ZIEGLER INVESTMENT BANKING

RELIGION FINANCE Z-NEWS

FEATURED ARTICLE

SIX QUESTIONS TO ASK BEFORE INVESTING IN COMMERCIAL PROPERTY

Would that empty Best Buy be a good buy? Or would the former Kmart be a better Target? Trust Ziegler to help you ask the right questions before you purchase commercial property.

The post-2008 real estate market has provided both charter schools and churches a number of opportunities to purchase commercial properties. Whether it is a vacant Home Depot store or a strip mall building, large commercial sites can be excellent long-term homes for a variety of organizations. Ziegler has provided financing for hundreds of millions of dollars of these types of projects. Along the way, we've gained a unique perspective from our clients about what to look out for when exploring the purchase of vacant commercial facilities. We've created a list of six vital questions that should be part of your due diligence process when considering the purchase of a commercial property.

1. Will the zoning be compatible for our proposed use?

Most zoning districts that contain commercial properties generally permit property owners to conduct a broad range of activities, including educational uses and public assembly. Be sure to ask the listing agent for a comprehensive breakdown of the zoning requirements. The property may need to be rezoned for your intended use, which can take time—and there are no guarantees.

The municipality might not rezone the property, but could instead issue your organization a "Conditional Use Permit" (CUP) to use the facility for your intended purpose. Sometimes CUPs are issued only for your specific organization and are not transferable to future buyers.

Most nonprofits that purchase a commercial property will immediately petition for an exemption from property tax. In most cases, municipalities are not allowed to discriminate against nonprofit buyers on the basis that a property would be removed from their local tax rolls; however, they can disguise a reluctance to grant the exemption via other means. They might claim that traffic congestion would be too high with your proposed use, or that you'd be incompatible with the other businesses in the area. In short, we recommend you confirm with the

	SIX MONTHS PRIOR	CURRENT
5 Yr Treasury	1.13%	2.00%
10 Yr Treasury	1.55%	2.50%
30 Day LIBOR	0.50%	0.77%
Prime Rate	3.50%	3.75%
30-year MMD	2.13%	3.12%

Source: Ziegler Capital Markets
Rates as of February 14, 2017

INTEREST RATE UPDATE

Observers will notice the significant changes in interest rates across the board in the table above when compared to where things stood six-months prior. After hitting record lows in July, most interest rate indexes have been on a steady climb upward. This is due to a variety of factors, including investors rotating money from bonds to stocks, the Federal Reserve raising the Fed Funds rate in December of 2016 and a general belief that the Fed will raise rates further in 2017. While no one can predict the future of rates, borrowers may want to consider accelerating any borrowing plans if possible so as not to miss out before rates might rise further

ABOUT US

Ziegler is a **national leader** in providing **financing** to **religious organizations nationwide**.

Contact us for assistance with **your financing needs**.

ZIEGLER
200 South Wacker Drive | Suite 2000
Chicago, IL 60606

CONTACT US
800 366 8899
askziegler@ziegler.com

municipality that your proposed use of the site will be allowed before spending significant additional dollars on architects' fees, feasibility studies, etc.

2. Would our neighbors be compatible with our mission?

Learn who your neighbors will be. Some big-box and strip mall properties have neighboring businesses that will complement your mission—a coffee shop or restaurant, for example. Other neighbors may be a detriment (think pawn shops and liquor stores). Only you can make the judgment about who you want next door. Ask questions such as: Would we share a parking lot? Will our activities and use of parking spaces conflict with that of the neighboring merchants? Is there a "condo" or "mall association" owners' group that would limit our say about how the common areas and parking lots are maintained?

Your organization might end up paying significant dollars for common-area upkeep for spaces that you do not necessarily use. It will also behoove you to check out the terms of your neighbors' leases, even if you are not their landlord. You wouldn't want to purchase a strip mall site only to find out that the other main tenants are all on their way out and the property or neighborhood is in major decline.

3. What is the condition of the building we are purchasing?

Before you make an offer, and before you negotiate a purchase price, you must understand the physical condition of the building you are buying. Some big-box sites are recently constructed and have excellent "bones" to them. They have minimal need for renovation and won't need critical items replaced. Other buildings are older and may require costly upgrades to elements that are on the verge of breakdown. The condition of the roof is critical, for example. A new roof for a big-box store can cost in the $150,000 to $400,000 range!

We strongly recommend that you hire an expert to perform a building inspection. Choose a building inspector who specializes in commercial properties. Your residential home inspector or board member with a skilled-trades background might not have the requisite skill set to judge the condition of an HVAC system for an 80,000 square-foot building.

Ziegler recently financed the purchase of a commercial office building for a school in the Midwest. The school hired a reputable construction inspector who identified approximately $1 million in concerns, ranging from the integrity of the HVAC system to deterioration of the exterior brick. While the seller was not willing to grant the buyer credit for every problem identified, they were willing to renegotiate a $300,000 reduction in the sales price. The $300,000 credit came two months after the parties had already agreed upon a purchase price.

The leverage provided by a property inspection can be tremendous. If you need a qualified inspector, contact us for recommendations in your marketplace. A qualified property inspector can generally provide a valuable report that will cost you in the range of $5,000 to $10,000, depending on the size of the property. It will be money well spent.

In addition to a building inspection, we recommend you engage an environmental firm to perform what is known as a Phase I environmental audit. These reports typically cost $2,000 to $4,000, depending on building size. The Phase I report will tell you whether the property has any pre-existing environmental hazards. Common examples are leaking underground storage tanks on-site or asbestos-containing materials used on the interior of the building. Remember, your constituency is trusting that you will not subject them any environmental hazards. If some level of environmental hazard is found later, you, the owner, may be liable for clean-up costs—even though you did not create the hazard. Phase I environmental audits are a must and are required by most lenders in order to obtain financing.

4. Are the renovation estimates we are receiving reasonable?

If you plan to renovate or retrofit an existing commercial building, it is essential to hire a reputable contractor to provide cost estimates. Give the contractor copies of your environmental audit report and building inspection report so they have a full view of the condition of the property.

If you've watched HGTV—ever—you know that remodeling expenses add up quickly. Not surprisingly, a significant interior build-out in a big-box store can cost more than you'd think, as well. One reason why: steel support columns. Churches planning to use the space for religious assembly will need to consider sightlines. The steel support columns found in many commercial buildings can block views. They are usually load-bearing, and removal can require a complete re-engineering of the roof truss system. We've seen a number of clients successfully relocate support columns, but planning is important. In many cases you'll need to make a cost/benefit decision. Support columns can also affect schools, as you'll need to engineer interior classrooms around them, which may result in some unusually sized rooms.

Finally, check the condition of the parking lot to make sure it will not require immediate repair after purchase. Your building contractor won't necessarily be an expert on parking lots. You might find you've purchased a fabulous building, but the parking lot requires $400,000 worth of work.

5. Do we need to be aware of any specific building code issues?

In some jurisdictions the building code requirements for "life safety" items, such as fire sprinkler systems and emergency exits, are more stringent for uses that involve children and/or public assembly. Explore these requirements carefully; they can impact your construction budget.

Additionally, most retail locations do not have enough restrooms for uses contemplated by schools or churches. You may find that building code not only requires the installation of additional restrooms, but that your staff and constituents will also need additional restroom facilities even if not required by code. These can be tricky to locate. Many times, installing the required laterals will involve concrete removal and trenching—at a minimum.

A final code concern is parking. Most jurisdictions have specific parking space requirements for either religious assembly or education. Does the site you are considering have enough parking for how you plan to use it? Most big-box sites do have ample parking; strip mall sites often have much less. You may need to explore neighboring parcels for cross parking agreements or easements and your lender may have an interest in reviewing any needed parking agreements.

6. Do we want to be landlords?

Will you inherit other commercial tenants at the site you are purchasing? When buying a commercial property, most organizations initially are excited about having rent-paying tenants to help pay debt service on their loan. But there are important pitfalls to being a landlord.

Operating a commercial property as a landlord requires your organization to become an expert in property maintenance. You'll be responsible for providing clean grounds, trash removal, utilities and a host of other issues. You'll likely also need to pay property taxes against the portion of the property occupied by for-profit tenants. If a tenant leaves or breaks their lease, you'll need skills in commercial real estate to find a replacement tenant. Long story short: Being a landlord can require a great deal of work that might take your eye off your organization's primary mission.

We've talked with a number of potential borrowers who focus on acquiring a site with income- producing tenants because the lease income would help them qualify for financing. When Ziegler underwrites a loan, we generally do not give one-for-one credit for potential future rental income. Why? Not only is such income sometimes deceptive (given all the costs to operate the building we listed above), but such income is many times not guaranteed by leases with tenants that have strong credit.

If your commercial lease is with Walgreens and is tied to their corporate revenues, that is a strong lease. If the lease is with a sole proprietor operating a daycare business, that lease income can be at significant risk, no matter what the length of the lease term. We've seen borrowers overleverage themselves with commercial properties, only to see a key tenant leave and find the income is not replaceable.

The presence of lease income in your organization's operating revenues over time is not always a blessing. We've seen successful organizations pledge to themselves that they would use any surplus lease income to either pay down debt or to fund special one-time projects. Years later, operating pressures can dictate that the lease income is applied to paying for normal operating expenses. Then, should that lease income go away, the organization has a large deficit to fill in the operating budget.

We know of one borrower who ultimately relied on lease income to pay 100 percent of mortgage debt service. This borrower later allowed certain leases to lapse because they wanted to use the extra space to expand their primary operations. They gave up the lease income thinking it could easily be replaced by expanded operations. It wasn't and this borrower subsequently defaulted on their loan.

Summary

Purchasing a commercial property can be a great option for organizations that need a large space to expand their operations. Ziegler has successfully funded a number of these projects such as helping a charter school create an 800-student facility out of a former Target store, and a church reclaim a vacant Kmart and turn it into a wonderful place of worship. If you understand all the moving parts we've outlined above, you are on the path to a successful outcome. Contact us if you have any questions or need assistance with related financing.

CASE STUDY

CROSSROADS COMMUNITY CHURCH

$10,700,000, SERIES 2016 ACQUISITION & PROJECT FINANCING

Crossroads Community launched public services as an independent community church in September 2006, meeting at a local high school. The church grew quickly and soon leased a commercial space in Santa Clarita in 2008, when attendance reached more than 200 people. Since that time, the church has grown to more than 1,400 in attendance at three weekend services.

In late 2015, as Sunday services began exceeding capacity in two venues, the church identified a 56,000-square foot commercial property that, if acquired and remodeled for church use, would provide the space the church needed for many years to come. In April 2016, the church entered into a lease agreement with an option to purchase the former industrial and warehouse site in Santa Clarita, with a plan to remodel the site and relocate church operations. Simultaneously, the church initiated a capital campaign to generate the cash that would be needed to make the purchase happen. The rest of the purchase and construction money would have to be borrowed.

The church discussed its building plans with a number of lending institutions, but failed to receive a satisfactory proposal. At that time, a consultant working with the church suggested calling Ziegler, because he knew about Ziegler's reputation for creative, long-term financing solutions.

After learning about the church's plans and evaluating multiple alternatives for structuring the financing, Ziegler was able to propose a structure that met the church's strategic objectives and coordinated project funding with the church's successful capital campaign efforts.

In August 2016, the church and Ziegler closed the loan, the proceeds of which were used to purchase the property and fund the construction project, which will include the completion of a 664-seat sanctuary and surrounding classrooms, and the build-out of the second floor with a youth assembly room, classrooms, and offices. The $10,700,000 financing package provided a 30-year, fully amortized, fixed-rate structure that eliminated interest rate risk for the church.

"After investigating several financing options, we determined that Ziegler offered the best financial package for Crossroads. The structure of the financing was exactly what Crossroads needed to accomplish our goal of the purchase and build out of our first permanent facility."

Steve Stark
Church Administrator
Crossroads Community Church

This client's experience may not be representative of the experience of other clients, nor is it indicative of future performance or success.