

“Becoming a Landlord”
Basic Real Estate Negotiation

Olivia

General Background:

Olivia and her brother William recently decided to enter into the business of commercial real estate. Their father had left them a \$100,000 inheritance to split 50-50 and had told them both that they should invest it in commercial property. They purchased a small strip mall together with solid, stable tenants and had hoped to sell the property at a profit in five to ten years.

While there is no formal agreement, the basic understanding had been that Olivia would put up the additional money necessary for the down payment, and William would find the property and manage it. Olivia lives in New York, while William lives in San Diego.

William's good friend Sonia is a local commercial real estate agent in the San Diego area. Sonia agreed to help identify possible properties and handle everything through the purchase of the property by Olivia and William for a 5% commission of the sales price (to be split between the sellers and buyers, so that Olivia and William would owe her 2.5%).

Sonia found an ideal strip mall that was for sale at \$1 million dollars (significantly below market rates according to Sonia), and it was not too far from William's home. All of the units were rented by stable businesses with multi-year leases. Some of the tenants were a little demanding over the last few years, however, concerning repairs and maintenance issues.

The opportunity was so good that Olivia and William decided to go ahead with the venture, and Olivia put in \$100,000 of her own money for a total down payment of \$200,000 (Olivia's \$100K plus the combined \$100K inheritance). Olivia also signed a mortgage to borrow \$800,000 to cover the remaining payment for the property. In addition, Olivia had to pay Sonia's commission of \$25,000 and also \$10,000 in various initial expenses and other minor costs.

The building earns about \$75,000 per year. Mortgage payments and other expenses add up to about \$75,000 per year, depending on any additional repairs.

After signing the agreement and taking ownership of the property, Olivia and William realized that they had not yet agreed on what compensation William would receive for managing the property. They had talked about an arrangement where Olivia has 75% ownership and William has 25% ownership of the property. Olivia is in San Diego this morning on other business, and the two have set up a meeting to figure out the details of William's compensation.

Inside Information for Olivia

You had not really thought about the issue of William's compensation for managing the property. At one point, you had even presumed (or at least hoped) that maybe that was just part of the trade: You would put up any remaining down payment and expenses money and take out the mortgage, and he would manage the property.

You are fine with some sort of minimal compensation for William, just to make sure that he actually responds to things if they arise. When you mentioned your arrangement to a friend who owned a number of apartment buildings on Long Island, he said that a managing company typically gets a portion of the rents, maybe 2-3% or something like that. You are not quite sure, to be honest.

You are a little surprised that he is raising such a minor issue anyways. What does it take to manage a strip mall with long-term tenants? Aren't we hiring groundskeepers and fix-it folks to handle everything? By comparison, it was not easy for you to withdraw the last remnants of your CD account. That money was hard earned. Even with your big salary, \$100k is a huge chunk of change. And signing onto an \$800k mortgage means you will probably have to put off moving any time soon. Also, the risk is entirely on you if something happens with the property (with William's credit history, only your name is and will ever be on that mortgage).

You realize that you have not really figured out all of the money that you have paid out so far - you had to pay Sonia and those expenses at closing. You decide you better figure out exactly what it is you have spent and how much "profit" there might be on this (and how you might calculate such a figure). You want to make sure that the 75 - 25 split on the property is measured correctly. Those additional expenses and any future expenses had better be subtracted out of any sale price before William starts thinking about his 25%.

You are eager to hear what William has in mind for his compensation. Unless pressed, you will let him start off the discussions. Find out what he is looking for before you suggest anything.