Family-owned Real Estate Businesses: Building Sustainable Success

By Paul Faxon and Blair Trippe

Real estate can be a very lucrative business for enterprising families.

Some families enter into the real estate business with intention, while others get there by default—often a natural evolution in the lifecycle of a family business that has progressed to the point of property ownership. However, the skills that may have helped to grow a successful family business do not necessarily translate into skillsets needed in real estate. Owning real estate as a family may offer enormous potential benefits, but it can also breed complacency and invite conflict in families not actively managing these assets or their differences. In fact, mismanaged family-owned real estate can be a tinderbox for conflict. But if a real estate business is established, managed, and well planned-for, it can offer unique advantages that augment success and unify the families that oversee it.

How Did We Get Here? Landing in the Real Estate Business

Families sharing ownership and management of real estate holdings face the same challenges as other enterprising families—and then some. One reason can be that a family's entry into the business of real estate may not be an intentional, or planned, one. Many families in family business find themselves in this situation at some point, in part, because investments in real estate are a natural endpoint in the life cycle of their original businesses, such as those in manufacturing, service, or retail. At some point while running and growing their family-owned companies, it is common for the owners to buy buildings that house their business and the surrounding property. Owning the properties allows the family to control their costs as well as mitigate risk, such as having to move a complex manufacturing process or losing a prime location that is central to the profitable operation of their business.

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Entering Real Estate to Expand Options for Succession Planning

Owning real estate also broadens options when it comes to developing an ownership succession plan for a family business. Separating the real estate from the operating company allows owners to give or sell the business to next-generation family employees, with real estate assets going to all next-gens, including those who do not work in the business. A long-term lease can provide some of the security and cash benefits available to siblings and cousins who choose careers in the family business as well as to those who pursue careers outside of that business. This strategy also makes it possible for a family to sell their operating company but retain a valuable asset for the rising generation. This can be a very good motivation for families to enter into the real estate business.

Becoming a Real Estate Family: Avoiding Hidden Pitfalls

Let's consider the possibilities and pitfalls that present themselves when a family chooses to sell its operating company and retain the real estate for the next generation. If those involved in this shift are educated about managing real estate and are motivated to actively engage in this type of business, it can be a profitable new beginning. But the tricky reality is that while real estate seems like one of the more "solid" and universally understandable business types, it is very easy for things to go terribly wrong without diligent and purposeful management. Whether a family entered the real estate business in a proactive or a reactive way, real estate businesses all too often careen down a dangerous path in the dark, with threats unnoticed until it may be too late. The risk is even higher for those who "fall into" real estate without the aspiration—and preparation—to become a real estate business/family.

Poor Performance Can Hide in Plain Sight

Unlike managers of a manufacturing or retail business, real estate company managers can be deceived into complacency, thinking that the business is chugging along fine as it is. This is especially true if when the next generation takes over the business there is little or no mortgage financing associated with the real estate portfolio. As long as rents keep coming in, there may be little to indicate the business is off course. Contrast this to a manufacturing firm, for example, in which there can be dramatic consequences if a manager relaxes her vigilance and takes her eye off the ball for a month or two. If quality control gets lax, or if the product or service loses its edge, the impact is quickly seen in the bottom line and felt in the empty pockets of company owners. The system is not forgiving, and signs of mismanagement quickly come into full view.

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A Forgiving Pace and Inertia Can Breed Complacency

Compounding the potential for complacency in real estate management are two additional characteristics of stability unique to real estate. Tenants not only sign yearly or multi-year leases—guaranteeing that landlords have a customer for a period of time—but moving is expensive and stressful. So once tenants are established in a property, there is great momentum for them to stay in that property. Compare this, again, to a manufacturing company in which owners and managers need to be ever vigilant in monitoring changes in the market, new competition, material price changes, etc. It is easy to see how one could inadvertently be lulled into complacency, neglecting to actively maximize, or even simply protect, real estate investments.

Compared to our hypothetical manufacturing business, real estate operates as a very different type of business, with a different pace. Events are typically slow-moving—tenants stick around, minimal maintenance can suffice, and a rising real estate market can elevate the values of all properties in a region. Even if a building is in disrepair or improperly managed, its value could increase simply with market increases. So, if a property is in a good location, its owners and managers may be tempted to relax their vigilance and not notice the start of serious problems. As long as the roof keeps out the water and rent comes in, cash flow from the real estate continues—and any trouble remains under the radar.

Challenges are Easy to Underestimate

From the outside it may seem relatively straightforward to manage real estate, and owners often underestimate the challenges and complexity of owning and managing this type of asset. While most people have not run a production line, designed products, or been held to the types of budgets and deadlines as are typical in many businesses, it is likely that most owners of real estate businesses have some experience of home ownership, mortgages, house renovations and maybe even AirBnB. Because real estate management, investment, and development are somewhat similar to the experiences of many owners, they can adopt a false sense of security, telling themselves, "I can do that."

The true story, told in the numbers, is often hidden. Legacy buildings were often bought long ago for relatively low cost and are debt-free. So as rents rise, owners and managers may see the real estate business as enormously profitable without requiring them to do much. But recasting the Return on Assets calculation to current asset value can expose a very different story, showing that properties are actually underperforming. That hidden story can also be all the more obscured when family managers are not educated in real estate management. For example, a tax efficient structure that sets up separate LLCs for individual properties can blur the sense of profitability of one property versus another, making the economics of the business significantly less evident than in traditional operating companies with one consolidated financial statement.

The bottom line: Owning real estate at a significant level, and managing it successfully, is far more complex and challenging than most people appreciate. It is very different from simple home ownership. Yet if the potential landmines are well identified and avoided, there may be abundant rewards in family-owned real estate businesses.

Overview of Opportunities and Advantages of Family-owned Real Estate

Owning real estate creates opportunity for next-generation involvement in family business on many levels, assuming the family is aligned on vision and risk tolerance. With investments in education and skill development, family can create opportunities in a variety of ways, including:

- Management
- Re-development
- Ground-up development
- Investment
- Real estate funds
- Vacation properties (special case)
- Tax management

Management

Many real estate families just become landlords: They start out in the real estate business simply by renting out legacy properties for uses in ways similar to the property's past use. When the properties themselves are simple—a handful of rental units, for example—priorities tend to be keeping the properties occupied, collecting rent, and maintaining the physical property. Competent management of shared legacy properties can provide a relatively low-risk cash flow for owners.

Where problems arise: When there is a lack of transparency about employment rules and salaries for family members entering the company. Because managing real estate at this level is something for which many family members may feel qualified, animosity can easily develop around the few that are chosen to run the company. Issues of fairness creep in from every corner, especially if the managers are receiving above-market compensation. At the other end of the spectrum are families that, in their quest to be "fair," include far too many family members in management of their properties—too many cooks in the kitchen, often with no clear job definition or accountability, and with too little income to provide for the many mouths.

Conflict can also burst on the scene if managers lose sight of the bigger picture. What sets truly successful real estate families apart is their entrepreneurial spirit and their focus on answering the core question in real estate: Is this the highest and best use of our property? Continually returning to this question keeps management on a path of proactive, entrepreneurial property management. Understanding how to anticipate changes in the local real estate market, demographics shifts, how to refinance and redevelop properties to higher and better use helps families build significant long-term wealth. Sometimes effectively answering that question over time requires continued education or engagement with trusted advisors with their fingers on the pulse of the industry. Without tuning in to the market and this entrepreneurial hunger, owners are likely to wake one morning to see their properties falling behind, as their neighbors build modern structures and profit from charging significantly higher rents.

Redevelopment

Taking an existing structure and renovating it for alternate use offers several challenges, as well as potential rewards. This undertaking requires the ability to finance, plan, and execute complex renovations. It may also require rezoning, which is required when owners want their manufacturing building to be repurposed for residential or retail property. The city or town is generally very invested in how its neighborhoods evolve and juggles many competing interests, so approvals for rezoning are often complex and difficult to acquire.

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This is an instance when a team of expert advisors and specialized education can make a big difference in outcome. Owners who may have inherited and managed properties may not be sufficiently knowledgeable or experienced to embark on a successful redevelopment project on their own—especially one that requires rezoning. But, those who appreciate the complexity of this work and are then willing to invest the time and talent to do it right can evolve with their properties, growing significant wealth and opportunity for themselves and for fellow owners.

Ground-up Development

Undertaking real estate development—such as building shopping centers, office buildings, senior living or other residential buildings or communities—is expensive, risky, and complex. Environmental impact, demographics, finance, and many other factors need attention from qualified professionals. This is not a job for the uninitiated. The risk associated with financing and choosing the right partners for such a project cannot be overestimated. Family members who initiate development work without the proper team can get in over their heads very quickly. It is critical to rely on the advice of a team of experts for this work.

Investment

Some families approach real estate first and foremost as an investment. They have no emotional or historical tie to their properties. They focus primarily on the financial opportunity of owning a property—perhaps renovating or managing it as well—for a period of time. Driven by their investment strategy, they often seek to replicate the strategy that has worked well for them in the past as they expand geographically.

Or these enterprising families may have learned enough about real estate and market influences to be able to pick good real estate funds that let them diversify their real estate portfolios with less risk and personal involvement. But this requires strategic thought, risk assessment, and shareholder alignment on debt tolerance.

Real Estate Funds

When a family real estate business has grown and developed a successful strategy and robust infrastructure for managing and/or developing properties and has developed the talent in their executive teams to take on bigger projects, they may seek to leverage that resource with other people's money. Because of their established reputation for success in such real estate ventures they may find these other investors trust them to use their money alongside their own to enable them to operate at a much higher level (and generate income for their investors.)

Raising these funds requires underwriting skills and capabilities as well as the ability to take on fiduciary duties and responsibilities inherent in working with other people's money. The advantages can be great. Operating at such a scale often means the risks are distributed across many different geographical markets and classes of properties. Many families can underestimate the difficulties and competitive environment in raising money; those who understand, have established a strong network, and can show a solid track record can be highly successful.

Vacation Properties (special case)

Sharing an historic family home or vacation property deserves its own special category. This can be a very rewarding endeavor and unique opportunity. These properties hold cherished memories,

emotional attachment, and significance as family gathering places—the setting of significant events in our family narrative. With all these rich gifts, they can also become lightning rods for family conflict over time.

Despite the best intentions of the senior generation that gifts shared vacation properties with the intent of helping the next generation make more memories, the gift may instead cause nightmares. Rather than achieving the intended goal of keeping the family together, the shared property transfer may actually highlight the differences between family members with regard to wealth disparity, vision for how the property should be shared, used, and paid for. The reality is that properties require care and attention, and not all next-gens are in a position to use the property. The cost of upkeep and use may not align across family branches, building resentment and discord among these family members.

Families considering a gift of shared property should consider an endowment for shared upkeep, taxes, and maintenance. They should also consider a process for scheduling use and for paying for non-essential projects as well as an exit strategy for those who may want to sell their share.

Tax Advantages of Real Estate

Depreciation to Shelter Income from Tax

Depreciation acknowledges that an asset wears down over time; in the case of residential real estate, the IRS believes over exactly 27.5 years (!). Unlike other business expenses, depreciation is a paper loss, meaning you don't spend any money but still get the expense. This can offset taxable income.

Depreciation is not unique to real estate, but real estate families are uniquely positioned to benefit from depreciation. This is because the cost of real estate is so large and it is often purchased with debt. There are many nuances and details related to applying depreciation expenses, and families benefit from seeking expert advice. One note is that when selling a rental property, it is likely owners will need to recapture the depreciation and pay taxes on it. This gives an incentive to either hold properties or use other tax strategies when selling, such as a 1031 exchange (see below).

In terms of keeping real estate, these holdings can be a valuable legacy to pass on to future generations, not just for income generation potential but also to transfer resources without heavy taxation. Instead of facing capital gains or recaptured depreciation from selling a property, heirs get a stepped-up basis with inherited real estate. Cost basis would be at the time of inheritance, so the property could be sold without being taxed on the gains it had made over the time of the other family member's ownership.

Exchanging Properties for Tax-free Growth: The 1031 Exchange

Real estate families are also able to manage tax on capital gains and depreciation recapture tax by using a 1031 tax-free exchange, allowing owners to trade one property for another without paying taxes. This is particularly helpful to many real estate owning families, because 100% of profits from the sale are available to reinvest in the next property, maximizing growth and compounding investments. The regulations covering 1031 Exchanges are very detailed and rigid, including use of a qualified intermediary; a tax professional should always be consulted. Bear in mind that only "real property" (buildings and land) can be exchange, not "personal property;" so for families with large, furnished rental properties (appliances, furniture) there could still be significant taxes involved in the transaction.

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Carried Interest Benefits

Carried interest is the portion of an investment fund's returns eligible for a lower capital gains tax rate of 23.8% instead of the ordinary income tax rate up to 37%. While recent tax reforms require fund managers to hold the relevant investments for three years to benefit, real estate investments are not affected as policy stands today. Carried interest on real estate investments can factor into a real estate families' strategies for managing tax on their assets.

In Summary

Real estate can be a lucrative holding for families, allowing them flexible options for managing, protecting or transferring assets—but success is far from guaranteed. Many families enter into the real estate business without a full understanding of its complexity and fail to maximize the benefits of their investments.

So what are the keys to success? Shareholder understanding of the real estate portfolio, clear performance metrics, and aligned risk tolerance—plus well-developed managerial skill. Doing the work to develop this capacity safeguards real estate investments and also protects family relationships, which are easily strained in ill-prepared real estate families.

Successful ownership requires specialized knowledge, appropriate attention, and the ability to anticipate the market to keep properties near their highest and best use. As with any shared family asset, when things go wrong—when there are misunderstandings or a lack of transparency—conflict is sure to follow.

But for the family that invests in its members' development—keeping up with advancing knowledge and infrastructure needs—and is able to grow and adapt with its increasingly complex properties, real estate offers unique advantages. Doing the work to build expertise and the capacity to manage differences can lay the foundation for success in shared family real estate.