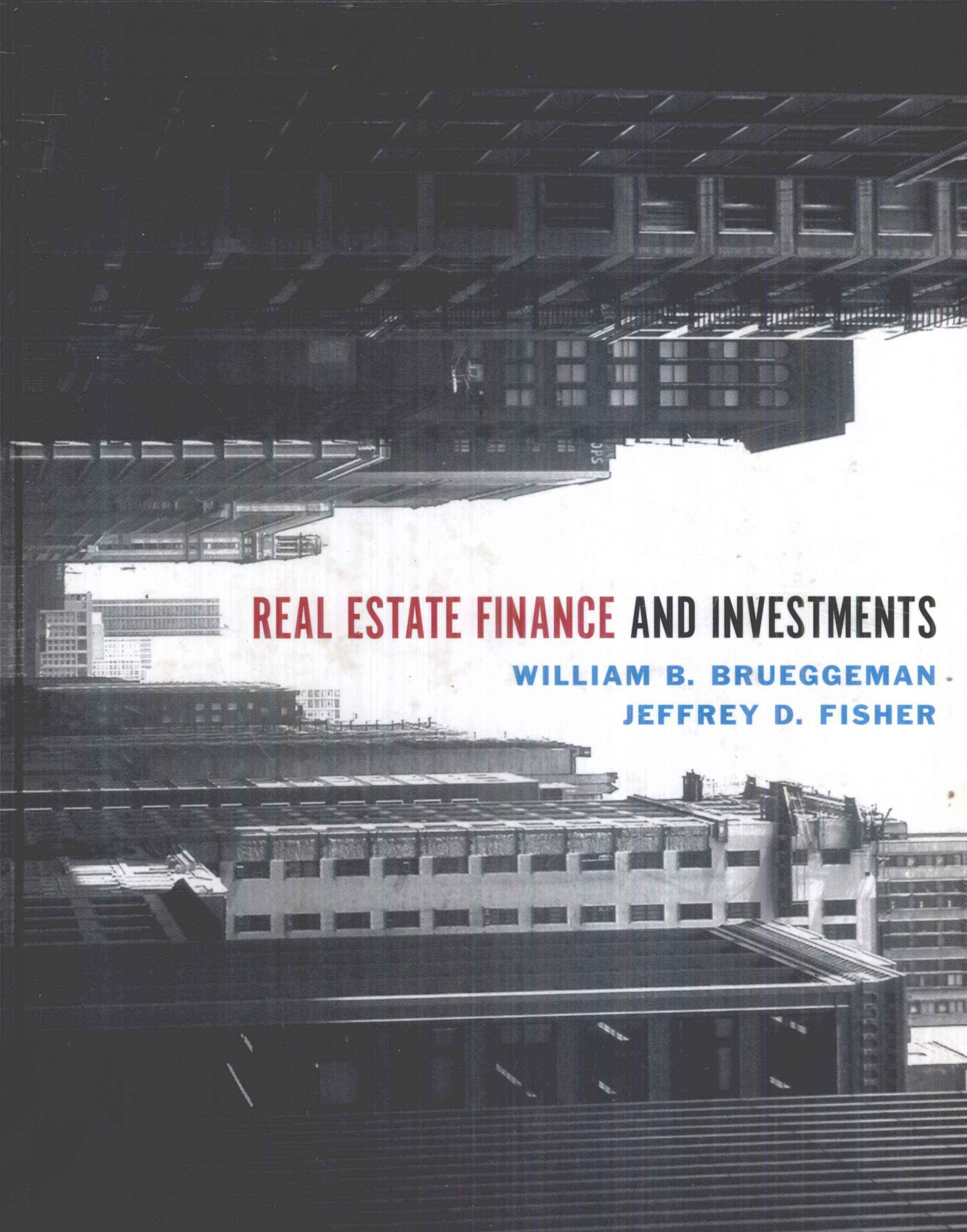

# REAL ESTATE FINANCE AND INVESTMENTS

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# Real Estate Finance and Investments

Twelfth Edition

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# Preface

Interest in real estate has increased dramatically in recent years as the various ways of investing in and financing real estate continue to evolve. There are a myriad of alternative ways of making equity investments in real estate, ranging from purchasing properties like an apartment building, either as an individual or in a partnership, to investing in publicly traded companies called real estate investment trusts (REITs) that develop and own hundreds of apartment properties throughout the nation. Investments can also be made in mortgages used to finance real estate, ranging from making a mortgage loan (as a lender) or purchasing a publicly traded mortgage-backed security (residential or commercial). This book prepares readers to understand the risks and rewards associated with these various ways of investing and financing both residential and commercial real estate. These concepts and techniques are important for all careers related to real estate, such as investing, financing, appraising, consulting, managing real estate portfolios, leasing, managing property, analyzing site location, and managing corporate real estate. It is also applicable for those who just want to better understand real estate for their own personal investment and financing decisions.

## Excel Spreadsheets and ARGUS Software—NEW Student CD

The book is rigorous yet practical and blends theory with application to real world problems illustrated through the use of a financial calculator, Excel spreadsheets, and software designed to analyze real estate income property. A CD that accompanies this edition of the book contains Excel spreadsheets that are provided to assist students in their understanding of many of the chapter examples and exhibits displayed throughout the text. Students can modify these spreadsheets to solve many of the end-of-chapter problems. In this way, students do not have to design spreadsheets to solve each problem set.

A trial version of the ARGUS software is also included on the CD. ARGUS is a Windows-based program that is widely used throughout the real estate investment industry to solve complex lease-by-lease investment and valuation problems. Examples containing leases are included in several problems in various chapters. Data files have been replicated so that these examples may be modified to accommodate homework problems at the end of chapters.

## Internet Tools and Assets

Making informed real estate investment and financing decisions depends on being able to get useful information on national and local market trends, interest rates, available investment and financing alternatives, and opinions from experts about the outlook for various real estate sectors. The evolution of the Internet has provided a rich source of information to real estate investors and lenders, and knowing how to find information on the web is an important part of the "due diligence" that should be done before making a real estate investment, investing in a real estate–related company, or even just purchasing and financing a home.

New to this edition are **Web App** boxes that provide examples of finding relevant information on the Internet related to the chapter material. The Web App boxes provide practical examples of the types of data and other resources that are available on the Internet used by real estate lenders and investors. This also provides a way for readers to stay current on many of the topics discussed in the book.

Also new to the twelfth edition are **URLs** that students can use to research various topics in the real estate discipline. Look for these at the end of each chapter.

McGraw-Hill/Irwin has a new Internet resource called **Real Estate Online.** Real Estate Online lets you stay current and expand your knowledge about the real estate field through online discussion questions, articles, and exercises. Access to this and other student/instructor's resources, including a **new online quiz feature,** is available at **www.mhhe.com/bf12e.**

## Plan of the Twelfth Edition

This edition is organized in five major sections:

Part I introduces real estate investment and financing by reviewing important legal concepts related to ownership rights and real estate notes and mortgages. The importance of the interest factor in financing is also reviewed. Many students will have been exposed to this material in other courses; however, this chapter provides a framework for many of the applications that are specifically applied to real estate throughout the book.

Part II of this edition focuses on the financing of residential properties. It includes the various types of mortgages and ways to analyze financing alternatives. A new chapter, Chapter 7, has been added in this edition that evaluates single family housing as an investment. This chapter discusses factors that affect the demand for housing and discusses how to analyze whether a residence should be rented or owned based on market rents, tax considerations, expected price appreciation, and other factors.

Part III turns to investment analysis and financing of income properties, including the importance of leases, valuation of income properties, various financing alternatives, risk analysis, and disposition decisions. The role of real estate for corporations not in the real estate business who must make lease versus own decisions is also discussed. Excel spreadsheets, as well as the ARGUS software, are integrated throughout this section of the text.

Part IV discusses the analysis of construction and land development projects. These projects differ from the analysis of existing projects in previous chapters due to the additional risk introduced by the development process. These risks and expected returns are discussed for both lenders and investors. This includes understanding how construction and land development loans are structured, including how the developer receives advances, or "draws," during development and how they are repaid.

Part V discusses alternative real estate investment vehicles such as partnerships, joint ventures, residential and commercial mortgage backed securities (CMBS), and real estate investment trusts (REITs). This allows readers to see all the different ways that investments can be made in real estate aside from simply buying a property. Readers will also see how "derivatives" can be created using real estate (or mortgages on real estate) as collateral. The last chapter considers the importance of real estate in a diversified investment portfolio that includes stocks and bonds. This provides readers with an understanding of how portfolio managers and institutional investors view real estate.

## Supplements

Several ancillary materials are available for instructor use. These include:

- Instructor's Manual—developed by Jeffrey Fisher and William Brueggeman.
- Test Bank—developed by Jeffrey Fisher and William Brueggeman.
- PowerPoint slides—developed by Tom Epperson, Auburn University.

## Acknowledgments

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We also continue to be indebted to people who have contributed to previous editions, especially the late Henry E. Hoagland, who wrote the first edition of this book and Leo D. Stone, who participated in several editions. Finally, we thank all of the adopters of the previous editions of the book who, based on their feedback, have made us feel that we have helped them prepare students for a career in real estate.


*William B. Brueggeman*

*Jeffrey D. Fisher*

# Brief Contents

# Table of Contents

# Chapter 1

# An Introduction to Real Estate Investment: Legal Concepts

This is not a book about real estate law; however, a considerable amount of legal terminology is used in the real estate business. It is very important to understand both the physical nature and property rights being acquired when making real estate investments. In this chapter, we survey many important terms pertaining to real estate. Additional legal terms and concepts will appear in later chapters of this book on a "need to know" basis.

Many of the legal terms currently used in the real estate business have evolved from English common law, which serves as the basis for much of the property law currently used in the United States. For example, the term *real* in real estate comes from the term *realty,* which has, for centuries, meant land and all things permanently attached (the latter would include immovable things such as buildings and other structures). All other items not considered realty have been designated as *personalty,* which includes all movable things (e.g., automobiles, shares of stock, bank accounts, patents). The term *estate* has evolved to mean "all that a person owns," including both realty and personalty. Hence, the portion of a person's estate that consists of realty has come to be known as *real estate.* However, in current business practice, although the term realty is sometimes used, we generally use the term *real estate* to mean land and all things permanently attached.

Understanding the distinction between realty and personalty is important because our legal system has evolved in a way that treats the two concepts very differently. For example, long ago in England, disputes over real estate usually involved issues such as rightful ownership, possession land boundaries, and so forth. When such disputes were brought before the court, much of the testimony was based on oral agreements, promises, and the like, allegedly made between the opposing parties, and these disputes were difficult to resolve. Decisions that had to be rendered were extremely important (recall that England's economy was very heavily dependent on agriculture at that time) and affected people's livelihood. Court decisions may have required one of the parties to vacate the land plus turn over any permanent improvements that had been made (houses, barns, etc.) to other parties. As the number of disputes increased, a pragmatic solution evolved requiring that all transactions involving real estate be evidence by a *written, signed contract* in order to be enforceable.[1]

[1] This requirement was included as part of the *Statute of Frauds and Perjuries,* which was passed in England in 1677 with the intent of reducing the number of disputes and questionable transactions brought before the court.

Parallel developments included (1) a system whereby land locations and boundaries could be more accurately surveyed and described in contracts and (2) an elaborate system of public record keeping whereby ownership of all realty within a political jurisdiction could be catalogued. Any transactions involving realty could then be added to this record, thereby creating a historical record of all changes in ownership and providing notice of such changes to the general public and especially to any parties contemplating purchasing or lending money on real estate. Similar practices continue today in the United States as we require written contracts, requirements, survey methods, and public record systems detailing the ownership of real estate within all counties in every state. We should note that many transactions involving personalty are not subject to the same contractual requirements as real estate and that oral contracts may be enforceable.

When investing in real estate, in addition to acquiring the physical assets of land and all things permanently attached, investors also acquire certain *rights*. Examples of these rights include the right to control, occupy, develop, improve, exploit, pledge, lease and sell real estate. These have come to be known as *property rights*. Hence, the terms real property and real property rights have evolved.[2] As a practical matter, in business discussions, the terms real estate and real property are sometimes used interchangeably. However, as we will see, many of the property rights acquired when investing in real estate are independent and can be separated. For example, these may be leased or pledged to others in exchange for rent or other consideration. This may be done without giving up ownership of the real estate. Indeed, understanding the nature of property rights and how they can be bundled and creatively used to enhance value is one goal of this textbook. The reader should refer to exhibit 1–1 for an outline of these concepts.

## Property Rights and Estates

As pointed out above, the term **real estate** is used to refer to things that are not movable such as *land* and *improvements* permanently attached to the land, and **ownership rights** associated with the real estate are referred to as **real property.** Real property has also been contrasted with **personal property.**[3]

It is important to distinguish between physical real estate assets and ownership rights in real property because many parties can have different ownership rights in a given parcel of real estate. Our legal system offers ways for the person financing or investing in real estate to be creative and to apportion these various interests among parties.

We generally refer to **property rights** as the right of a person to the possession, use, enjoyment, and disposal of his or her property. With respect to its application to real estate, *interest* is a broad legal term used to denote a property right. The holder of an interest in real estate enjoys some right, or degree of control or use, and, in turn, may receive payment for the sale of such an interest. This interest, to the extent that its value can be determined, may also be bought, sold, or used as collateral for a loan.

The value of a particular parcel of real estate can be viewed as the total price individuals are willing to pay for the flow of benefits associated with all of these rights. An individual does not have to be an owner per se to have rights to some of the benefits of real

[2] For nonrealty, the term *personal property* has evolved, and personal property rights would include the bundle of rights which are similar to those listed above but pertaining to personalty.

[3] We should also point out that there are some items known as *fixtures*. These are items that were once personal property but have become real property because they have either been attached to the land or building in a somewhat permanent manner or are intended to be used with the land and building on a permanent basis. Examples include built-in dishwashers, furnaces, and garage door openers.

**EXHIBIT 1–1 Basic Property Concepts Important in Real Estate Finance and Investment**

| (1) The General Nature of Property | (2) Classification of "Things" | (3) Examples | (4) Property Ownership: Evolution of Legal Requirements/Evidence |
|---|---|---|---|
| Any "thing" that can be possessed, used, enjoyed, controlled, or conveyed is generally considered to be property. | A. Real Property (Realty) | A. Land and all things permanently affixed (buildings, sidewalks, etc.). Immovables. Fixtures. | A. Written contracts, legal descriptions, surveys, deeds, wills, possession. Public notice. |
| | B. Personal Property (Personalty) | B. Intangibles and all movable things (e.g., autos, stocks, patents, furniture). | B. Contracts oral or written, purchase orders/invoices, etc. |
| **Property Rights** | | | |
| Rights that can be exercised by the property owner. These include possession, use, enjoyment, control, and the creation of interests in property. | | | |
| **Interests in Property** | | | |
| Created by owners of real estate who pledge and encumber property in order to achieve an objective without giving up ownership. | | Property owner pledges real estate as security for a loan. Property owner grants an easement to another party to cross land in order to gain access to another site. | Mortgage liens, easements, etc. |

estate. For example, a person who leases the land, a **lessee,** has the right to exclusive use of the property for a period of time. This right of use has value to the lessee, even though the term of the lease is fixed. In exchange for the right to use the property, the lessee is willing to pay a rent for the term of the lease. A holder of a mortgage also has some rights as a nonowner in real estate pledged as security for a loan. These rights vary with state law and the terms of the mortgage, but, in general, the lender (or mortgagee) has a right to repossess or bring about the sale of a property if the borrower defaults on the mortgage loan. The mortgage provides the lender with what is referred to as a **secured interest.** Obviously this right has value to the lender in the event of default and reduces the quantity of rights possessed by the owner.

It should be clear that some understanding of the legal characteristics of real estate is essential to analyzing the relative benefits that accrue to the various parties who have some rights in a particular property. In most real estate financing and investment transactions, we generally think in terms of investing, selling, or borrowing based on one owner possessing all property rights in the real estate. However, as we have discussed, all or a portion of these rights may be restricted or transferred to others. Remarkably, the various holders of these separate rights generally enjoy their respective rights in relative harmony. However, conflicts arise occasionally concerning the relative rights and priorities to be accorded to the holders of these interests. The potential for such conflicts may also affect the value or price individuals may be willing to pay for an interest in real estate and, ultimately, the value of property.