

# Commercial Real Estate Definition and Types

By JAMES CHEN Updated July 31, 2023

Reviewed by SOMER ANDERSON

Fact checked by RYAN EICHLER



Investopedia / Daniel Fishel

## What Is Commercial Real Estate (CRE)?

Commercial real estate (CRE) is property used exclusively for business-related purposes or to provide a workspace rather than a living space, which would instead constitute residential real estate. Most often, commercial real estate is [leased](#) to tenants to conduct income-generating activities. This broad category of real estate can include everything from a single storefront to a huge shopping center.

Commercial real estate comes in a variety of forms. It can be anything from an office building to a residential duplex, or even a restaurant, [coffee shop](#), or warehouse. Individuals, companies, and corporate interests can make money from commercial real estate by leasing it out, or holding it and reselling it.

Commercial real estate includes several categories, such as retailers of all kinds: office space, hotels and resorts, strip malls, restaurants, and healthcare facilities.

### KEY TAKEAWAYS

- Commercial real estate refers to properties used specifically for business or income-generating purposes.
- Commercial real estate differs from residential real estate because it has the potential to generate profit for the property owner through capital gain or rental income.
- The four main classes of commercial real estate are office space, industrial, multifamily rentals, and retail.
- Commercial real estate provides rental income as well as the potential for some capital appreciation for investors.
- Publicly traded real estate investment trusts (REITs) are a feasible way for individuals to indirectly invest in commercial real estate.

## Understanding Commercial Real Estate (CRE)

Commercial real estate and residential real estate comprise the two primary categories of real estate property. Residential properties include structures reserved for human habitation and not for commercial or industrial use. As its name implies, commercial real estate is used in commerce, and multiunit rental properties that serve as residences for tenants are classified as commercial activity for the landlord.

Commercial real estate is typically [categorized into four classes](#), depending on function:

1. Office space
2. Industrial use
3. [Multifamily](#) rental
4. Retail

Individual categories may also be further classified. There are, for instance, a number of different types of retail real estate:

- Hotels and resorts
- Strip malls
- Restaurants
- Healthcare facilities

Similarly, office space has several subtypes. It is often characterized as class A, class B, or class C:

- **Class A** represents the best buildings in terms of aesthetics, age, quality of infrastructure, and location.
- **Class B** buildings are usually older and not as competitive—price-wise—as class A buildings. Investors often target these buildings for restoration.
- **Class C** buildings are the oldest, usually more than 20 years of age, located in less attractive areas, and in need of maintenance.

Note that some [zoning](#) and licensing authorities further break out industrial properties—sites used for the manufacture and production of goods, especially heavy goods—but most consider it a subset of commercial real estate.

# Commercial Leases

Some businesses own the buildings that they occupy. However, the more typical case is that the [commercial property is leased](#). Usually, an investor or a group of investors owns the building and collects rent from each business that operates there. Commercial lease rates—the price to occupy a space over a stated period—are customarily quoted in annual rental dollars per square foot. Conversely, residential real estate rates quote as an annual sum or a monthly rent.

Commercial leases will typically run from one year to 10 years or more, with office and retail space typically averaging five- to 10-year leases. This can be contrasted with more short-term yearly or month-to-month residential leases.

There are four primary types of [commercial property leases](#), each requiring different levels of responsibility from the landlord and the tenant.

- A [single net lease](#) makes the tenant responsible for paying property taxes.
- A [double net \(NN\) lease](#) makes the tenant responsible for paying property taxes and insurance.
- A [triple net \(NNN\) lease](#) makes the tenant responsible for paying property taxes, insurance, and maintenance.
- Under a [gross lease](#), the tenant pays only rent, and the landlord pays for the building's property taxes, insurance, and maintenance.

## Managing Commercial Real Estate

Owning and maintaining leased commercial real estate requires full and ongoing [management by the owner](#). Property owners may wish to employ a commercial real estate management firm to help them find, manage, and retain tenants, oversee leases and financing options, and coordinate property upkeep and marketability. The specialized knowledge of a commercial real estate management company is helpful, as the rules and regulations governing such property vary by state, county, municipality, industry, and size.

The landlord must often strike a balance between [maximizing rents and minimizing vacancies](#) and tenant turnover. Turnover can be costly for CRE owners because space must be adapted to meet the specific needs of different tenants—for example, if a restaurant is moving into a property once occupied by a yoga studio.

## How Investors Make Money in Commercial Real Estate

Investing in commercial real estate can be potentially lucrative and serve as a [hedge](#) against the [volatility](#) of the stock market. Investors can make money through property [appreciation](#) when they sell, but most returns come from tenant rents.

### Direct Investment

Investors can use [direct investments](#) where they become landlords through the ownership of the physical property. People best suited for direct investment in commercial real estate are those who either have a considerable amount of knowledge about the industry or can employ firms that do. Commercial properties are a high-risk, high-reward real estate investment. Such an investor is likely to be a [high-net-worth individual](#) since CRE investing requires a considerable amount of capital.

The ideal property is in an area with low CRE supply and high demand, which will give favorable rental rates. The strength of the area's local economy also affects the value of the CRE purchase.

### Indirect Investment

Alternatively, investors may invest in the commercial market indirectly through either ownership of various market securities, such as [real estate investment trusts \(REITs\)](#) or [exchange-traded funds \(ETFs\)](#) that invest in commercial property-related stocks, or investment in companies that cater to the commercial real estate market, such as banks and Realtors.

## Advantages of Commercial Real Estate

One of the biggest advantages of commercial real estate is attractive leasing rates. In areas where the amount of new construction is limited by either land or law, commercial real estate can have impressive returns and considerable monthly [cash flows](#). Industrial buildings generally rent at a lower rate, though they also have lower overhead costs compared with an office tower.

Commercial real estate also benefits from comparably longer lease contracts with tenants than residential real estate. This long lease length gives the commercial real estate holder a considerable amount of cash flow stability, as long as long-term tenants occupy the building.

In addition to offering a stable and rich source of income, commercial real estate offers the potential for capital appreciation, as long as the property is well-maintained and kept up to date. And, like all forms of real estate, it is a distinct asset class that can provide an effective [diversification](#) option to a balanced [portfolio](#).

## Disadvantages of Commercial Real Estate

Rules and regulations are the primary deterrents for most people wanting to invest in commercial real estate directly. The taxes, mechanics of purchasing, and maintenance responsibilities for commercial properties are buried in layers of legalese. These requirements shift according to state, county, industry, size, zoning, and many other designations. Most investors in commercial real estate either have specialized knowledge or a payroll of people who do.

Another hurdle is the increased [risk](#) brought with tenant turnover, especially relevant in an economy where unexpected retail closures leave properties vacant with little advance notice.

Another hurdle is the increased [risk](#) brought with tenant turnover, especially relevant in an economy where unexpected retail closures leave properties vacant with little advance notice.

With residences, the facilities requirements of one tenant usually mirror those of previous or future tenants. However, with a commercial property, each tenant may have very different needs that require costly refurbishing. The building owner then has to adapt the space to accommodate each tenant's specialized trade. A commercial property with a low [vacancy](#) but high tenant turnover may still lose money due to the cost of renovations for incoming tenants.

For those looking to invest directly, buying a commercial property is a much more costly proposition than a residential property. Moreover, while real estate in general is among the more [illiquid](#) of asset classes, transactions for commercial buildings tend to move especially slowly.

### Pros

- Hedge against stock market
- High-yielding source of income
- Stable cash flows from long-term tenants
- Capital appreciation potential

### Cons

- More capital required to directly invest
- Greater regulation
- Higher renovation costs
- Illiquid asset

## Commercial Real Estate and COVID-19

The global COVID-19 pandemic beginning in 2020 did not cause real estate values to drop substantially. Except for an initial drop at the beginning of the pandemic, property values have remained steady or even risen, much like the stock market, which recovered from its dramatic drop in the second [quarter](#) (Q2) of 2020 with an equally dramatic rally that ran through much of 2021. <sup>[1]</sup>

This is a key difference between the economic fallout occurring in 2020 and what happened a decade earlier. What is not known is if the required remote work environment that began in 2020 for most Americans will have any long-term impact on corporate office needs.

Companies have begun to roll out hybrid solutions requiring employees to return to the office. For example, in May 2023, Amazon required employees to begin returning back to physical offices at least three days each week. <sup>[2]</sup>

However, the commercial real estate has still yet to fully recover. Consider how American Tower Corporation (AMT), one of the largest United States REITS, was priced at roughly \$250 per share in June 2022. Fast-forward one year, the REIT traded at roughly \$187 per share in June 2023. <sup>[3]</sup>

## Commercial Real Estate Outlook and Forecasts

The U.S. commercial property market took a big hit during the [2008–2009 recession](#), but it has experienced consistent annual gains since 2010. These gains have helped recover the recession-era losses. Most research maintained that the property market remains healthy overall. J.P. Morgan, in its 2019 Commercial Real Estate Outlook, largely echoed this view, commenting that 2019 was the 10th year of increases in commercial property rents and valuations. <sup>[4]</sup>

After major disruptions discussed above as part of the pandemic, the commercial real estate is attempting to emerge from an unclear state. According to J.P. Morgan Chase, remote and hybrid work have largely reduced demand for office space. B- and C-class office buildings may face more difficult prospects, but A-class spaces with long-term leases (of at least a decade) seem to be more favorably positioned to recover. <sup>[5]</sup>

For the most part, CBRE agrees. In their 2023 forecast, CBRE stated it would be a year more favorable for tenants. In addition, less than 38 million square feet of commercial office space is slated for delivery in 2023, down 27% from the average of the past five years. These supply constraints appear due to developers hitting pause, according to CBRE. <sup>[6]</sup>



## **What Is the Difference Between Commercial and Residential Real Estate?**

Residential real estate is used exclusively for private living quarters. Commercial real estate refers to any property used for business activities. Types of commercial real estate include hospitals, assembly plants, storage warehouses, shopping centers, office spaces, or any other location for a business enterprise.

## **Is Commercial Real Estate a Good Investment?**

It can be. Commercial real estate can have impressive returns and considerable monthly cash flows, and returns stood up well during the market shocks of the past decade. As with any investment, however, commercial real estate comes with risks.

## **What Are the Disadvantages of Commercial Real Estate?**

Rules and regulations are the primary deterrents for most people wanting to invest in commercial real estate. The taxes, mechanics of purchasing, and maintenance responsibilities for commercial properties are buried in layers of legalese, and they can be difficult to understand without acquiring or hiring specialist knowledge.

## **The Bottom Line**

Commercial real estate refers to real estate that is used specifically for business or income-generating purposes. It differs from residential real estate because it has the potential to provide rental income as well as capital appreciation for investors. The four main classes of commercial real estate are office space, industrial, multifamily rentals, and retail.

Investing in commercial real estate usually requires more sophistication and larger amounts of capital from investors than does residential real estate, but it can offer high returns. Publicly traded REITs are a feasible way for individuals to indirectly invest in commercial real estate without specialist knowledge of the sector.