

## Should You Invest In Retail Condos?

By David V. Tran

### What Are Retail Condos?

Retail condos are commercial properties in which you can purchase a unit in a multi-unit shopping center. Just like residential condos, you do not have your own lot because all the units in the center share a lot with common parking lot and common area. The property is normally governed by a “Covenants, Conditions & Restrictions” (CC&R) document which describes all the rules and restrictions you have to abide by. You will have to pay a monthly owners association fee based on the square footage of your unit for the maintenance of shopping center.

### What You Should Know Before Investing

Retail condos are often offered for sale in densely-populated metros where there is a high barrier for entry for shopping centers, e.g. California or Florida. The developers target small business owners who aspire to own their own unit and small investors who can only afford to purchase a unit or two. This is a brilliant marketing strategy to get top price for a vacant shopping center. The developers often start marketing the project months if not years before construction even begins. They also

1. Require the initial deposit, as much as 50% of purchase price, to be paid directly to the developers and not the neutral third party, i.e. escrow companies. This way they can use the money for development. It also minimizes their borrowing expenses on construction loans which

often carry pretty high interest rate. For the developers, this is a smart thing to do. However, as a buyer there is a risk that you may not be able to get your money back if things go wrong, e.g. the developers cannot complete the construction. So make sure you deal with reputable developers with good track records.

2. Do not offer to pay commission to real estate brokers to represent the buyers. This is primarily due to the fact the demand is high while supplies are limited. It also minimizes expenses and maximizes profits for the developers (there is nothing wrong with this practice from a business viewpoint). As a buyer, you don't have an experienced broker to guide you through a complex commercial real estate transaction. Since many residential real estate disclosures and laws to protect buyers are not applicable to commercial real estate, you may want to pay someone knowledgeable to assist you with the transaction. Otherwise, you may end up signing a contract that lopsidedly protects the developers and not you. It's better safe than sorry.

3. Offer lower price as incentive for early buyers in the early stage when there is nothing to see besides a conceptual or architectural drawing of the property. The prices go up in as more and more units are sold. The difference between the first phase and final phase when the construction is completed could be as much as



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50%. This is a common pricing practice in residential development. Near the end of construction, demands may surge as buyers start seeing a nice shopping center. This motivates greedy and unscrupulous developers to find reasons to cancel the contracts to early buyers so they can sell to new buyers at higher prices. There have been lawsuits against a developer in San Jose for selling the same unit to several different buyers. So if you are dealing with a developer with no proven track records, you may want to subtly remind him that you have big guns, figuratively speaking. This is accomplished by having an experienced commercial real estate broker to represent you to make sure you don't unknowingly breach your contract. You may also want to have an attorney reviewing all the contracts to make sure there are no holes. That way, any greedy sellers will think twice before having any funny ideas.

### Potential Drawbacks for Retail Condos

The upside is retail condos are often at a very good location, e.g. adjacent to Walmart or Target, where there is a severe shortage of retail spaces. The vacancy for commercial retail properties in the Bay Area is about 3%, among the lowest if not the lowest in the nation. However, there are some drawbacks that you should consider before investing:

1. It's very difficult obtain financing for the purchase if you are investor. Commercial lenders don't lend money to investors to purchase a vacant commercial property. Most likely you need to purchase in all cash. So you don't have the benefits of maximizing leverage associated with real estate investment. If you plan to use the unit for your own business, it is possible to get a Small Business Administration (SBA) loan with 10-20% down payment.
2. With tenant improvement credit to tenant and leasing fee, the final cost is close to \$700/SF (if you purchase near the end of construction). To get a fair 6% return of your investment, you will need to lease it at \$3.50 per square foot plus triple-net (NNN) expenses estimated about \$.50 to \$1 per square foot. This is within fair market rent for retail space in the Bay Area. However, it's more towards the upper end. So it may take awhile to lease it as there are not a lot of businesses that can be profitable paying such high rents. Tenant turn over rate may be high as your tenant's business may not be strong enough to sustain such high expenses.
3. To maximize profits, the developers tend to provide a minimum number of parking spaces, e.g. 4 spaces

per 1000 SF. If other units around your unit have businesses that require a lot of parking spaces like restaurants, you may have problem leasing your unit. You or our tenants could also lose business because the customers cannot find parking spaces.

4. In a typical shopping center, the tenant can demand the landlord to give him/her the exclusive right to operate a certain type of business. However in a retail condo project, you don't have this exclusive right as there is no single landlord for the whole center. This is one of the main reasons you will see few brand name tenants, e.g. subway sandwiches, in a retail condo center. So if you or your tenant has a good business, e.g. a hair salon, others can open another hair salon next door to compete & take you or your tenant out of business. So you may see 2 real estate offices, 2 coffee shops, and 3 cellular phone stores in a 20 unit retail condo complex. In another example, let's say you want to open an upscale boutique selling expensive and brand name merchandises, there is nothing in the CC&R that prevents the store on the left selling cheap toys and the store on the right being a butcher shop. So the lack of exclusivity and consistency may be the biggest drawbacks for retail condos.



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