WHAT REAL ESTATE OWNERS

Should Know About Capital Expenses

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All real estate—whether a multitenant building, warehouse or office—needs regular upkeep to keep things in good operating condition. Most of the time, routine maintenance is sufficient, but once in a while, a significant expenditure is needed, such as for a new roof or heating, ventilation and air conditioning system.

Real estate owners who haven't planned for these kinds of nonrecurring expenses can face dire consequences. In industrial, retail or multitenant properties, the landlord is typically responsible for major equipment and can be held liable if there is a loss of heat or the space can't be inhabited. Without funds set aside, owners could be forced to come up with cash, cutting into distributions or possibly even requiring a capital call.

"You don't want to get stuck and not have the cash to pay for major capital items. Often assets held by families over a long term can have a lot of deferred maintenance," says Juliana Ricks, Senior Vice President at Whittier Trust.

Real estate is an asset class that requires ongoing maintenance. It may seem obvious to set aside money for capital expenses, yet this is frequently overlooked. That's especially true when high-net-worth families own properties without debt.

Lenders typically require capital reserves as well as regular inspections. But for high-net-worth individuals who own properties outright without debt, there's no one looking over their shoulders to remind them. Budgeting for these items is extremely valuable.

Creating A Plan

Capital expenses such as a new roof or HVAC unit don't come up often, but when they do, they are significant. A roof can last 25 to 30 years, as can an HVAC system. But once they need to be replaced, it can cost hundreds of thousands of dollars. Property owners who haven't prepared for these replacement costs are unpleasantly surprised.

To avoid such surprises, Ricks recommends a five-year capital plan. "We look at the remaining useful life of major equipment and major capital items and plan in advance for when those need to be replaced," she says. A good rule of thumb is for an owner to set aside 20 cents per square foot per year as a reserve for capital expenses.

Building up a reserve protects distributions over the long run. "You want to smooth out the distributions and make sure that you can provide consistent cash flow to all of the beneficiaries of the income coming from the properties," Ricks says.

Another upside to having a reserve for capital expenses is that it can also be used for improvements that increase the value of a property in case of a sale or refinancing. Owners want to make sure the property is positioned well and isn't devalued because of deferred maintenance.

Getting A Good Deal

Family owners who have held a property for many years don't always realize the kinds of large expenses needed to maintain it. Unlike stocks or bonds, real estate is a unique asset type that requires investment. If there's a hefty repair needed, it's not an option to sell off a portion of the building the way you can sell off part of a stock or bond portfolio.

"It's a tangible asset that operates differently from other investment types. It needs to be treated differently," says Ricks.

As part of the capital plan, experienced property managers should get multiple bids for every project. That way, "you can confirm that you are receiving the most cost-effective work on every property," Ricks says. Having multiple bids can help with cost savings over the long run and keep expected work on budget.

The bottom line is that keeping up with capital expenses maintains a property's value and can help attract or retain tenants.

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