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Opinion: Why everyone loses money in real estate



There are many, many mistakes to make in commercial real estate, John McNellis writes.

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By John McNellis

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Editor's note: Our frequent contributor John McNellis has just released the third edition of his bestselling primer, "Making It In Real Estate." Praised as both the "best damn book on development" and "CRE's Bible," the primer is required reading at colleges and universities nationwide. Given the Iran war's dramatic chilling impact on business, the opening chapter in his section on losing money is particularly apt.

Let's get this out of the way. If your career is the buying, selling, developing or redeveloping of real estate, you will lose money one day. There are simply too many variables beyond your control – sometimes beyond your imagination – that can slam your project. Sooner or later, business will blindsides you with anything from [spiking interest rates](#) to your anchor tenant's bankruptcy to a Chinese virus that [kills more office buildings](#) than people. Those who've done more than a dozen deals and swear they've never lost a dime might charitably be viewed as outliers (emphasis on the [last two syllables](#)).

In 2016, we inventoried the projects we'd done over the previous 30 years and divided them into winners and losers. Of our roughly 70 deals, we'd lost money on five of them, or seven percent of the time. To be clear, we were only counting real losers where, say, we'd bought a property for a million and sold it for \$800,000. If we were to count the deals where we lost only our time – rightly viewed, more valuable than money – that number would more than double.

By the way, a deal isn't a loser if you go into escrow to buy a property, spend, say, \$25,000 in architectural, engineering and investigative costs and then decide the deal doesn't pencil and walk away. Our business is hard. Making real money requires taking real risk, and if you're not taking shots, you have no chance. Walking away is hard. It requires discipline, insight, and a dash of courage.

With hindsight's humbling clarity, our mistakes were obvious. Our losses arose from: 1) overpaying; 2) overleveraging; 3) abusing the 1031 tax deferred exchange; 4) doing wrong-sized deals; 5) overdeveloping; 6) failing to pivot; 7) trusting the government; 8) inadequate due diligence; 9) holding out for the last dollar; and 10) plain bad luck. Bad luck came in last because, standing alone, it is seldom catastrophic. As with tossed cigarettes, bad luck usually needs an accelerant – other blunders – to torch a pile of money.

Overpaying is both the best way to lose money in commercial real estate and the most understandable of mistakes, yet another triumph of hope over experience. No one ever thinks they're overpaying at closing. Buyers rejoice when the title company announces the deal is on record, dousing themselves with figurative and sometimes literal champagne in their mercantile joy. We certainly did. How does it happen that investors so often overpay?

It's often some combination of misplaced optimism, inexperience and, let's be frank, need. Optimism can best even the most skilled players, causing them to believe that, say, the last three years' rent increases will hold steady over the next three. Bidding contests – best and final wars – have a way of fueling that optimism, raising bidders' competitive ardor to a point where they stick their pro formas in their back pockets and pray. (For the record, we run from bidding contests, certain that only the track wins horse races). Inexperience needs no comment. Everyone starts out inexperienced; even the best developers paid on-the-job tuition, learned their craft the hard way, and were burned more than once along the way.

Need often plays an outside role in overpaying. You work for a fancy institutional investor and need to close \$50 million worth of industrial buildings by year end to earn your bonus, or you need to buy half a dozen apartment buildings a year merely to keep your job. Or, you're out on your own – with no salary and decimating your savings – and need to close something tomorrow just to pay off

your credit cards. Unbearable pressure may create great diamonds, but it doesn't lend itself to great deals. The good news is that, with time and a little success, need tends to fall away as a catalyst for overpayment. We made our worst mistakes early in our careers, when our financial needs were greatest.

Buying for the wrong reason is another freeway to failure. The classic example is the rich guy who buys a trophy property in his home town so he can admire it on his way to his country club. He doesn't realize his trophy is for dumbest deal of the year.

The only right reason for buying commercial property is to make money. If you buy it for any other reason, chances are you won't.

John McNellis is owner of Palo Alto-based developer McNellis Partners. His columns appear frequently in the Business Times. His book, "Making It In Real Estate," is [available on Amazon.com](#).