders want every dollar of their loan accounted for. Uses include the purchase of inventory, furniture, fixtures, equipment, machines, repairs and improvements, and working capital (money for the business' day-to-day activities). Your business' income must cover your expenses. You need more money if your expenses are more than your income. Use of funds must be fully documented (page 15).

You are usually allowed to use the commercial loan money to pay for legal fees, environmental remediation, zoning fees, building plans and permits.

The SBA Perspective

The Small Business Administration/SBA offers loan guarantee programs for buyers of commercial real estate.

The 7(a) Program

- Terms up to 25 years, and a variable interest rate that is tied to a certain level over the prime rate.
- The actual real estate loan comes from a commercial lender. The SBA guarantees the loan. If the borrower does not repay the loan, the SBA will reimburse the lender up to the amount of their guarantee.
- Loans/guaranty can be used for working capital, machinery and equipment, furniture and fixtures, as well as land and building (purchase/renovation/new construction).

The 504 Program

- You occupy 51% of a building's floor plan. If, however, you are building a structure, you must occupy 60% immediately.
- Terms up to 20 years.
- The borrower must put down 10% (may be more in some cases) of the total loan amount.
- 50% of the loan is funded by the lender, who determines the interest rate on their portion, and holds the first mortgage.
- 40% of the loan is funded by an economic development company, certified by the SBA. The interest for this portion is set by the Treasury's 10-year bond market. The economic development company then sells a bond, guaranteed by the SBA, into the bond market. When the bond is sold, the EDC repays the bank its 40%, and then holds the second mortgage.
- You can find economic development companies in your area by checking with your state's economic development office, the State Treasurer or the Secretary of State, or the SBA.

What They Have In Common

- Terms of any SBA loan will not change, even if the lender is taken over or sold. No changes can take place without your consent. The borrower and their attorney should review the lender's loan agreement before the Closing since the lender could include many things. Changes may be done later by the lender first and then the borrower is notified.
- There is no balloon. A balloon loan has a long term, or amortization, but a shorter maturity. For example, let's say the loan has a 20-year term with a 5-year balloon. At the 5-year mark, the entire balance of the loan is due, or must be refinanced. Usually, non-SBA commercial mortgages are balloon loans.

When The Lender Says "Yes!"

If your lender is interested in financing your commercial real estate, you will receive a Term Sheet and/or a Commitment Letter.

The Term Sheet

A Term Sheet will sometimes be generated, although it is not a requirement or an approval. It specifies the borrower, guarantor, loan amount, term or length of the repayment period, interest rate, prepayment structure, prepayment penalties, collateral being put up, fees being charged, as well as any covenants or stipulations agreed to by both parties (such as the lender not allowing you to borrow from another lender).

You must review the Term Sheet very closely, preferably with your business advisor and/or your attorney. If you agree with everything it specifies, sign and return to the lender.

The Commitment Letter

This letter is based on the Term Sheet (if provided) and outlines every detail of the agreement, including the amount of insurance. Your attorney, advisor and accountant should review the commitment letter very carefully. Pay attention to the "suspense date." This is usually 10 to 30 days after it is issued, and it is the deadline for signing the letter. Should you require more time, it is acceptable to ask the lender for it. But remember that if the suspense date is not honored, the lender's commitment expires and you will need to reapply for financing.

Once the lender receives the signed letter, money may be requested from you for the appraisal, environmental inspections and other administration costs. At this point, the lender can still change the terms and conditions of the funding, but not without your written approval.

If your loan isn't approved:
Receiving a rejection letter from a lender is not good news, but it's very important to understand why. A short, cordial conversation may give you valuable advice and feedback you can use to revise your loan request. Often, a rejection does not reflect shortcomings in your loan request. The lender may simply have too much money out in commercial loans in your particular category. You may submit your request to another lender who would be more receptive to your type of loan.

The Value of an Appraisal

Developing an opinion of the value of property is called an appraisal. Since no two properties are identical in nature or location, it is important to have an appraisal done by a professional. Your lender, not you, will select an appraiser from their list of qualified and approved professionals. As the borrower, you pay the lender for the appraisal.

In the past, when assets were overvalued or decreased in value without being revaluated, lenders have had serious problems. In an economy that goes up and down, lenders don't want to see your real estate drop in value, so they usually require a 20- to 30% down payment (10% for SBA guaranteed loans), and then finance the remainder of the property's appraised value. Lenders base their maximum loan amount on either the sale price of the property, or on the appraisal value, whichever is lower.

If additional collateral (like the borrower's home) is needed to secure the loan or to back up a personal guarantee, the lender will use 80% of the collateral's appraised value less any liens or mortgages.

What Is Discounted Collateral?

Commercial mortgages may be discounted from 20- to 40%, as shown:

Appraisal of borrower's home	$100,000
Lender discounts appraisal 20%	–$20,000
Lender's discounted value	$80,000
Mortgage/Loan amount	–$50,000
Usable equity	$30,000

To protect themselves against a drop in the property's value, lenders often require more than a first mortgage on a commercial property, such as a personal guarantee secured by a mortgage on their personal property, in addition to the current mortgages on the property. They may take a lien on all of the company's assets, including Furniture, Fixtures, Equipment and Machinery (FFEM). Lenders might also want your Accounts Receivable and Inventory as collateral too but try to avoid this, because if you apply for a line of credit, they would be used to secure the line. A commercial real estate mortgage without an SBA guarantee is usually written with a 15-year term and a 5-year balloon (every five years, the lender may roll the remaining balance over for an additional five years with a different interest rate). Lenders may also "call" the loan (require full repayment of the remaining loan principal) on the balloon's maturity date.

The Down Payment

The amount of money you have to "put down as a deposit" on a property (10% - 40% depending on the type of loan) is based on either the appraised value of the real estate or the sale price, whichever amount is lower, since lenders will finance the smaller amount. If the property cannot be transferred because the title isn't clear or because it doesn't pass an environmental inspection, the deposit is refunded to the buyer.

If financing is secured and the property passes all inspections, but the buyer backs out, the seller may keep the deposit, unless another arrangement has been specified in the Purchase & Sales Agreement (page 19).

Environmental Inspection

Lenders also require an environmental inspection, which the buyer pays. Keep in mind that the seller or seller's broker must be notified in advance of these inspections. A Phase One environmental study must also be ordered by the lender and paid for by the buyer. If any environmental issues are uncovered, the seller must correct them, or the lender can withdraw approval for financing.

Making an Offer

Once you know that you have an interested lender in place, it's time to make an Offer to the seller. The Offer doesn't just include the sale price, but also more specific terms – which is why it must be prepared by your attorney, then reviewed by your business advisor and accountant before bringing it to the seller.

If the seller accepts your Offer, he or she will return a signed copy to you. This will serve as the basis for the Purchase & Sales Agreement (page 19), which is developed by the seller's attorney.

The Door Is Open for a Closing

Once the Commitment Letter is signed by you and returned, the lender's attorney will go to work developing the Closing documents (page 19) and confirming that all legal requirements have been satisfied, and that all permits and licenses can be transferred to the new property owners. The lender's attorney's fees are your responsibility and are paid at the Closing.

The Foundation for Your Success is a Business Plan

Here's the Plan

In order to secure a loan for a piece of commercial real estate, you will have to complete and submit a business plan – even if your business is already established. Lenders need to make sure that the revenue your business generates will be sufficient to meet the monthly mortgage payments. In addition, you must understand where the money will be coming from, and how it will affect your Balance Sheet (page 15) and Profit & Loss Statement (page 17).

A business plan looks at every facet, every aspect, and every dimension of your business. Writing your plan is an invaluable exercise for creating clarity and helping you foresee problem areas. A well executed business plan will give a lender everything needed to make an easier, quicker decision on your loan – and to offer it at the best rates and terms.

The components of a business plan are:

- **Summary or Cover Letter**
  Be sure to answer all of the following questions:
  - How much money are you requesting?
  - What is the loan's purpose?
  - How will it be repaid?
  - What collateral are you offering?
  - What terms are you requesting?
  - What products or services will you offer?
  - What experience do the business owners have?
  - What markets will you be involved in?
  - Who is your biggest competition?
  - Why are you a better choice?
- **Business Description**
  This detailed description must include the legal name of the business, the location address, your taxpayer identification number (TIN), names of owners with percentage breakdown of ownership, legal structure, purpose, rationale for financing, short-term goals for the first year, long-term goals, industry information, history and schedules for operation.
- **Professional Team**
  Include names, addresses, phone numbers and email addresses for all the members of your team, as outlined on pages 4 and 5. Team members include your broker, attorney, accountant, banker, insurance agent and business consultants.
- **Property History**
  Answer questions like: Why is the property being sold? What other purposes was this property used for in the past?

- **The Management Team**
  The resumé and background of anyone who owns 20% or more of the business will need to be submitted. Your lender wants to feel comfortable that the people who own the property are competent and responsible. Don't hesitate to explain each person's qualities and experience.
- **Operations/Suppliers**
  Tell your lender about the day-to-day running of the business. Explain what facilities and equipment are necessary to produce and distribute its products and services. Include a copy of any leases, existing or new. Provide a list of suppliers and explain what they will be supplying and at what terms.
- **Marketing**
  Show your lender that you understand your market by creating a profile of your customer base, including its geographical scope and size. Explain your products and services in relation to your market, how you will distribute and how you will promote. Include copies of any copyrights, patents and licenses.
- **Competition**
  Develop a list of your closest competitors and explain their strengths and weaknesses. How will you differentiate your business from theirs? What reasons will customers have to switch to your business? Estimate the percentage of the market owned by each of your competitors, and explain how you are going to take customers and sales away from them.
- **Location**
  Explain why you chose this location. Your description of the property should include topics like zoning and traffic patterns. Talk about the general vicinity, the kinds of businesses there and the general economic temperature of the area. If renovations will be necessary, show all costs and a timetable for completion. Include copies of all the quotes you have received for renovation work.
- **Leases**
  If there are any new or existing leases that must be honored by you, the new buyer, you must include copies of them in your business plan. Any proposed leases that may take effect after the Closing must also be included.
- **Licenses**
  Any licenses or permits that will be transferred to the new owner(s) with the sale of the property must be included.
- **Appraisals and Environmental Reports**
  Make copies of all reports, whether old or new. Lenders welcome an abundance of data on property value, and environmental reports are crucial to minimizing their liability.
- **Financial Statements**
  Your business plan must include several financial statements (pages 14-18).

The Financial Statements

In order to feel confident that your business can repay the real estate loan, your lender will require one to three years of past financial documents and projections.

Lenders will "crunch" the numbers in the five documents highlighted on this page, using them to make the decision on whether to approve your loan request. With the exception of your tax returns, each of the four financial statements is further explained in pages 15 through 18.

If the loan you are seeking is exclusively for real estate, it may be structured in two different ways. First, the operating company can make the loan to the real estate holding company you've set up as a separate entity and second, the loan could be structured to name the operating company and the holding company as equal co-borrowers.

Tax Returns

Anyone who will hold a 20% or more interest in either the operating company or the real estate holding company must submit tax returns from the last three years. Does the property have its own legal identity? For example, the seller's real estate holding company may own the property (see Idea on page 6). If rental income will be necessary to pay the monthly loan, the seller needs to provide the past three years of tax returns.

The Balance Sheet {PAGE 15}

This is a snapshot of your business, a moment frozen in time. You will need to provide Balance Sheets for the past three years. If you've been in business for less than three years, submit your fiscal-year-end statements for the time you've been in business. You will also need to create an "after" Balance Sheet, showing the day after the loan closes (page 15). Use the most current Balance Sheet for the "before-the-loan" version. The loan itself will be reflected on the liability side, while use of the loan proceeds (such as an increase in fixed assets or working capital) will be reported on the asset side or reduced in Accounts Payable on the liability side.

The APOD Report {PAGE 16}

An Annual Property Operating Data (APOD) is one of the most popular reports in real estate investing because it gives you a quick evaluation of property performance for the first year of ownership. The APOD shows you what a property will take in, and also what it will cost. It concisely reveals income, operating expenses, net operating income, debt service, and cash flow, making it a good "first glimpse" of the investment opportunity.

The Profit & Loss Statement/P&L {PAGE 17}

The P&L, also called the Income Statement or Income & Expense Statement, is a company report card, showing the performance of a business over a period of time. The seller provides a P&L for the previous year, only as it pertains to the real estate that will be purchased, as well as interim statements that are less than 30 days old. This allows you, the buyer, to build your financial projections. Based on the seller's information, you, the buyer, need to provide the lender with a projected P&L statement for one year, broken down month by month. It should show expenses paid by the operating company for the real estate – not just the loan itself, but also things like interest, property taxes and hazard insurance.

The Cash Flow Statement {PAGE 18}

Simply put, this statement shows how much money "flows" into the business, and how much "flows" out. Breaking down the year month by month, it shows how much money is left at the end of each month to carry into the following month. Be sure to include the assumptions you used to construct your projections. Ask your lender how many years of cash flow projections are required, and whether to show them monthly or quarterly.

The Balance Sheet

A MOMENT FROZEN IN TIME

The balance sheet is a snapshot of the business, like a moment frozen in time, and the numbers change daily. It shows what you own, and what you owe.

The two sets of numbers shown here reflect the changes that result from financing. From these two versions, your lender will see how the loan will be used. The most current set of numbers reflects the day before the loan, and the second set of numbers reflects the day after the loan.

Balance Sheet

ITEM	Before Financing AMOUNT	CHANGE	After Financing AMOUNT	NOTE
Cash	$59,750	$(23,000)	$36,750	A
A/R, Inventory, Prepaid Expenses	$46,600	0	$46,600	B
Deposit	$8,000	$(8,000)	$0	
Total	**$114,350**	**$(31,000)**	**$83,350**	
FFEM/Furniture Fixtures Equipment Machinery	$85,000	0	$85,000	
Real Estate	$0	$200,000	$200,000	
Total Assets	**$199,350**	**$169,000**	**$368,350**	
Current Liabilities	$43,350	0	$43,350	C
Loan Amount	$0	$180,000	$180,000	D
Total Liabilities	**$43,350**	**$180,000**	**$223,350**	
Stock	$10,000	0	$10,000	
Retained Earnings	$146,000	$(11,000)	$135,000	E
Equity/Capital/Net Worth	**$156,000**	**$169,000**	**$145,000**	
Total Liabilities & Equity	**$199,350**		**$368,350**	

These numbers must be the same

Notes

A Breakdown: Cash

10% down $12,000

Closing Costs $11,000

Total $23,000

$20K (10% down on $200K loan) less $8K deposit

$3000 legal, $2500 appraisals, $1500 environmental study, $4000 loan points

Cash before $59,750

Plus deposit $8,000

Total $67,750

Less down ...... ($20,000)

Less Closing .... ($11,000)

Cash After $36,750

B Breakdown: A/R, Inventory, PP Exp

A/R $36,000

Inventory $10,000

Prepaid Expenses $600

Total $46,600

C Breakdown: Current Liabilities

Accounts Payable $23,650

Accrued Expenses $700

Line of Credit Payments .. $19,000

Total $43,350

D Breakdown: Loan Amount

Loan Amount $200,000

10% Down Payment: ... ($20,000)

Loan Balance $180,000

6%, 20 yrs ($1290/month, $15,480/year)

E Breakdown: Retained Earnings

Before $146,000

Closing .... ($11,000)

After $135,000

Note: Retained Earnings would drop to $123K if both the Down Payment/$12K and Closing/$11K were deducted

The APOD Report

YOUR "SNAPSHOT" OF INCOME AND EXPENSES

An APOD Report, which stands for Annual Operating Property Data, shows you clearly and concisely what a property will take in (Income) and what the property will cost (Expenses) during the first year of ownership. Keep in mind that this report summarizes yearly, not monthly figures. It is a good first glimpse of the investment, helping you to evaluate how it is expected to "perform". Your accountant or business advisor can assist in the preparation of your APOD report.

Simplified APOD Data Example

Property: **Industry Park**

Type: **Commercial Building |** Land: **40,000 sq. ft. |** Building: **25,000 sq. ft.**

Purchase Price	$200,000
Acquisition Fees (appraisal, etc.)	$5,000
Loan fees (two points)	$3,920
Legal fees	$2,080
Total Cost	**$211,000**
Less: Down Payment (10% of $200,000)	($20,000)
Mortgage Amount	**$191,000**

Loan is for 20 yrs at 6% is $1369 per month or $16,428 per year

ANNUAL INCOME:

Rental Income	$13,500
Less Vacancy Factor (5%)	($675)
Total Income	$12,825

Rent 1500 sq. ft. @ $9.00 per sq. ft.

ANNUAL EXPENSES:

	BOTH COMPANIES	OPERATING COMPANY ONLY	HOLDING COMPANY ONLY
Taxes	$9,000	$9,000	$0
Insurance	$4,000	$4,000	$0
Maintenance.	$4,500	$4,500	$0
Repairs	$1,000	$1,000	$0
Utilities	$10,800	$10,800	$0
Legal & Accounting Fees	$2,500	$0	$2,500
Licenses	$500	$500	$0
Supplies	$250	$0	$250
Landscaping	$900	$900	$0
Snow removal	$400	$400	$0
Miscellaneous	$350	$350	$0
Condo fee	$2,400	$2,400	$0
Alarm	$600	$600	$0
Total Annual Expenses	**$37,200**	**$34,450**	**$2,750**
Net Income Total Income-Total Expenses	**($24,375)**	**($21,625)**	**$10,075**
Less: Mortgage Payments	($16,428)		($16,428)
Cash Flow Net Income-Mortgage	**($40,803)**		**($6,353)**

Operating Company and Holding Company explained on page 6 "Idea"

Figures are based on a "triple net lease" which sends related expenses to the Operating Company

Mortgage payments by the Holding Company, not the Operating Company

The Holding Company is short this amount for the mortgage payments.

Annual amount (or $529 monthly) paid by the Operating Company, see Related Expenses on P&L (page 17)

25,000 sq. ft.
1,500 rental
23,500 sq. ft.

See APOD Cash/Flow number

Cost Per Square Foot

	Before depreciation	After depreciation
Square feet	23,500	23,500
Cash flow	$(40,803)	$(40,803)
Depreciation	$0	$4,103
Cash Flow – Depreciation	$0	$(36,700)
Cost per sq. ft. (Cash Flow/Square feet)	$(1.74)	$(1.56)

Range of negative numbers since it is an expense.

$200K	for land & building
($40K)	land only
= $160K	building only
÷39	years allowed by IRS
$4,103	depreciation

The Profit & Loss Statement

BEFORE AND AFTER FINANCING

The Profit and Loss statement (also called P&L, Operating Statement, or Earnings Statement) is the "report card" for a business and is developed monthly, quarterly or annually. When buying real estate, you need to develop and review the P&Ls for "Before" and "After" financing (see the statement below). A P&L is developed for the Operating Company only (see Idea on page 6). The Holding Company doesn't need a P&L since their only income is the rent (paid by the Operating Company) and their only outflow of cash is the commercial mortgage/loan payment.

Profit & Loss Statement
Before and After the loan/financing for the Operating Company

	BEFORE	AFTER	% OF SALES
Sales/Income	$328,790	$328,790	100%
Less: purchases/cost of goods sold	($94,856)	($94,856)	(29%)
Gross Profit	**$233,934**	**$233,934**	**71%**
EXPENSES:	**BEFORE**	**AFTER**	**% OF SALES**
Accounting	$2,000	$2,000	0.61%
Advertising	$6,575	$6,575	2.00%
Automobile	$3,000	$3,000	0.91%
Bank Charges	$120	$120	0.04%
Commissions	$6,575	$6,575	2.00%
Credit Card Merchant Fees	$3,289	$3,289	1.00%
Dues & Subscriptions	$500	$500	0.15%
General insuarance	$2,780	$5,000	1.52%
Group insurance	$6,000	$6,000	1.82%
Internet	$1,176	$1,176	0.36%
License taxes	$300	$300	0.09%
Line of credit interest	$1,140	$1,140	0.35%
Miscellaneous	$1,440	$1,144	0.35%
Office supplies	$1,500	$1,500	0.46%
Miscellaneous	$300	$300	0.09%
Payroll	$112,296	$112,296	34.15%
Payroll taxes	$13,476	$13,476	4.10%
Postage	$522	$522	0.16%
Real Estate Taxes	$0	$8,000	2.43%
Rent and Related Expenses	$30,000	$39,903	12.14%
Repairs & Maintenance	$2,700	$2,700	0.82%
Security system	$900	0	0%
Shipping supplies	$1,644	$1,644	0.50%
Telephone	$4,560	$4,560	1.39%
Travel	$4,000	$4,000	1.22%
Utilities	$1,104	$1,104	0.34%
Total Expenses	**($207,897)**	**($216,900)**	**(66%)**
Net Profit/Loss Gross Profit less Total Expenses	**$26,037**	**$17,034**	**5%**

The P&L vs. APOD

You may notice that this projected P&L is similar to the APOD (page 16). What's the difference? The P&L is created for the Operating Company that occupies the real estate, and it shows the rent payment and related operating/business expenses. The APOD is created for real estate only and used primarily by an "investment buyer."

RELATED EXPENSES	
License/permits	$500
Real Estate taxes	$9,000
Hazard insurance	$4,000
Maintenance	$4,500
Repairs	$1,000
Utilities	$10,800
Snow removal	$400
Other	$350
Condo Fee	$2,400
Alarm system	$600
Total Expenses	$33,550
Payments to Holding Company (See Cash Flow amount on pg.16)	$6,353
Total Rent & Related Expenses (or $9976 per quarter shown on pg.18)	$39,903

The Cash Flow Statement

WHAT COMES IN AND WHAT GOES OUT

Cash is the fuel that runs your business, so you must be acutely aware of how it is "flowing." This statement covers the money coming in and going out – and how much "stays" in the company for daily expenses and emergencies. It will show you the maximum loan payment the business can afford – a crucial number. Keep in mind that your business may produce a profit, but still not have a positive cash flow. Shown here is a Cash Flow Statement after financing. The seller will provide a Cash Flow Statement before you buy or finance a business.

Cash Flow
After Financing for the Operating Company

	1ST QTR	2ND QTR	3RD QTR	4TH QTR	TOTAL
CASH IN:					
Sales & Accounts Receivable	**$84,288**	**$44,261**	**$65,553**	**$134,691**	**$328,793**
CASH OUT:					
Expenses					
Accounting	$500	$750	$250	$500	$2,000
Advertising	$1,330	$648	$1,768	$2,829	$6,575
Automobile	$750	$750	$750	$750	$3,000
Bank charges	$30	$30	$30	$30	$120
Commissions	$1,330	$648	$1,768	$2,829	$6,575
Credit Card Merchant Fees	$665	$325	$884	$1,415	$3,289
Dues & subscriptions	$0	$500	$0	$0	$500
General insurance	$278	$834	$834	$834	$2,780
Group insurance	$1,500	$1,500	$1,500	$1,500	$6,000
Interest on line of credit	$190	$285	$285	$285	$1,045
Internet	$294	$294	$294	$294	$1,176
Miscellaneous	$360	$360	$360	$360	$1,440
Office supplies	$375	$375	$375	$375	$1,500
Miscellaneous	$75	$75	$75	$75	$300
Payroll	$28,074	$28,074	$28,074	$28,074	$112,296
Payroll taxes	$3,369	$3,369	$3,369	$3,369	$13,476
Postage	$138	$138	$138	$138	$552
Rent and Related Expenses	$9,976	$9,976	$9,976	$9,976	$39,303
Repairs & maintenance	$675	$675	$675	$675	$2,700
Shipping supplies	$333	$162	$442	$707	$1,644
Taxes and license fees	$0	$300	$0	$0	$300
Telephone	$1,140	$1,140	$1,140	$1,140	$4,560
Travel	$1,000	$1,000	$1,000	$1,000	$4,000
Utilities	$276	$276	$276	$276	$1,104
Total Expenses	**($52,658)**	**($52,484)**	**($54,263)**	**($57,431)**	**($216,835)**
Purchases Only product costs including raw materials and direct labor	**($14,941)**	**($10,888)**	**($22,005)**	**($41,047)**	**($88,881)**
TOTAL CASH OUT Total Expenses plus Purchases	**($67,599)**	**($63,372)**	**($76,268)**	**($98,478)**	**($305,716)**
BEGINNING CASH Use Ending Cash from previous quarter for Beginning Cash in next quarter	**$36,750**	**$53,439**	**$34,329**	**$23,614**	
CASH CHANGE Cash in less Total Cash Out	**$16,689**	**($19,111)**	**($10,715)**	**$36,213**	
ENDING CASH Beginning Cash and Cash Change	**$53,439**	**$34,329**	**$23,614**	**$59,827**	

Cash amount after financing on pg.15

Agreeing on the Purchase & Sales

The Purchase & Sales Agreement/P&S is a contract between the buyer and seller for the sale of real estate, and spells out very specific terms and conditions. It is developed by the seller's attorney or real estate broker.

Sometimes, before the P&S is signed, the buyer will make an Offer, which is drafted by his or her attorney. This Offer is not required but, if both parties sign it, it may be used instead of the P&S, or the P&S may be based upon the Offer.

Whether there is a P&S or a written Offer in place, the seller usually responds to the buyer's offer with adjustments and this is called the Counter Offer. A negotiation period is common before both parties agree on every detail.

Time Is As Important As Money

The seller usually grants a 60 to 90 day period from the signing of the P&S to the Closing. This gives the buyer time to prepare documents, complete inspections and provide for transfers. It's preferable to ask for a 90 to 120 day period, since it may take time to get the appraisal and environmental assessment completed. The P&S should allow for an extension, to accommodate any delays or problems.

Transparency Is a Must

A "real estate disclosure statement" is a declaration by the seller of everything known about the property. It does not eliminate the need for inspections, nor does it act as a warranty. Buyers need to ask about any defects, problems or issues, preferably before the appraisal and environmental inspection are done. Due Diligence involves investigating the property before signing contracts and includes a recent survey, environmental study, title search, physical inspection, zoning permit/review, and operating cost analysis. Any and all problems must be addressed and corrected by the seller before the lender will approve financing.

Get a Safety Net in Place

Protect yourself by making sure there is a financing contingency in place. This states that if the buyer is unable to finance the real estate, the seller must return the deposit – deducting any out-of-pocket expenses that were incurred – and the P&S becomes null and void.

The Closing Is Just The Beginning

The end of the process is the Closing, which the lender will schedule. The buyer/borrower, any guarantors, the seller, the lending officer and the lender's attorney will attend the Closing. All legal documents necessary for the Closing will be required, including personal guarantees, the mortgage and note, the loan agreement (as outlined in the commitment letter), the appraisal and the environmental study. When these documents are finalized, they should be carefully reviewed by your attorney before you sign them for the Closing. At the Closing (which your attorney does not need to attend), there will be numerous documents for both the seller and buyer to sign, but the real estate will not officially transfer to you until the lender's attorney records to deed and files the mortgage and/or liens with the appropriate state and local government agencies. Only after the lender is officially notified that this has taken place – putting the lender in the appropriate legal position – does the money transfer to the seller.

If your loan becomes past due, your lender's attorneys may draw up a forbearance agreement, which outlines what the lender will do in order to clear the delinquency. The legal fees for creating this are the buyer's responsibility, plus a lending fee of the outstanding loan principal which must be paid at the time the agreement is signed.

Some of the liens that the lender's attorney files include:

- A first mortgage on the property in question
- 1st Uniform Commercial Code (UCC) liens on furniture, fixtures, equipment and machinery
- An equity mortgage, which secures a personal guarantee, such as a second mortgage on the principal buyer's real estate
- Mortgages on other property, which may be owned personally or by the company
- Other assets (like a Certificate of Deposit), which may need to be offered as collateral

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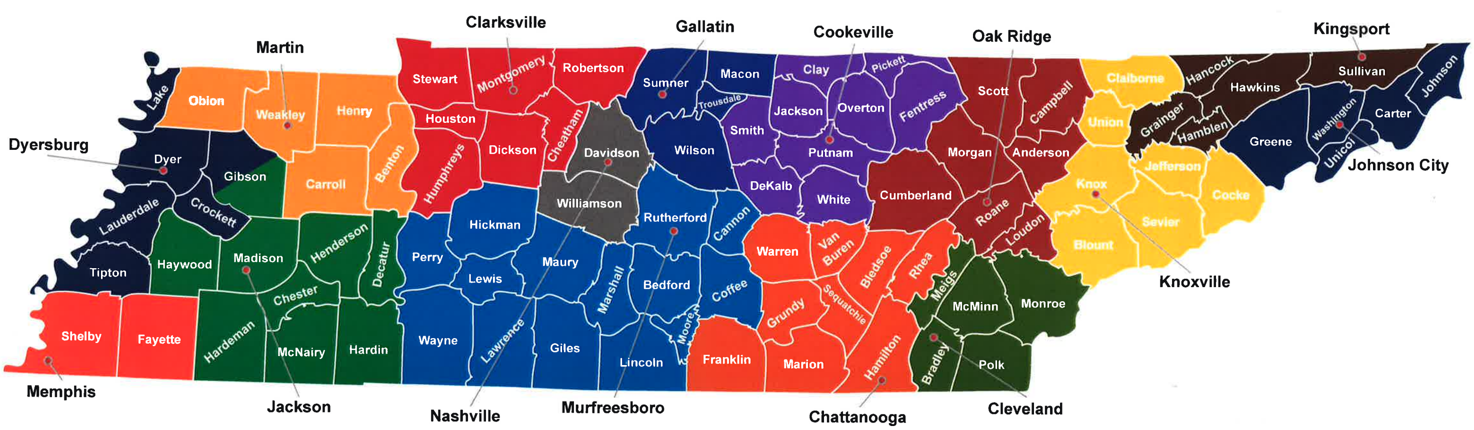

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