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The Ten Scariest Sentences You'll Hear in a CRE Deal

Here's one: This is a one-of-a-kind asset that will always keep its value.

By Joseph J. Ori | March 15, 2023 at 08:34 AM

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There are many positive words and terms of wisdom in the CRE industry: That was a great deal, great management equals great value, you make money when you buy not sell, I would rather buy a Class B property in an A location than a Class A property in a B location, we don't buy properties with negative leverage and I would rather own a good property at a great value, rather than a great property at a good value. Conversely, there are also some very scary words and phrases in the CRE industry. Below are ten of the worst.

1. **Yes, we are buying this deal at a low cap rate, but; this is a one-of-a-kind asset that will always keep its value.** This happens in every CRE cycle (apartments before the great recession and industrial properties from 2017 to 2022) with many overpriced institutional deals at sub 4.0% cap rates when the investor who won the overpriced bid for the property is trying to justify the outlandish price.
2. **The major tenant in the building is rated BBB (investment grade) and its highly unlikely they will go out of business.** The credit rating of many companies changes over time as their core business deteriorates, they make a bad acquisition, the new CEO is a poor manager, competitors enter the industry, or the company becomes highly leveraged. In corporate finance, there is a term called, "fallen angels" or companies that were once rated investment grade, but their business deteriorates, the credit rating drops to junk status, and they default on the rent.
3. **This time it's different.** This occurs when CRE investors mistakenly think a technological, economic, demographic or property use change will create great real estate value. Most of the time these perceived changes are just fads and poor business models, like shared-office space will dominate office leasing (see the WeWork debacle), online shopping is going to "kill" malls and shopping centers (see

Amazon stock price) and house flipping is a profitable business (see the disastrous forays in home flipping by Zillow and Opendoor).

4. **Sometimes a higher and better use is to sell it to someone else.** This is a Sam Zell quote and means, that if your property turns out to be a dog, sell it to someone else.
5. **If you buy this property with a large vacancy, you will get the benefit of the new leasing.** This is what the seller and broker will often tell the buyer when trying to sell a property with a large vacancy. Hey buyer, you can make a lot of money buying this property at an inflated price and leasing the vacant space. If that's the case, why doesn't the seller keep the property and get the cash flow and value increase from the new leases?
6. **This portfolio is "Pigs and Queens".** The normal distribution for any large portfolio of CRE assets is 20% Class A (queens), 60% Class B and 20% Class C (pigs). Owners rarely sell a Class A or Class C portfolio because the Class A portfolio will be too expensive, and nobody wants the Class C properties. Therefore, sellers have to mix and match to get rid of the Class C assets. Whenever you are looking to buy a large CRE portfolio, make sure the cap rate is higher because of the Pigs.
7. **This property type or market is dead and will never come back.** This is heard a lot during times of financial distress or in a crash. Properties and markets always heal and turn around. Think of vacation homes in 2010, malls in 2018 and Class B/C office buildings today.
8. **These empty stores will never get leased.** This refers to large retail bankruptcies like RadioShack, Toys R Us, Sears, JC Penney, Gymboree, and many others, which placed thousands of empty stores on the market in the 2017 to 2022 period, but most locations were leased up within two years. The CRE industry is very adept at taking vacant stores and big boxes and recycling them into leased spaces and other uses.
9. **This large CRE Excel worksheet with many spreadsheets is error-free.** Every large and complicated Excel underwriting spreadsheet used to analyze CRE deals has at least one formula error.
10. **Financial engineering is more important than price.** This is a Wall Street strategy that was very prevalent and led to the financial crisis in 2007 and includes using convoluted debt structures, high leverage, securitization, mezzanine, and equity structures to make a bad or overpriced deal look good. Think of "Lip Stick on a Pig."

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