Pros and Cons of Investing in Commercial Real Estate | Nolo.com

Understand the advantages and disadvantages of investing in Commercial Real Estate.

Any type of property, whether it's commercial or residential, can be a good investment opportunity. For your money, commercial properties typically offer more financial reward than residential properties, such as rental apartments or single-family homes, but there also can be more risks. Understand the full pros and cons of investing in commercial properties is important so that you make the investment decision that's right for you.

What Is a "Commercial Property?"

Commercial properties may refer to:

- retail buildings
- office buildings
- warehouses
- industrial buildings
- apartment buildings
- "mixed use" buildings, where the property may have a mix, such as retail, office and apartments.

There are nuances to managing each of these types of properties. To paint a general picture of what it's like investing in commercial property, let's examine the pros and cons of investing in a single-story commercial retail building, such as a community "strip mall".

Positive Reasons to Invest in Commercial Property

Here are some of the pros of buying commercial real estate over residential property.

Income potential. The best reason to invest in commercial over residential rentals is the earning potential. Commercial properties generally have an annual return off the purchase price between 6% and 12%, depending on the area, which is a much higher range than typically exists for single family home properties

(1% to 4% at best).

Professional relationships. Small business owners generally take pride in their businesses and want to protect their livelihood. Owners of commercial properties are usually not individuals, but LLCs, and operate the property as a business. As such, the landlord and tenant have more of a business-to-business customer relationship, which helps keep interactions professional and courteous.

Public eye. Retail tenants have a vested interest in maintaining their store and storefront, because if they don't, it will affect their business. As a result, commercial tenants and property owner interests are aligned, which helps the owner maintain and improve the quality of the property, and ultimately, the value of their investment.

Limited hours of operation. Businesses usually go home at night. In other words, you work when they work. Barring emergency calls at night for break-ins or fire alarms, you should be able to rest at night without having to worry about receiving a midnight call because a tenant wants repairs or has lost a key. For commercial properties it is also more likely you will have an alarm monitoring service so that if anything does happen at night, your alarm company will notify the proper authorities.

More objective price evaluations. It's often easier to evaluate the property prices of commercial property because you can request the current owner's income statement and determine what the price should be based on that. If the seller is using a knowledgeable broker, the asking price should be set at a price where an investor can earn the area's prevailing cap rate for the commercial property type they are looking at (retail, office, industrial, etc.). Residential properties are often subject to more emotional pricing. See the Nolo article *Is that Residential Real Estate Investment Property Worth It?* for more on the subject, including an explanation of cap rates.

Triple net leases. There are variations to triple net leases, but the general concept is that you as the property owner do not have to pay any expenses on the property (as would be the case with residential real estate). The lessee handles all property expenses directly, including real estate taxes. The only expense you'll have to pay is your mortgage. Companies like Walgreens, CVS, and Starbucks typically sign these types of leases, as they want to maintain a look and feel in keeping with their brand, so they manage those costs, and you as an investor get to have one of the lowest maintenance income producers for your money. Strip malls have a variety of net leases and triple nets are not usually done with smaller businesses, but these lease types are optimal and you can't get them with residential properties. For more on common lease terms, such as net leases, see the Nolo article *Commercial Leases: Negotiate the Best Term* and related articles in the Business Space and Commercial Leases section of this site.

More flexibility in lease terms. Fewer consumer protection laws govern commercial leases, unlike the dozens of state laws, such as security deposit limits and termination rules, that cover residential real estate. For more on commercial leases, see the Nolo book *Negotiate the Best Lease for Your Business,* by Janet Portman and Fred Steingold.

The Downside of Investing in Commercial Property

While there are many positive reasons to invest in commercial real estate over residential, there are also negative issues to consider.

Time commitment. If you own a commercial retail building with five tenants, or even just a few, you have more to manage than you do with a residential investment. You can't be an absentee landlord and maximize the return on your investment. With commercial, you are likely dealing with multiple leases, annual CAM adjustments (Common Area Maintenance costs that tenants are responsible for), more maintenance issues, and public safety concerns. In a nutshell, you have more to manage; and just as your tenants have to worry about the public eye, you do as well.

Professional help required. If you are a do-it-yourselfer, you better be licensed if you are going to handle the maintenance issues at a commercial property. The likelihood is you will not be prepared to handle maintenance issues yourself and you will need to hire someone to help with emergencies and repairs. While this added cost isn't ideal, you'll need to add it on to your set of expenses in order to properly care for the property. Remember to factor in property management expenses when evaluating the price to pay for a commercial investment property. Property management companies can charge between 5-10% of rent revenues for their services, which include lease administration. Evaluate beforehand if you want to manage leasing and the relationships yourself, or if you want to outsource those responsibilities.

Bigger initial investment. Acquiring a commercial property typically requires more capital up front than acquiring a residential rental in the same area, so it's often more difficult to get your foot in the door. Once you've acquired a commercial property, you can expect some large capital expenditures to follow. Your property might be humming along for a few months and wham, here comes a $10,000 bill to address roofing repairs or a new furnace. With more customers there are more facilities to maintain and therefore more costs. What you hope is that the gains in revenue outweigh the gains in costs, to support purchasing a commercial property over a residential one.

More risks. Properties intended for commercial use have more public visitors and therefore have more people on the property each day that can get hurt or do something to damage your property. Cars can hit patrons in parking lots, people can slip on ice during the winter, and vandals can spray paint the sides of the building. Incidents like these can occur anywhere, but chances of experiencing something like these events go up when investing in commercial properties. If you're risk adverse, you may want to look more closely at putting your money in residential properties.