

# ZIEGLER INVESTMENT BANKING

CHARTER SCHOOL FINANCE Z-NEWS

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## 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**.

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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

## PEPIN ACADEMIES

\$12,165,000, SERIES 2016A&amp;B ACQUISITION &amp; PROJECT FINANCING



Pepin Academies operates two campuses in Hillsborough County, Florida and is authorized as a public charter school by the Hillsborough County School District. The school currently serves approximately 680 students in grades K-12, focusing on students with varying levels of disabilities including Learning Disabilities, Autism Spectrum Disorder, Attention Deficit Disorder to, pervasive development delay and medical conditions that affect learning, such as Tourette syndrome among others. The school also operates a transitional program for students age 18-22 who are not yet able to transition into the workforce or an institution of higher education. The School is named after the Pepin family, local Tampa philanthropists who have supported the school since inception in 1999.

In 2016 Pepin had the opportunity to purchase a 60,000 square foot commercial building in the Riverview neighborhood of Tampa to allow them to expand their Riverview Campus and provide a permanent home at that location. Ziegler was able to assist by helping Pepin develop a financing plan that involved the issuance of approximately \$12,165,000 in Bonds issued through the Florida Development Finance Corporation. Bonds proceeds were used for the acquisition of the commercial building, construction costs to retrofit the building for educational purposes and additional funds were used to refinance certain bank debt related to the Pepin Hillsborough Campus. Due to private use for a portion of the commercial building the School purchased, approximately \$2.6 million of the bonds were taxable.

Pepin Management needed to secure the new location in time for the opening of school on July 25, 2016. The tight timeline for needed municipal approvals from Hillsborough County kept everyone on the deal team moving forward with a common goal of success. The result was a closing on July 21st, meeting the deadline.

Pepin had other financing alternatives available, but elected to work with Ziegler on a fixed-rate bond structure to take advantage of a historically low period of interest rates. The bond financing's 30-year term provided for permanent financing with no need to later renegotiate the loan or have the School assume interest rate risk down the road with an adjustable rate. Further, the bond financing allowed for 100% financing of the building acquisition and related construction build-out.

*"For our students and staff at Pepin Academies, I can only say thank you so very much! The efforts of Ziegler and our financing team allow us to have an amazing educational facility that will serve our students for many years to come. If there is ever anything that I can do as far as a reference for Ziegler, please let me know!"*

**Dr. Craig Butz**  
Executive Director  
Pepin Academies

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