

INVESTING IN RESIDENTIAL VERSUS COMMERCIAL PROPERTY

Investing in residential real estate has some distinct differences from investing in commercial property. Generally speaking commercial real estate investments deliver higher financial yields but there are some caveats to consider that can rule out many investors.

Financial Considerations

- Commercial real estate can frequently yield from 6-10% where a residential investment may only yield 2-4% in an area like the Lower Mainland of Vancouver.
- A residential property collects market rent and deducts the expenses with the landlord assuming the risk and responsibility of ownership costs; whereas commercial income property usually have triple net leases where there is a stipulated basic rental amount or net income yield on an annual basis and all or virtually all operating and ownership costs with the exception of interest and taxes are passed on to the tenant. This structure ensures that any fluctuations in ownership costs are borne by the tenant and results in a much more efficient and stable investment over time.
- Residential income property usually requires a minimum of 20% down and commercial property usually requires 30% + down
- Although commercial rental yields are higher the cost of borrowing to purchase commercial property is usually at least 1.5-3.0% higher than the prevailing residential mortgage rates to compensate for some of the higher risks in income and liability involved in commercial ownership
- Commercial properties typically sit vacant for a longer time period than residential properties but longer lease terms tend to compensate for the difference in cash flow over time for those who can weather the gap
- The last 3 items tend to limit the amount of commercial property investors to higher net worth individuals

Legal & Administrative Considerations

- The Residential Tenancy Act provides a huge amount of protection for residential tenants and enforce conditions that can be very onerous on a landlord that can result in unpaid rent for landlord debt service and being stuck with a deadbeat tenant for months on end with no ability to re-let the space
- Commercial tenancies are governed by contract law and entirely negotiable. These are business contracts.
- Commercial lease agreements are generally for multiple years and if tenants move on the onus is frequently on the tenant to find a replacement if they leave before the lease term.
- Rent is dictated by the market and negotiation and there are no rules in place in regards to annual increases; rent is based on supply and demand.

- The nature of the commercial real estate industry is such that lease agreements are much more protective of the landlord's real estate asset and interests than a tenant's, a polar opposite to residential tenancies
- Commercial property ownership and management is much more complex than residential investing for several reasons:
 - more extensive legal knowledge required in lease terms and negotiation
 - more complex and costly repairs and operating expenses to manage and fund in owning commercial properties
 - numerous variables to consider in assessing different property types to purchase and their long term potential and how to extract maximum value over time
 - more detailed and time consuming property management and accounting

Other Considerations

- Residential real estate is much more familiar to us all in what tenants need and want, how the facilities and their maintenance and management
- Residential rental income, expense and asset values are readily available in abundance
- Residential real estate is almost always more liquid in the event of a required sale
- In contrast there are a great many factors that can impact commercial properties existing and potential income, cost of ownership and liquidity and a professional appraisal is almost always required to determine real value given the lack of public information
- The wide range of commercial property segments and sub categories can be intimidating to a new commercial investor
- Residential property can frequently require more management due to higher tenant turnover and leaner budgets that do not always provide for professional property management
- Although more onerous in management sophistication, a commercial property owner can typically charge their professional management costs right down to their accounting back to the tenant
- Residential tenants rarely treat a rental like their own which can result in more frequent repairs and maintenance eroding rental returns
- A business owner leasing commercial property is most frequently responsible for internal maintenance and repairs at the risk of their damage deposit and in many cases takes a level of pride and ownership in their place of business in order to project a positive image of their business to customers, colleagues and other business associates.

Astute investments in commercial real estate can result in big wins just as easy as one bad step can have severe consequences to an investor. If an investor surrounds themselves with a solid advisory team including a qualified commercial realtor their chances of success are far greater.