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Commercial Real Estate Investment: Opportunities for Income Generation in Today's Environment

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In this white paper

1 Advantages of investing in real estate

2 Factors to consider when investing in real estate

3 Comparing yields of different investment portfolios under different tax liabilities

5 Conclusion

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Commercial Real Estate Investment: Opportunities for Income Generation in Today's Environment

In the last few years investors have had to contend with more than just the ups and downs of the financial markets. Tax cuts legislated by the Bush administration in 2001 and 2003 were first scheduled to retire at the end of 2010 but were then extended to 2012. At the end of last year, we also saw the expiration of tax relief measures put in place to stimulate the economy during the "Great Recession." All these events have added another layer of complication for investors.

The beginning of 2013 brought some relief, as new legislation raised some taxes while letting others expire, as illustrated in Figure 1. Wealthier investors now find themselves paying increased capital gains and dividend taxes, along with the Medicare tax, with the potential for further tax changes in the future. Investors may feel we are entering a more negative environment for after-tax returns; however, as we'll discuss in this paper, not all tax increases are created equal. For example, tax changes combined with the current interest rate environment have made some types of real estate investments more compelling for those looking for additional sources of income from their portfolios.

Advantages of investing in real estate

Before we review the interest rate and tax environment that has created a potential opportunity for commercial real estate investors, let's first look at the reasons why real estate may be a useful addition to an investment portfolio for certain investors.

Owning real estate can potentially provide the following benefits to a well-diversified investment portfolio:

- Yield enhancement
- Positive prudent leverage
- A potential hedge against inflation
- Accounting for depreciables and cost recovery

Yield enhancement

Unlike owning a home, commercial real estate investments typically generate cash flows from the tenants' rental income. In general, commercial properties are occupied by tenants who hold long-term leases. Moreover, many buildings will have more than one tenant, so if one tenant experiences financial difficulties, the investor's risk of receiving no income

Figure 1. Individual Income Tax Rates for 2013

Taxable Income		Ordinary Income	Capital Gains and Dividends	Medicare Tax	
Single	Joint			Earned Income[1]	Investment Income
$0+	$0+	10%	0%	2.90%	0%
$8,925+	$17,850+	15%			
$36,250+	$72,500+	25%	15%		
$87,850+	$146,400+	28%			
$183,250+	$223,050+	33%			
$200,000+ (AGI)	$250,000+ (AGI)			3.80%	3.80%
$250,000+ (AGI)	$300,000+ (AGI)[2]				
$398,350+	$398,350+	35%			
$400,000+	$450,000+	39.60%	20%		

[1] Earned income Medicare tax includes 1.45% employer portion
[2] Phaseout of personal exemptions and itemized deductions begins

Source: Wells Fargo Wealth Management, 01/13 from the property may be reduced by rents received from the other tenants. As a result, in normal economic conditions, the building's cash flow may be relatively predictable.

A portion of the rents generated should be reinvested into building management and maintenance. To maintain the value of the building, investors should continue to maintain the building, and complete upgrades to help enhance both the value of the building, increase the building's useful life, and potentially attract additional tenants. If investors do their homework before purchasing the property and the investment is managed sensibly, there should be sufficient funds to generate an income stream with the potential to enhance the yields of their overall portfolio.

Positive prudent leverage

Today's low interest rate environment offers an opportunity to finance commercial property prudently, as borrowing costs are likely to be significantly lower than the generated cash. Additionally, due to the limited supply in certain markets, the potential exists for occupancy gains, growth in rents, and capital appreciation over the next few years.

A potential hedge against inflation

While many leases are long term, contractual leases will typically include clauses that allow for periodic rent adjustments based on increases in the Consumer Price Index (CPI). If the building is a retail property, it is possible to tie rents to increases in tenant's revenue.

Accounting for depreciables and cost recovery

Depreciation is the process of recovering the cost of income-producing improvements through yearly tax deductions, thereby creating an adjusted cost basis.

There are three factors that determine a depreciation schedule:

1. Cost basis in the property
2. Recovery period
3. Type of depreciation method utilized

Advisors may refer to depreciation, along with mortgage interest, as "tax savings" because they are deducted from a real estate investment's net operating income prior to the calculation of taxable income. Cash flow is the net operating income less debt service and tax liability. Cost recovery, or what some advisors refer to as "deprecation recapture," is the taxable amount due from the gain on an asset sold that was depreciated and used to offset the ordinary income tax liability created by the income stream. This gain (amount depreciated during the holding period) is taxable at a maximum rate of 25 percent. The technical IRS term for gain related to depreciation on residential property is called unrecaptured section 1250 gain.

Factors to consider when investing in real estate

As with any investment, physical real estate holdings may not be a suitable investment for every investor and in every type of investment portfolio. Investors are confronted with many decisions when thinking about whether to acquire real estate, what it means to own the real estate, and how to dispose of the real estate if you decide to take profits.

Working with your advisors, you will want to undertake the following steps before adding commercial real estate to your portfolio:

- Strategic analysis to determine whether the investment makes sense in the context of your portfolio
- Acquisition analysis to make sure you are identifying the most suitable type of investment
- Holding decisions to make sure you are comfortable how the building will be managed and what the ownership structure should be
- Disposition decisions to be clear on how long you intend to hold the investment

Strategic analysis

When you undertake the strategic analysis to determine whether a commercial real estate acquisition is appropriate for you, the first thing you will want to consider is whether it makes sense in relation to the rest of your investment portfolio. Do you want to buy a property for income purposes, potential price appreciation, or both?

You may want to think about how much liquidity you need in your portfolio. If you need to be able to access funds quickly, then you may want to consider a more liquid alternative, such as a publicly traded real estate investment trust (REIT). Also, what does the liabilities side on your balance sheet look like? A key component of any decision to undertake such an investment will need to consider how much debt you feel comfortable taking on.

Next, look at market factors. Based on the current real estate cycle, is this an opportune time to buy? If the answer is yes, then analyze different markets to determine which one would make sense. As part of this analysis you will want to look at local factors like tax rates and the political environment (i.e., how favorably the local city council treats investors).

Acquisition analysis

Once you have made the decision that a commercial real estate investment makes sense (and what specific location is most suitable), you will want to think about what type of real estate you want to buy: retail, office, and/or industrial. An important part of this decision-making process includes thinking about potential financing options, sources of debt and equity capital available for different types of commercial real estate investments, and which one is suitable for your specific circumstances. In addition, you will want to consider the rate of interest on any loan you will be taking out, the cash flow the building is likely to generate, and the management costs of the building. This leads next to questions about how the ownership should be titled, and the price and terms of the investment.

Holding period decisions

Related to the acquisition analysis, you and your advisors will want to determine how the building will be managed and how much you are going to want to spend on building improvements. Other things to think about: whether you are going to want to change the property use and what your operating strategy is going to be.

Disposition decisions

In addition to answering the how, where, when, and what, your disposition decisions should include the price you expect to obtain at the time of sale, the disposition method, and how you will want to market the building.

Comparing yields of different investment portfolios under different tax liabilities

Let's consider the following hypothetical example to illustrate the potential benefits of investing in commercial real estate and outline the potential tax savings that may result by comparing the previous tax environment to the current tax environment.

In our hypothetical example we have made the following general assumptions:

- Janet has $5 million of investable assets within a well-diversified portfolio. She is in the highest income tax bracket and subject to the additional 3.8 percent Medicare tax on capital gains.
- Janet is considering purchasing a $4.55 million commercial single tenant absolute net lease (all operating expenses are the contractual obligation of the tenant) asset that produces an annual net operating income figure of $364,000. The $4.55 million offered price equals eight percent cap rate (or the expected yield on the investment—$364,000/$4,550,000).
- Per the CPI Adjustment clause in the lease, the income stream will escalate at an annual rate of 2.5 percent.
- 80 percent of the asset's market value can be attributed to improvements. Tax law only allows the property's improvements to be depreciated. Land value cannot be depreciated. If 80 percent of the assets value is attributable to the property's improvements then the depreciable value is $3.64 million.
- There is a five-year holding period with a disposition price estimated at an eight percent cap rate (expected yield). Following this five-year holding period, expected net operating income disposition price is calculated by dividing the expected net operating income by eight percent or the expected yield for the purchaser.
- There is a disposition cost of five percent value (i.e., realtor commissions, closing cost, etc.)
- The expected after-tax total return on a well-diversified financial portfolio is 4.5 percent. Any amount not utilized in the purchase of the real estate asset, plus all income generated from the real estate asset, will be invested in the portfolio during the holding period.

Our financing assumptions for this property are as follows:

- 75 percent loan to value loan amount (i.e. $4,550,000 x 75% = $3,412,500). Said loan amount would require a down payment of $1,137,500 ($4,550,000 – $3,412,000).
- 5.5 percent interest rate with a loan cost of one percent
- 25-year amortization period
- Annual debt service (principal and interest) equals $254,400.

In Figure 2 below, we see the reduction in expected annual cash flow of the real estate asset.

Figure 2

	Previous Income Tax Environment	Current Income Tax Environment
Net Operating Income	$364,000	$364,000
Mortgage Interest	($185,373)	($185,373)
Cost Recovery	($89,730)	($89,730)
Loan Cost	($3,400)	($3,400)
Taxable Income	$85,497	$85,497
Tax Liability	$29,924	$33,857
Net Operating Income	$364,000	$364,000
Debt Service	($250,548)	($250,548)
Cash Flow Before Tax	$113,452	$113,452
Before Tax Yield on Equity ($113,452/$1,137,500)	9.98%	9.98%
Cash Flow After Tax	$83,528	$79,595
After Tax Yield on Equity ($83,528/$1,137,500)	7.34%	7.00%

Source: Wells Fargo Wealth Management, 05/13

Hypothetical examples do not represent actual performance results achieved and are for illustrative purposes only.

In Figure 3, we see the reduction in expected after tax sales proceeds.

Figure 3

	Previous Income Tax Environment	Current Income Tax Environment
Projected Sales Price	$5,231,000	$5,231,000
Cost of Sale	($261,550)	($261,550)
Mortgage Balance Payoff	($3,035,231)	($3,035,231)
Net Sales Proceeds Before Tax	$1,934,219	$1,934,219
Tax on Ordinary Income	($5,950)	($6,732)
Tax on Cost Recovery Recapture	($115,093)	($115,093)
Tax on Capital Gains	($60,668)	($96,259)
Net Sales Proceeds After Tax	$1,752,508	$1,716,135

Source: Wells Fargo Wealth Management, 05/13

Hypothetical examples do not represent actual performance results achieved and are for illustrative purposes only.

In Figure 4, we see that the internal rate of return (IRR) on this real estate asset would only be reduced by 0.76 percent under the current tax environment. Earlier we had talked about ordinary income tax bracket increasing by 4.6 percent, capital gains tax rate increasing by 5.0 percent, and the addition of the 3.8 percent Medicare tax on capital gains on investment real estate.

The increases in "tax savings" from depreciation of improvements and mortgage interest at the higher income tax rate have a greater effect on the annual cash flow of the property. In addition, the depreciation that increased the "tax savings" is only taxed at the disposition stage at the 25.0 percent cost recovery recapture rate. Therefore, getting a tax deduction at 39.6 percent and then paying the tax on the cost recovery at 25.0 percent resulted in a 14.6 percent savings.

Figure 4

After Tax Cash Flow Summery	Previous Income Tax Environment	Current Income Tax Environment
Year 0 (Equity into Project)	($1,199,000)	($1,199,000)
Year 1	$83,528	$79,595
Year 2	$89,524	$85,183
Year 3	$94,228	$89,820
Year 4	$99,013	$93,435
Year 5 (Cash flow during year plus net sales proceeds)	$102,492+$1,752,508	$96,085+$1,716,135
	IRR = 14.61%	**IRR = 13.85%**

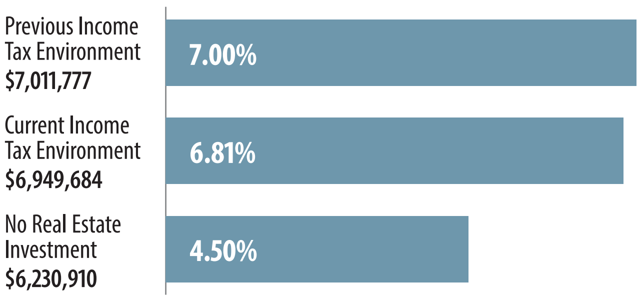
Source: Wells Fargo Wealth Management, 05/13

Hypothetical examples do not represent actual performance results achieved and are for illustrative purposes only.

Remember that Janet has $5.0 million of investible assets. Now let's take a look at Janet's capital accumulation, and compare her investment in the previous and current tax environment. What would Janet have accumulated if she had kept the $5.0 million of investible assets in a well-diversified and balanced portfolio earning 4.5 percent after tax instead of investing in real estate?

In Figure 5, we see that in the previous tax environment, Janet would have accumulated $7.01 million or a compounded growth rate of 7.0 percent using our example. In the current tax environment she would have accumulated $6.95 million or 6.81 percent compounded growth rate. That is a difference of 0.19 percent over the five-year holding period. Now if Janet had kept the investable assets in a well-diversified and balanced portfolio, she would have accumulated $6.23 million or the expected 4.5 percent compounded growth rate. Once again, the advantages of owning real estate assets are utilized by the investor from the "tax savings" deductions. Having a percentage of her investments in real estate allow an increase of 2.31 percent in Janet's compounded growth rate.

Figure 5. Compounded Growth Rate of Capital



Source: Wells Fargo Wealth Management, 05/13

Hypothetical examples do not represent actual performance results achieved and are for illustrative purposes only.

Conclusion

A real estate investment requires a commitment not just with the purchase, but all the legal and ongoing management decisions that you are going to have to make over time to own and manage building. Property management decisions include lease and tenant management; rent collection and record keeping; compliance with building codes, zoning, and ordinances associated with the building; and maintenance and repairs. Working with your advisors you may decide that it makes sense to employ a specialist or a management company to help you manage the building. If after you have run the numbers this option makes the building less attractive, you may want to contemplate other investment options, such as public or private REITs.

With the right building, a favorable interest environment, and changes in tax laws, investors may find potential opportunities for income generation and capital gains in today's commercial real estate investment environment. Again, a decision to purchase physical property shouldn't be taken lightly. Investors considering this option need to undertake thorough due diligence with their advisors.

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