

I'm Gonna Build My Own Office

You hear we're in our second year of a recession and you think your landlord is going to go easy on you at renewal time. You've got an expiring 5 year old \$10.00 full service lease in the Northwest quarter of OKC and you're sure it won't go up too much, if at all. Wrong.

The landlord comes at you with \$15.00 and doesn't seem willing to negotiate. In addition to that, the Fortune 500 Company in the suite next to you is expanding and you get the feeling that they want your space. So, you call the surrounding buildings and they all quote a \$16.00 equivalent full service rate. Hmm – you just wonder if maybe you could build your own building...

First of all, you should heed the following warning: "Buildings are designed and built by trained professionals. Do not attempt this in your own office." Having said that – here goes. To build you need:

- **Time:** 1 year of significant time and energy commitment, delicate timing issues.
- **Land:** 5 times the square footage as the building; buy land appropriate to the use
- **Design:** Suitable for your use, has room for expansion or contraction, perhaps use for tenants, meets fire codes, city parking and access requirements, Americans with Disability Act, and national construction codes, lender construction requirements.
- **Financing:** Arrange interim (construction) and long-term financing
- **Management:** Be prepared to manage the building and eventual operation of the building.
- **Budgeting:** Run your numbers and see if it really pays

Time:

Never underestimate the time building will cost you. Even after the plans, location and motif are finished, the decision makers will either have to wash their hands of it (which never happens, especially in smaller offices) or be prepared to cope with many, many daily challenges. Many of these challenges will have to be decided ON THE SPOT while highly paid professionals and tradesmen crank their meters. Planning helps with this, but does not prevent it entirely. The general rule for major projects is that "soft costs" (architects and engineers) cost 10%-30% of the total cost. The more of this cost you incur, the less work you will have to do - if you choose your professionals wisely.

Figure it will take 6 months to interview and hire professionals, design the building, acquire land, arrange financing and get approvals. It will take 3-12 months to build, depending upon availability of skills, materials and weather. This assumes your municipality is cooperative. Edmond and Norman are notoriously persnickety about their building standards and uses, so add another 6 months minimum to the up front time to deal with these municipalities. Re-zoning requires additional time anywhere and usually public notice and discussion.

Finally, timing your move requires lots of strategic and tactical planning. You have to decide early on if you want to risk being out of business or having two locations. You can never time it perfectly. Most people choose to have two locations. You will have to get your current landlord to accommodate your timing needs unless you plan to move while your current lease is in force. Be sure to give proper notices for vacating the current lease.

Land:

There are 7 basic aspects to land, only two (location and amount) are readily apparent:

- Location: Where it is in town and how do you get to it now?
- Quantity: How much do you need?
- Ownership: Will they sell and if it's a group of people – will they agree on a sales price?
- Use Restrictions: Can you legally run your business out of that location? If not, can you get it re-zoned?
- Access: Can you get the utilities curb cuts, traffic flow and parking on the site?
- Future plans: Will the site be obliterated by plans to build a freeway, canal, pipeline, park or power line?
- Environmental: Has the site been contaminated, or is it near a contaminated site?

Location:

This is the most important part of any new building decision and is wholly dependent on your business needs. Cost and location are connected by market position. If your business requires convenience access and visibility, then you will have to buy higher cost land.

If your business is a “destination” like a dentist, specialty shop or well-known service that your customers or employees will find, then you can invest in lower cost land and advertise to educate the public. The perfect example of this is Disney World. They built at inexpensive Orlando, Florida and the world found them!

Quantity:

Generally, you need 5 times as much land square feet as you need for your business. If you plan to build a 10,000 SF single story office building, you need 50,000 SF of land to allow for parking, access and landscaping. Since an acre is 43,560 SF you will need about 1.15 acres. It's always important to err on the side of too much land, because land is cheap and if your needs change, you can accommodate them at the site. Moving, as you will discover, is expensive.

You may decide to become a landlord while you are building your own building. Any tenant will have to live with the same zoning as your business and you will have to be sure the land is zoned for multi-tenant occupancy like your business. Having a tenant allows you to enjoy the same financial benefits your landlord now enjoys – and the same risks. Having a tenant is an excellent idea for a small business with a building. The tenant defrays the costs of developing the property and somewhat subsidizes your rent. In addition, if the business grows, you can move the tenant out (at the end of their lease,

of course) and occupy the space they helped pay for. Or, if you grow tired of your business, you can rent the whole building out and become a landlord. Small Business Administration (SBA) loans will allow up to 49% of the building to be leased out.

Ownership:

Just because you want to buy land, that doesn't mean you can buy it. Land can be owned by unwilling sellers or cantankerous groups of owners (like heirs) who cannot decide if they really want to sell. In addition, there are occasionally title or loan issues that can delay the transaction for the land. Sometimes, there are deed restrictions which prohibit the use of the land beyond the zoning restrictions. Most title problems are solvable – in time

Use Restrictions:

This is very important because most cities restrict the type of use and structures that can be built within their municipality. The simplest idea is to build in space zoned and used for your purpose. If you are a dentist and there is vacant land next to a doctor and zoned for that use, you are in good shape. If the land is zoned differently than your use, but there is similar use in the immediate area, you are in better shape. If you want to change use, be prepared for a fight. Even if you are going from an intense use to a less intense use, you may have to fight because municipalities like the tax dollars that intense uses (like shopping centers and automobile plants) generate.

If the property seems like it's zoned properly already – ASK! Zoning people are very knowledgeable and helpful. Tell them everything BEFORE you buy the property. If you are going to cut hair and sell shampoo, don't assume both are OK. Sometimes minor uses cause problems. If you quiz the zoning people carefully before you buy, you will at least know the possible problems you will have later. Also, cities will impose new development restrictions to preserve the feel of a neighborhood or improve it. It's not unusual to find a new "construction standards overlay" that took place within the last few years.

Finally, if you need to get re-zoned, hire an experienced zoning attorney with a known reputation. It's expensive, but this area of law is so specialized and political, you need a very well qualified and connected specialist to do it right.

Access:

Never assume you can get the same access your neighbors have. Standards for curb cuts and traffic flow have changed drastically in the past decade. Many traffic planners are restricting access to the thoroughfares to signal controlled intersections only in the interest of safety (you often have to purchase those curb improvements and traffic signals as part of your permit requirements). Just because the 25 year old building next to you has a cut doesn't mean you will get one – you may have to buy part of his, if he'll sell. Use the same idea for traffic planning as for zoning – ASK! More than one would-be owner builder has run aground on the traffic problem.

Be prepared to have projected traffic and occupancy numbers for the city when asking for utilities and other services. Hook-up fees are often based upon these numbers and the capacity of the municipal systems. For example, last year Norman was not allowing building permits in areas that had not already been platted due to sewage treatment restrictions. The wise people of Norman passed a bond issue and corrected the

situation, so now building is OK, but this kind of temporary complication can only be discovered by talking to the municipality.

Future Plans:

Just because the neighborhood is sleepy doesn't mean it's going to stay that way – ask thousands of people in the metro who now have new streets, freeway off ramps and toll ways on what used to be their property! Any time you are considering purchasing commercial property, contact the city transportation planning department, school districts, the department of transportation, the utility companies, and any other pertinent municipal planners to verify that your prime site isn't in the "condemnation path" of their projects. You will be paid fairly (thanks to the 5th amendment to the US Constitution) but you will lose all the time you spent developing your perfect location, because even a partial taking will leave you with something less than what you need unless you planned for the taking. A note on condemnation – most of the time it's good for the landowner and increases the value of the property through greater access and position. Prior planning is essential to maintain the value of the property to the user.

Environmental:

Recent changes in our views on land use have changed our views on the value of land. Clean up standards are so strict and environmental laws are so accusatory that buying land can lead to great liability. Current environmental laws assign environmental liability to anyone who has ever held title, whether they are guilty of pollution or not. You have to have environmental surveys done on property while it is under contract and before closing. These surveys probe in greater and greater depth (kind of a pun) depending on the past uses of the property. If the property has never been anything but pasture, then only aerial photos and testimony to that effect are needed. However, if the property has been used for years, as often happens in urban uses, detailed studies of use and probable pollutants from them will probably require environmental sampling to assure the buyer that it is clean, or at least quantify the extent of pollution.

These surveys serve both the buyer and seller. If the property is clean, it assures top price for the seller and verifies for all time that the property was clean when sold. If it's polluted, then the buyer has a sense of the environmental risk and the seller can document the extent of the pollution, in case the buyer turns out to be a polluter.

Design:

Since you are building your own building for long-term occupancy, you want to do it right. Engage an architect or a contractor familiar with the type of building that you want. They can help you prevent the really expensive (steel and concrete) mistakes. They can also get the plans approved and stamped much faster than you can because they have done it before. A really good architect, contractor or interior designer will interview you and your key people to figure out what you need.

They will design the space for efficiency and to allow for easy expansion. They can do this by planning utilities and connections that will allow you to grow or divide the space with a minimum of expense.

Financing:

The purchase of the land begins a substantial investment in your new business location. Several banks offer seamless construction to occupancy financing. Most of the time the construction financing is completely separate from the final loan. The reason for this is that construction financing is very labor intensive and technical. The loan company will release part of the construction loan provided the construction has been done and is done to specification. This is to keep the builder / contractor from taking all the cash and leaving the lender without adequate collateral. For these reasons, construction financing is at a higher interest rate and is strictly short term.

After the building is completed, long-term or interim financing is usually placed to take over the construction financing. Long-term financing is best begun by signing a note with a balloon payment at your bank. The rates on these loans tend to be higher than the long term, fixed-rate mortgages available on the mortgage markets. Bank loans are usually fixed rate or variable rate 5 year mortgages with a 15-20 year amortization schedule. During the term of the mortgage, you can shop around for a long-term mortgage and roll the bank financing into it. Make sure the bank cuts you a deal without prepayment penalty or a deal so good you won't want to get another deal. Because the mortgage market is so market sensitive, you can't get a commitment until your building is up and functioning.

Also, by waiting a few years for permanent financing, your appreciation and principal retirement will increase your loan to value ratio. This is the ratio of debt to market value of the property. When this ratio is 70% or lower so you might even be able to get a non-recourse loan, which means that you or your business are not liable if the loan goes into default, the mortgage company just takes the property and calls it even.

Management:

One often-overlooked aspect of owning property is its management. It's like watching a person throw the dough up in the air to make a pizza. It looks simple, and it is – but if you've never done it, you should prepare yourself for some humbling learning experiences.

The greatest challenge will be the first phase of owning a building – construction. Take sober stock of your talents in your business. Are you the planning and executing kind of business, like manufacturing or project work? Or are you creative and people oriented, like advertising or PR? If your managerial expertise is too far from the tasks of construction, you will have severe challenges in construction and you should hire professionals who are familiar with construction.

Oh, and one other thing – listen to them! If a contractor tells you it takes 90 days to lay carpet and you ask two other carpet contractors and they tell you 75 and 100 days – don't think you can get it done in 25 days and move in. They know – you don't.

Once you move into your new business location, the management keeps on going. The first year will be numerous surprises – plumbing that is troublesome, new circuits you discover you need, air conditioning that needs re-routing and changing thermostat locations. Just count on it. Also, you will have to get accustomed to seasonal challenges like lawn work, freezing pipes, water routing and the odd bit of post-tornadic

roof and landscaping repair. You should have preventative maintenance schedules for all aspects of the building like rotating machinery, concrete and asphalt sealing, carpet cleaning, janitorial work, painting, and lawn maintenance. Plan for major items like foundation maintenance / repair and roof replacement repair. Owning a building is a long-term proposition.

If you have a tenant, you have to budget 5% - 10% vacancy to account for lost rent during re-tenanting and the cost of tenant improvements and commissions. You also have to manage this task through marketing the space either with professionals or on your own. If managing isn't your cup of tea, you can hire independent managing companies who will charge about 4% to 6% of the market rent per month to manage the property.

Budgeting:

OK, so here we are at the final stage, now that we really know what we're getting in to. You have a 5,000 SF lease for \$15/SF which you can sign for 3 years. That's \$6,250 per month. The landlord does all the management and pays your utilities, taxes and janitorial. All you have to do is keep track of your key.

If you build that 5,000 SF office building, you will have to buy 5,000 SF times 5 or 25,000 SF at about \$3-\$6/SF in North OKC, so let's assume you pay \$5/SF or \$125,000 for the land. You can probably build the structure for \$110/SF. You can spend as little as \$75/SF for minimal office or as much as \$200/SF for medical space. At \$110/SF, you are going to spend \$550,000 for your space with landscaping, parking and curb cuts and maybe even a traffic signal! This means you will have a total investment of \$125,000 in land plus \$550,000 for a total of \$680,000 in the building and grounds.

The Bottom Line

If you borrow your \$680,000 at 30 year t-bill rates plus 250 basis points (a typical add-on basis rate), your rate is about 5.4% for the 30 year t-bill and 2.5% for the basis points, or 7.9%. To amortize this over 30 years is \$4,910 per month. It will cost you approximately \$4.25/SF per year to insure, pay taxes, haul garbage, light, heat, cool, water, maintain and clean your new building, so that comes out to an additional \$1,770 per month for a grand total of \$6,680 per month!

So – here is the bottom line:

- Rent for 3 years: \$6,250 per month
- Own for 30 years: \$6,680 per month, which is made up of \$4,910/month fixed and \$1,770 expenses which are subject to change.

The real reasons for owning:

Why **would** you own? Well – there is the 30 year partially fixed rental rate (expenses will rise like rent does) and the allure of controlling property.

If you are a closely held partnership or company, you can rent from a closely held company and take advantage of depreciation to build wealth. You can exchange equity in the building through a tax-deferred exchange and continue to build wealth without taxation.

If you have a tenant, you can move their rate to meet the market and cover some of your costs – or the market might force you to subsidize their rent.

If you are a veterinary business whose clientele will stay the same for years and you want to control your location and build wealth in your building as well as in your practice – owning is for you. If you are a Dot com company whose business changes radically from wild profit to wild change – better rent. In between these extremes lies the great majority of American business. Most going concerns have better rates of return from their business than from real estate. However, few things are as stable as an investment in your own location's real estate.

Owning versus leasing is an important decision for any business. In the final analysis, it is not the bottom line, but the business plan that drives the need to own.