Baceline Investments LLC

A Solution to Volatility: Debt-Free Income Properties

by John F. Holman

Tired of the volatility and poor performance of traditional investments (stocks, bonds and cash) over the past decade? If so, consider what many major endowment funds have done for many years and seek alternative investment opportunities that offer less volatility because their performance does not normally correlate with traditional investments.

One such alternative investment that has performed well over time is buying income-producing commercial properties for cash. Buying well-located, high occupancy, triple-net-leased commercial real estate for cash offers a low volatility investment that produces consistent and predictable income and stability of principal.

For many years, insurance companies and individual investors have purchased commercial properties for cash to maximize income and minimize investment risk. Purchasing a property for cash eliminates the expense of debt service, restrictions on the sale of properties imposed by some debt instruments, the risk of foreclosure, and provides a predictable income.

Conceptually, owning income-producing properties free of debt creates an investment that is like a real estate backed bond. Corporations often issue bonds to purchase buildings and equipment to expand their operations and income. The buildings and equipment are purchased for cash, and the additional operating income generated is used to repay the principal and interest payments on the bonds. Eventually, the bonds are paid off and the corporation keeps the potential capital appreciation of the real estate. Debt-free income properties allow investors to do the same thing.

Tenant leases on such properties provide security for the payment of income, similar to a corporation's promise to make bond interest payments. Triple-net-leased properties offer the additional benefit of having the tenants pay the real estate taxes, maintenance and insurance, in addition to their rent.

Moreover, depreciation deductions from the real estate will tax shelter a portion of the income and profits are taxed at capital gains rates.

Investment sponsors that buy debt-free income properties create an investment that is also similar to a balanced account offered by traditional money managers. Money managers that offer balanced accounts to investors normally buy bonds for cash to produce income and stocks for cash for their capital appreciation potential. When income-producing commercial real estate is purchased for cash, investors receive a bond-like income with the potential for capital appreciation from the real estate ownership.

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However, unlike a bond, income generated from the properties can increase over time, due to increased occupancy and increased rental rates. Increased income from the property offers the immediate benefit of a higher return to the investors and the long term potential for greater capital appreciation.

Real estate, like most types of investments, moves in cycles. In down real estate cycles, the all-cash buyer can benefit by buying at lower prices. If they buy income-producing real estate for cash, they are under no pressure to sell the properties until the right time in the real estate cycle. Cash has always been king, and the all-cash buyer has the safest long-term real estate investment.

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One reason for our recent financial market crisis was the use of financial engineering by Wall Street to create complicated investment products with little or no economic merit. These products failed for many reasons, including the investment structure and fees charged by the creators. Buying properties for cash is like reverse financial engineering, the smoke and mirrors are eliminated and what is left is an investment that offers safety, income, tax benefits and capital appreciation potential.

Value managers like Warren Buffett historically only buy companies that have little or no debt, but also generate high positive cash flow. Accordingly, buying debt-free income properties could be considered as a value investor approach, particularly in down real estate cycles where the properties can be purchased at lower prices.

There are only a few investment sponsors that buy debt-free income properties, and charge no front-end fees. Most real estate sponsors charge large front-end fees, thereby resulting in less of the investor's capital being used to acquire the real estate.

Mark Twain once said, "I'm more concerned about the return of my capital, than the return on my capital!" Debt-free income properties offer a solution to this problem. The investors own the properties debt free, and they receive the income on a partially tax-sheltered basis. Because of the safety features and buying opportunities presented by debt-free income properties, investors in such offerings could declare: "Bull or bear, we don't care!"

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