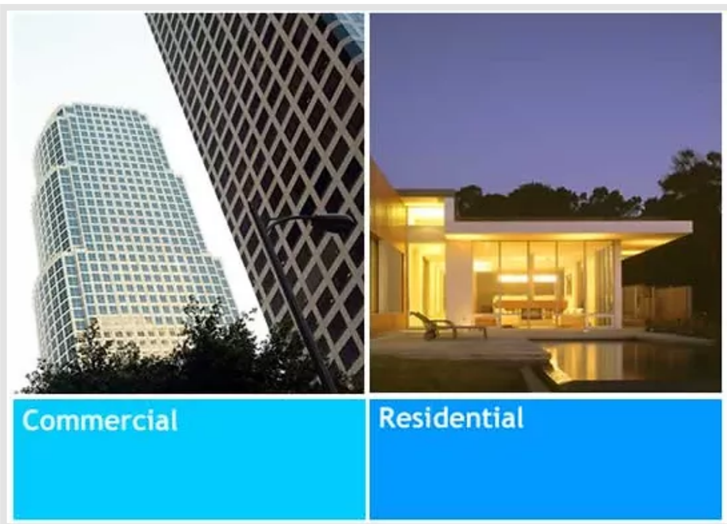
Should I invest in residential or commercial real estate? (Part 2: Commercial)

Understanding commercial real estate, and choosing between the two.

January 15, 2016 BY IAN IPPOLITO



Many so-called “experts” will tell you that residential (or commercial) investing is significantly better than the other. However, most are only familiar with the one that they recommend. Before making your first investment, it’s vital to **fully understand both**, so you can figure out what makes the most sense for you.

In part one of this tutorial, we talked about residential investing. In this part, we’ll talk about **commercial investing.**

What is it?

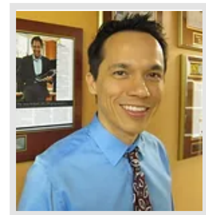
Commercial real estate involves **structures that businesses occupy (and/or the land under them).** This includes office, retail, industrial, apartments (5+ rental units), hotels, self storage, mobile home parks, etc.

Bankin’ dollars

Commercial investing usually **generates more cash flow per square foot** than residential. This means it tends to be much more profitable. This is a **huge difference** and no doubt one of the **main reasons that many people invest** in commercial real estate.

Also, the **leases** on commercial investments (other than apartments) are generally **much longer** (often 5 to 20 years versus one year). So it usually

About Ian Ippolito



Ian Ippolito is an investor and serial entrepreneur. He has been interviewed by the Wall Street Journal, Business Week, Forbes, TIME, Fast Company, TechCrunch, CBS News, FOX News and more.

Ian was impressed by the potential of real estate crowdfunding, but frustrated by the lack of quality site reviews and investment analysis. He created The Real Estate Crowdfunding Review to fill that gap.

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produces a much **more stable and reliable income stream**.

However, commercial real estate is not without its **downsides**.

Every rose has its thorn

Commercial investing has historically **required much deeper pockets** than residential. A typical investment might require millions of dollars instead of a few hundred thousand. Larger commercial projects are in the hundreds of millions of dollars.

Banks financing loans usually **require 30% or more** down, which also makes funding more difficult.

For these reasons, **traditionally only the wealthiest investors could afford to invest** in commercial. However **that's now changing**. With the invention of **real estate crowdfunding**, the entry cost has dropped as low as $2500, and is now **in reach of practically every accredited investor**. (See What Is Real Estate Crowdfunding?)

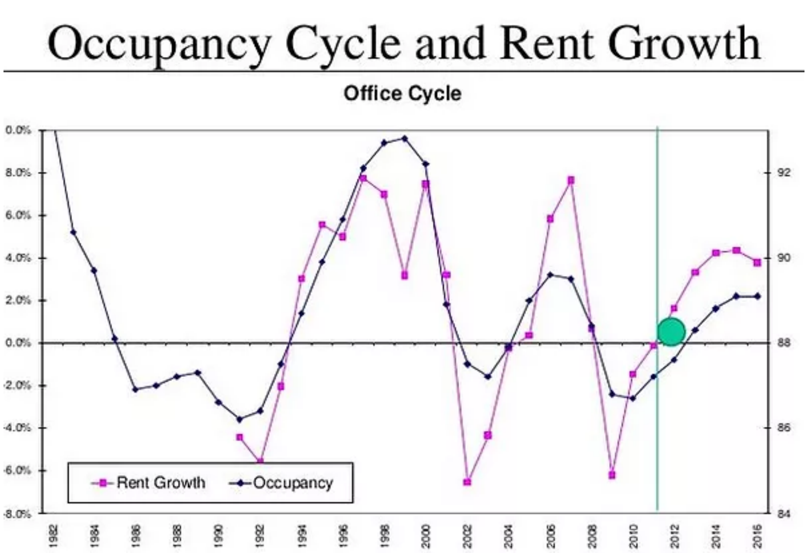
Eventually, crowdfunding will be accessible to all investors, and minimums will drop even lower. So **this issue is becoming less and less of a problem**.

Tidal wave

However, the other major downside of commercial real estate will probably never go away. Commercial real estate is **much more volatile and cyclical** than residential.

Before the Great Recession, **residential** real estate had never experienced a nationwide downturn for almost 100 years (the last time was the Great Depression). In contrast, **commercial tends to** go through a **down cycle about every eight years**. That's more than **10 times as volatile**.

So it's really **important to time commercial** investments properly.



Also, each **individual asset type** has its own **unique cycle**, which can be significantly different than the others.

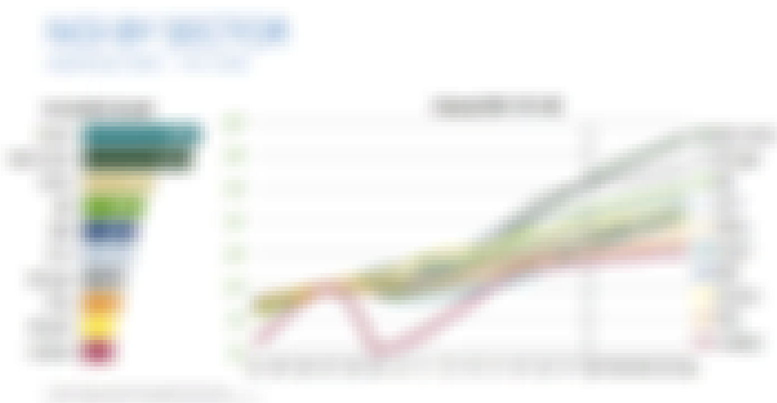
For example, right now, **apartments are mature** in their cycle while **industrial properties are very early** in their cycle. And on top of that, each individual geographical market may be a bit ahead or behind on the national cycle.

So it's **important to keep track** of all of these things **and consider them** in any potential commercial real estate investment. (See What Is the Real Estate Cycle?) This requires **a lot more homework** than the typical residential real estate investment.

Recession risk

In a **recession**, the **different asset types** are not created equal. Some have **alot more** be **recession risk** than **others**.

For example in past cycles **hotels** (lodging) have been the most volatile (**first to get hit, fell** the **farthest** and **stayed down the longest).** And on the other side of the spectrum are **mobile home parks and multifamily** which historically have been much **steadier**.



However there is **one big caveat** to the above. **Too much new construction** in the **area** of a property you buy can easily **spoil the party** and make a historically safe asset class **very risky**.

Many would say that's **happening right now** in many markets in **self storage and senior housing** (and in many primary markets and downtown areas with **multi family**). So you have to **understand** the **risk** of that **unknown**. And a smart investor **does their homework** at the **property level** to **minimize** a chance of a **nasty surprise**.

Mobile home parks (manufactured homes) have a **unique advantage** here of being so unpopular in communities that barely any new ones are being approved. So this keeps **supply down.** On the other hand it's very **hard to find quality deals** because everyone knows this, and the industry is also very fragmented.

Timing Matters

Due to the above issues, **timing is crucial**. It's **important to fully understand the asset class** and **stay up-to-date** on the latest trends.

For example, in the retail world, **power centers were heavily in favor** for a long time. However, with the rise of the Internet and e-commerce, these are **no longer the safe bets** that they once were.

There are **many companies that offer** this **crucial analytical information** for free on the Internet such as Marcus and Millichap, and the Urban Land Institute.

Equity or debt?

As an investor, you can **choose to invest** in commercial real estate via **either equity or debt**. (See What's the Difference between Equity and Debt?)

Income is often done through a **lease** that can be either single net, double net or triple net. **Single net** require you to be responsible for much of the maintenance. **Triple net** puts all of the maintenance responsibility on the tenant. This creates a very low maintenance investment and when done on high quality credit tenants, can be similar in safety to a bond.

Final conclusion: Which is better?

There are many people that will tell you residential investing is much better than commercial (and vice versa). So **which of the two** (residential or commercial real estate) **is objectively the best**? There's no single answer to this that applies to everyone and at all times. The **answer depends on your investment goals**, tolerance for risk, and where we happen to be in the cycle.

Residential real estate is less risky and requires less homework and knowledge. But it also has lower returns. **Commercial real estate returns much higher yields**, but it's also much more volatile and requires much more understanding to choose wisely.

Why choose?

In my opinion, **choosing** between the two is a **false choice**, and a remnant of an older time. Before crowdfunding, it made sense that many investors would choose to concentrate on only one of the other, so they could build up all the necessary knowledge. But **today, it's possible to invest in both**, and I believe a properly diversified portfolio requires both.

Commercial real estate yields more but is more volatile. So I **favor it** in my portfolio **when the** commercial real estate **cycle is favorable**. However, as it **starts to age** and gets near the end of the cycle, I **move my assets into residential** real estate. If both look overheated, then I **move assets into cash or alternative** investments.

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What's your opinion?

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Charles Q. Pace

Just for clarificiation, what is considered early or late in the physical cycle? You mention that apartments are late in their cycle. Does that mean that they are at the bottom of the rent growth/occupancy curve or does that mean that growth/occupancy look like they are near peak levels? I would guess the latter but it depends on where the cycle starts, you know?

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Charles Q. Pace

I think I answered my own question from your article on the financial cycles. So, apartments were near the recession stage, at least in 2015. Still hovering in that stage I would imagine.

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