THE COUNSELOR ALSO LISTENS

The author recounts what happens when a real estate counselor advises himself on the turnaround of an eyesore property.

By Irwin J. Barkan, CRE

This is the story of a real estate counselor who advised himself and his friends on how to turn a problem property into a solid investment. Since it is a semiautobiographical story, I will leave open the question of whether it is wise for a consultant to counsel himself, and I will suggest that he needs to know when to keep quiet and listen. Imagine a time when strip center rehabs were not popular.

The city of Hedgelong, an aging mill town, has a solid blue collar population of approximately 50,000 people. Its numerous arterial roads traverse dense center city sections and extend into rural farm areas in the outlying areas. In 1984, the Hedgelong Plaza Shopping Center was a physical and economic disaster. It had been put up for sale by the same family who had built it over 25 years ago, and it had been on the market for over two years.

The land originally was purchased by a strong development and construction company that made its living building W. T. Grant's and J. M. Fields stores and adjoining strip shopping centers across New England. The shopping center, a classic first generation strip center, was built in 1959 when land was easy to find, there were not any zoning problems and development was simple – build the building, collect the rent, plow the parking lot. I am sure that locating in Hedgelong Plaza, with its 27 acres and 3,000 feet of frontage, made all the sense in the world to J. M. Fields, A&P and the other retailers who entered into long-term leases with the developers. However, during the 1960s and 1970s, Hedgelong crumbled as new road and growth patterns took shoppers away from the site. By 1984, J. M. Fields had gone bankrupt many years before, and had been

replaced by a retail salvage operation whose motto stressed how conservative the company was when it spent its own money. The Hedgelong Plaza A&P, closed since 1977, was one of the many boarded-up relics of the grocery chain's miscalculations.

A dark A&P store, the low-image salvage operation and a parking lot with a sea of potholes was a cause for concern by the anxious real estate acquirers. Most buyers passed up this property, even though the shopping center generated an actual *cash yield* on a 90% leveraged basis. The lease for the A&P building, which extended through 1991 for $55,000 a year (less than $3.00 per square foot) had been sold to a local supermarket company whose extensive holdings included a

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store only two miles away. In classic fashion, the supermarket company purchased a basketful of leases from A&P, reopened stores in locations that suited its marketing purposes, but kept other sites closed to stifle competition or wait for future opportunities.

The underlying estimate of value was made on the following basic and simple issues. Despite the closed and boarded-up A&P, with rotting plywood over the windows, all other space was occupied. The rent roll in 1984 included Radio Shack, Thom McAn, a greeting card shop, CVS, a major drug chain, a clothing store, Singer Sewing Center, a sporting goods outlet, local gas company, liquor store, laundromat, A&P, Fotomat, Grossman's Lumber and a car repair shop.

Perhaps nothing was as strong an indicator of value than the fact that CVS had increased the size of its store, while the A&P was closed and an eyesore. Sales in the center ranged from as low as $40 per square foot to as high as $140 per square foot in the CVS. (The economics of the rent roll are shown in Exhibit I.) The property had other negatives:

- Layout was choppy, and as a result, stores in the shopping center were large, inefficient and poorly visible.
- The shopping center was located far from the main concentration of people and activity in Hedgelong. A four-lane interstate highway had been built through Hedgelong but on the opposite side of town.
- The shopping center had over 200,000 square feet of retail space to let and needed major thoroughfares, intersections and traffic patterns to support large retailers.

EXHIBIT I

1983 Rent Roll

Tenant	Total Number of Square Feet	Price Per Square Foot	Term of Lease	Type of Lease Option	Total Yearly Rent
Radio Shack	1,400	$3.09	TAW		$ 4,320
Tom McAn	2,875	2.09	7-83		6,000
Card Shop	2,800	3.57	6-84	5 yr.	9,996
CVS	13,083	3.37	6-92	25 yr.	44,000
BayBank	1,350	2.81	TAW		3,793
Friendly's	2,310	2.32	TAW		5,350
Beef House	6,000	3.91	9-87		23,452
Tops Clothing	2,500	3.43	12-85	3 yr.	8,580
Singer Sewing Center	770	3.42	12-85	3 yr.	2,640
Sporting Goods	855	3.41	TAW		2,915
Hedgelong Gas Co.	810	4.93	9-83		4,000
Pizza Parlor	1,112	5.00	1-92		5,560
Liquor Store	1,800	2.33	TAW		4,200
Laundry	1,600	4.12	6-85	5 yr.	6,600
A&P	23,418	2.37	6-91	20 yr.	55,500
Fotomat	PAD	NA	7-84	5 yr.	2,400
Car Repair	3,960	1.51	4-84	2 yr.	6,000
Grossman's Lumber	25,895	1.24	8-85	5 yr.	32,199
Total	92,538	—	—	—	$227,505

- The center was bordered by the Merrimack River, a classic geographical boundary that kept individuals in adjoining communities from making convenient stops at the center.

The challenges were to: resolve the status of the boarded-up A&P by forcing the leaseholder to open the store or face eviction; convince another food retailer to move into the shopping center, which was a secondary market location, and face powerful competition from a supermarket chain with outlets in better locations of Hedgelong; and arrange financing for an investment that looked bad, had marginal economics, a mediocre location and obstacles to every upside theory or strategy.

The sellers were smart enough to refuse a contingency to the purchase that required the supermarket company to open a store at the A&P site as a precondition to the sale. In fact, one reason the sellers put the property up for sale was a seven-year history of discussions with the supermarket company that had produced more acrimony than solution.

Discussions with food retailers shed light on the degree of competition in the food market trade and the tenant of the dark store, Mr. Delam, president of the Delam Supermarket Company: "You want us to help you fight him? You must be crazy!"

As far as financing was concerned, a voice inside me (and the voices of my counselor partners) kept asking, "Why the heck do I want to buy this headache? Why would *anyone* want to buy this property?" Why should I be willing to spend $1.3 million for a group of old, decrepit buildings that are in need of substantial capital improvement and enormous patience? Similar to most real estate questions, the answers came back to the basics—the underlying value of the property and the direction of long-term growth patterns.

Phase One: Securing The Financing

After scanning the horizons for legitimate and sensible bankers to loan on this property, I was steered by a counselor to a small commercial bank. Like so many banks, it was controlled by a few key officers whose method of doing business for many years was to loan money to their friends. Not only did the bank officers and I have a mutual business acquaintance, but the chairman of the board used to play poker with a long-time family friend.

Interspersed among vignettes about long-past evenings, the bank chairman and I did focus on the $800,000 real estate loan at hand. Our discussions indicated that my numbers made sense. Because the sellers were taking back a substantial purchase money note at low interest, I was asking only for a 65% acquisition loan, and I was putting 10% equity into the deal. Therefore, the banker was loaning against what appeared to be a fully leased property.

The good news about the bank officer was he did not ask for an appraisal; he did not visit the property during loan review; and he never looked beyond the reasons for the

purchase money financing, which were based on the seller's belief that the property probably was not worth much more than the first mortgage. He also assumed that knowledgeable real estate professionals who were willing to invest some of their own money and a lot of their time would recognize value and make a serious attempt at making the deal work.

Interest rates in 1984 were still at double-digit, prime rate levels and anticipated equity yields. Our pro forma assumed that a five-year development would yield a 17.5% return after taxes on $430,000 invested (see Exhibit II). After the full investment, the leverage would be 74%—not that good, but we were projecting rents of $6 and $7 per square foot in order to be conservative.

Phase Two: The Acquisition And Bright Ideas

So I bought the property in 1984 and planned a series of problem-solving actions to reopen the dark A&P store. The Delam Supermarket Company, which owned the lease, had a formidable lock on the Hedgelong food market trade area. It had not dawned on me that this, and not the boarded-up A&P, was the company I was dealing with.

On my first visit to my new tenant's office, I should have gotten the hint. The company's offices were set on 20 acres of prime industrial land off the interstate, and included 20,000 square feet of brand-new office space attached to a modern 1,000,000-square foot wholesaling operation. After being ushered into the president's large and comfortable office, I gave him a long, detailed, smart-aleck proposal on how we could resolve our mutual problems. I presented him with this written proposal:

Premises: Construction of a 11,208-square foot addition to the existing store to increase total square footage to 35,000 square feet. Landlord's contribution to the tenant for construction of the addition: $300,000

Lease Term:
A. Existing expiration: June 1991
B. Proposed:
- 15-year initial term from March 1, 1984 through February 28, 1999
- First extension option 10 years
- Second extension option 5 years

Base Rent:
A. Existing: $2.37 per square foot: $55,500 annually for seven years through June 1991
B. Proposed:
- $2.90 per square foot; $101,500 for years 1-7
- $4.00 per square foot: for years 8-15
- Rent adjusted by CPI increase for option periods

Percentage Rent:
A. Existing: 1.25% of sales in excess of $4,310,810, capped at $15,000 until June, 1991
B. Proposed: 1.25% of sales in excess of $8,750,000, capped at $15,000 until June 1991; no cap on percentage rent thereafter

EXHIBIT II

Benefits Analysis

	Partial 1983	1984	1985	1986	1987	1988
Rental Income	79,779	268,026	287,171	316,537	330,462	358,863
Operating Expenses						
Vacancy @ 5%						
Management @ 5%						
Real Estate Tax (1982)						
Total Expenses	(33,209)	(102,977)	(108,891)	(112,827)	(118,221)	(122,061)
Net Income Avail.	46,570	165,049	178,280	203,710	212,241	236,802
Debt Service	(47,631)	(144,576)	143,999	(141,746)	(138,750)	(138,750)
Cash Flow	(1,061)	20,473	34,281	61,964	73,491	98,052
Depreciation 1.4M	26,417	79,333	79,333	79,333	79,333	79,333
Profit (Loss)	(27,478)	(58,860)	(45,052)	(17,369)	(5,842)	18,719
Tax Value in the 50% Bracket (1984 Rules)	13,739	29,430	22,526	8,684	2,921	(9,359)
Total Benefits	12,678	49,903	56,807	70,648	76,412	88,693
Equity Required						
Per Year	155,000	125,000	100,000	50,000	0	0
Cumulative	155,000	280,000	380,000	430,000	430,000	430,000
After Tax Yield	8.2%	17.8%	14.9%	16.4%	17.7%	20.6%

Common Area Maintenance:	Tenant to pay pro rata share of maintenance and taxes
Continuous Operation:	Tenant to operate store during regular business hours of the Hedgelong Plaza

My coup de grâce was to raise the possibility of legal action which I thought I had at my disposal, namely to evict this tenant from the boarded-up store unless he accepted my fair proposal. In the beginning of strip development, the supermarket anchors had no obligation except to pay the rent on a monthly basis. The future upside for investment was the hope of a percentage rent that would be calculated on revenues in excess of a base amount. Some states have interpreted lease language to require stores to stay open if percentage clauses were included as rent obligations. The logic was that the owner had leased the store under the assumption that future benefits would include additional rent from store activity. If the store activity ceased, then the negotiated bargain could not be carried out, and therefore, the tenant was reneging on implied obligations. Most states, however, have rejected this interpretation in favor of the black-and-white view that if the lease does not say the stores must stay open, they do not have to stay open. Massachusetts law, and this lease in particular, precluded any real hope of forcing the supermarket owner to open his store.

Little did I suspect that the supermarket owner, a well-dressed and softspoken man in his sixties, was listening intently and getting a good laugh at my "bright" ideas! The president of Delam Supermarkets had started with a local convenience store in a working-class neighborhood. His company was now organized into one of the great retailing machines of northern New England. It combined the sustenance of all business—cash flow—with a hunger for control of real estate. It would have been clear to a casual observer who had the stronger position. Of course, he was getting fine use of the dark A&P store: it was stifling potential competition to the company's two stores on the other side of town; it was storing used equipment at a rent below comparable warehouse space; and it was inventoring a future location with long-lease extension.

Light Dawns On the Counselor

After listening politely for over 20 minutes to my self-asserting ideas, Mr. Delam sat back in his chair, stopped me in midsentence, and said, "You know, we have 25 shopping centers."

By some miracle, the counselor's voice inside me said, "Now's the time to keep quiet." I looked back at the president of the company and said, "Okay, let's forget my ideas. You tell me what we're going to do." This simple question proved to be the beginning of the end of the problems of Hedgelong Plaza.

The supermarket owner looked at my plan, reached into a drawer for an architect's scale and a pencil, and started chopping. He said, "This center was built wrong from the start, and we're finally going to correct it." Pointing to the far end of the shopping center, where a home improvement store sat, he said, "This is where I want my store to be. We're going to demolish everything between my new store and the old J. M. Field's building and link the two buildings in a single strip."

This plan involved demolition of 35,000 square feet of what I thought to be perfectly good rental space. I looked at the supermarket owner and said, "You realize that I purchased this shopping center on the basis of the cash flow from the tenants in place. How the heck do you expect me to demolish buildings, build new buildings and keep old loans and purchase money mortgages in place, to say nothing of the relocation problems and new lease terms I will have to resolve to make the deal work?" His answer: "Worry about that later."

Conclusion

I have tried to stay away from too many numbers in telling this tale because, in the end and certainly in retrospect, yield analyses and projections would have been meaningless, nonsensical or misleading. Patience and the perception of value were the ordinary cures for this problem—as they are for most real estate problems.

At the beginning of the investment, I owned 100,000 square feet on 13 acres of land with a new annual cash flow of about $150,000, had a debt of $1.2 million and an expected equity yield in 1987 of 17% on $430,000 equity. I have taken no money out of the deal and now own only nine acres of land with 65,000 square feet of building, which is mortgaged at $2.4 million with $600,000 of equity.

You may ask, how have I done better by converting less space into substantially more cost, debt and required equity? I convinced myself, and my partners in a new syndication, to infuse the capital needed to accomplish Mr. Delam's ideas and replaced the understanding banker and the purchase of money mortgages with an equity-enhanced construction loan supported by the new deal with the supermarket company in a complete recapital formation of the shopping center. So long as the shopping center landlord and supermarket company acted together, the underlying value of the property could only go up.

I will continue to need patience. Three years after purchasing the shopping center, initial construction is just being completed, and the new supermarket will not open until the lease on the home improvement store expires in 1990. In 1984, I based my numbers on $6 and $7 rollovers of old and tired tenants. Today, I sit with a brand-new, 35,000 square foot shell and am setting up for tenants who will pay up to $12.50 per square foot.

Training, experience and good financial management are important to both real estate counseling and risking your own time and money. Ironically, all my training led me to the simplest of solutions—keep quiet, listen and learn. If that fails, open your eyes—don't say anything—and look around for value.