



Real Estate Finance & Investments

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E L E V E N T H E D I T I O N

REAL ESTATE FINANCE AND INVESTMENTS

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PREFACE

The world of real estate finance and investments continues to evolve as real estate equity investments and mortgages play an expanding role as investments in both private and public markets. Similarly, this book continues to evolve to provide students with the tools that they need to understand and analyze real estate markets and the investment alternatives available to both debt and equity investors. The revisions we have made in this edition of the book reflect the need for students to expand their understanding of these topics when preparing for a career in the field of real estate.

Public market vehicles for financing and investing in commercial real estate such as commercial mortgage-backed securities (CMBS) and real estate investment trusts (REITs) have matured since the last edition of this book. We have completely revised the chapter on REITs and expanded the coverage of CMBS accordingly.

We have also expanded the discussion of the importance of the underlying economic factors that ultimately affect the value of properties. Factors that affect the supply and demand for different property types are very dynamic and ultimately affect the risk and value of residential and commercial properties.

We continue the tradition of having a book that is very “user friendly” for students. Calculator solutions are shown for many of the problems. Traditional table solutions are also shown in the early chapters to aid in the understanding of the time-value-of-money concepts being illustrated. We are also making computer spreadsheets available that

can be used to solve many of the end-of-chapter problems.

This book can be used by professionals as well as by academics and students. We have always strived to include material that is used in everyday practice. Our goal continues to be to help everyone advance their ability to analyze and better understand the institutions and instruments common in real estate markets.

We would like to thank several people who contributed to the eleventh edition revision. Eric Clausen updated the information on FHA, VA, and conventional loans in Chapter 6. Ron Donohue with the Hoyt Group made substantial revisions to the chapter on REITs. Jacey Leonard assisted with the revision of the Instructor’s Manual and with the creation of Excel spreadsheet templates that are available for use with the book.

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 with their feedback have made us feel that we have helped them prepare students for successful careers in real estate.

**William B. Brueggeman
Jeffrey D. Fisher**

BRIEF CONTENTS

PART I

INTRODUCTION

- 1 Overview of Real Estate Finance and Investments 1
- 2 Legal Considerations in Real Estate Finance 9
- 3 The Interest Factor in Financing 45

PART II

FINANCING RESIDENTIAL PROPERTIES

- 4 Fixed Rate Mortgage Loans 79
- 5 Adjustable Rate and Variable Payment Mortgages 115
- 6 Underwriting and Financing Residential Properties 145
- 7 Residential Financial Analysis 176

PART III

FINANCING INCOME PROPERTIES (DEBT AND EQUITY)

- 8 Introduction of Income-Producing Properties and Valuation Fundamentals 209
- 9 Introduction to Leases, Projecting Cash Flows, and Investment Value 257
- 10 Investment and Risk Analysis 287
- 11 Financial Leverage and Financing Alternatives 332

- 12 Partnerships, Joint Ventures, and Syndications 367
- 13 Disposition and Renovation of Income Properties 388
- 14 Financing Corporate Real Estate 409

PART IV

FINANCING PROPOSED PROJECTS

- 15 Financing Project Development 433
- 16 Financing Land Development Projects 467

PART V

REAL ESTATE CAPITAL MARKETS AND SECURITIES

- 17 The Secondary Mortgage Market: Pass-Through Securities 495
- 18 The Secondary Mortgage Market: CMOs and Derivative Securities 526
- 19 Real Estate Investment Trusts (REITs) 565
- 20 Real Estate Investment Performance and Portfolio Considerations 587

Appendix A Annual Compound Interest Tables 609

Appendix B Monthly Compound Interest Tables 625

CONTENTS

PART I

INTRODUCTION

1 Overview of Real Estate Finance and Investments 1

- Introduction 2
- Financing Residential Properties 3
- Financing Income-Producing Properties 4
- Financing Real Estate Development 6
- Real Estate Capital Markets
and Securities 7

2 Legal Considerations in Real Estate Finance 9

- Property Rights and Estates 9
 - Definition of an Estate 10
 - Classification of Estates 11
 - Examples of Freehold Estates 11
 - Estates Not Yet in Possession
(Future Estates) 12
 - Leasehold Estates 12
- Assurance of Title 13
 - The Meaning of Title 13
 - Deeds 14
- Methods of Title Assurance 14
 - Title Covenants in Deeds 15
 - Abstract and Opinion Method 16
 - The Title Insurance Method 16
- Recording Acts 17
- The Mortgage Instrument 19
 - Definition of a Mortgage 19

- Note versus Mortgage 19
- Interests That Can Be Mortgaged 20
- Minimum Mortgage Requirements 20
- Important Mortgage Clauses 21
- Assumption of Mortgage 23
- Acquiring Title "Subject to" a Mortgage 24
 - Property Covered by a Mortgage 24
 - Junior Mortgages 25
 - Recording of Mortgages 25
- Other Financing Sources 26
 - Seller Financing 26
- Land Contracts 26
- Mortgage Default 27
 - What Constitutes Default? 27
- Alternatives to Foreclosure: Workouts 28
 - Restructuring the Mortgage Loan 28
 - Transfer of Mortgage to a New
Owner 30
 - Voluntary Conveyance 31
 - Friendly Foreclosure 32
 - Prepackaged Bankruptcy 32
- Foreclosure 32
 - Judicial Foreclosure 32
 - Redemption 33
 - Sales of Property 33
 - Effect of Foreclosure on Junior
Lienors 37
 - Deficiency Judgment 37
 - Taxes in Default 37
- Bankruptcy 39
 - Chapter 7 Liquidation 39
 - Chapter 11 39
 - Chapter 13 40

3 The Interest Factor in Financing 45

- Compound Interest 45
- Compound or Future Value 46
 - Use of Compound Interest Tables 50
- Use of Financial Calculators 52
- Present Value 54
 - A Graphic Illustration of Present Value 54
- Compound or Future Value of an Annuity 59
 - Use of Compound Interest Tables for Annuities 61
- Present Value of an Annuity 63
 - Use of the Present Value of an Annuity Table 65
- Accumulation of a Future Sum 67
- Determining Yields or Internal Rates of Return on Investments 68
 - Investments with Single Receipts 69
 - Yields on Investment Annuities 72
 - Effective Annual Yields: Extensions 74
 - Solving for Annual Yields with Partial Periods: An Extension 75

PART II

FINANCING RESIDENTIAL PROPERTIES

4 Fixed Rate Mortgage Loans 79

- Determinants of Mortgage Interest Rates:
 - A Brief Overview 79
- The Real Rate of Interest: Underlying Considerations 80
- Interest Rates and Inflation
 - Expectations 80
- Interest Rates and Risk 81
- A Summary of Factors Important in Mortgage Pricing 83
- Development of Mortgage Payment Patterns 83
 - Early Mortgage Lending Patterns 83
 - The Constant Amortization Mortgage Loan (CAM) 84
 - Fully Amortizing, Constant Payment Mortgage Loan (CPM) 86
- Constant Payment and Constant Amortization Loans: A Comparison 89
- Determining Loan Balances 92

- Loan Closing Costs and Effective Borrowing Costs: Fully Amortized Loans 93
- Truth-in-Lending Requirements and the Annual Percentage Rate 96
- Loan Fees and Early Repayment: Fully Amortized Loans 97
- Charging Fees to Achieve Yield, or Pricing CPMs 101
- Inflation and Mortgage Pricing
 - Problems 102
 - Effects on Lenders and Borrowers 102
- The Graduated Payment Mortgage (GPM) 105
- Reverse Annuity Mortgages (RAMs) 111

5 Adjustable Rate and Variable Payment Mortgages 115

- ARMs and Lender Considerations 116
- The Price Level Adjusted Mortgage (PLAM) 119
 - PLAM: Payment Mechanics 120
- ARMs: An Overview 123
- ARMs Illustrated 123
- Problems Lenders and Borrowers Face with ARMs 126
- Risk Premiums, Interest Rate Risk, and Default Risk on ARMs 127
- Expected Yield Relationships and Interest Rate Risk 130
- ARM Payment Mechanics 132
- Expected Yields on ARMs: A Comparison 138
- Shared Appreciation Mortgages 140

6 Underwriting and Financing Residential Properties 145

- Underwriting Default Risk 145
- Classification of Mortgage Loans 146
 - Conventional Mortgage Loans 147
 - Insured Conventional Mortgage Loans 147
 - FHA Insured Mortgage Loans 148
 - VA Guaranteed Mortgage Loans 150
- The Underwriting Process 152
 - Borrower Income 152
 - Verification of Borrower Assets 154
 - Assessment of Credit History 154
 - Estimated Housing Expense 155

Other Obligations	155
Compensating Factors	155
The Underwriting Process Illustrated	156
Underwriting Standards—Conventional and Insured Conventional Mortgages	156
Underwriting Standards—FHA Insured Mortgages	158
Underwriting Standards—VA Guaranteed Mortgages	161
Underwriting and Loan Amounts—A Summary	162
Property Appraisal	163

7 Residential Financial Analysis 176

Incremental Borrowing Cost	176
Early Repayment	178
Origination Fees	179
Incremental Borrowing Cost versus a Second Mortgage	180
Relationship between the Incremental Cost and the Loan-to-Value Ratio	181
Differences in Maturities	182
Loan Refinancing	184
Early Repayment: Loan Refinancing	185
Effective Cost of Refinancing	187
Borrowing the Refinancing Costs	188
Early Loan Repayment: Lender Inducements	189
Market Value of a Loan	190
Effective Cost of Two or More Loans	191
Second Mortgages and Shorter Maturities	193
Effect of Below Market Financing on House Prices	194
Assuming a Lower Loan Balance	195
Cash Equivalency	196
Cash Equivalency: Smaller Loan Balance	197
Cash Equivalency: Concluding Comments	198
Wraparound Loans	199
Buydown Loans	201
Appendix: After-Tax Effective Interest Rate	205
Example	205
Monthly Payments	206

Effect of After-Tax Interest Cost on Loan Decisions	206
Negative Amortization Loans	206

PART III

FINANCING INCOME PROPERTIES (DEBT AND EQUITY)

8 Introduction to Income-Producing Properties and Valuation Fundamentals 209

Property Types	209
Regional Economic Influences on Property Values	212
Analogy with the Law of Comparative Advantage	212
Economic Base Analysis—Location Quotients	213
Supply and Demand Analysis	215
Local Market Studies of Supply and Demand	218
Location and User-Tenants	220
The Business of Real Estate	222
The “Market” for Income-Producing Real Estate	223
Valuation Fundamentals	224
Appraisal Process and Approaches to Valuation	225
Sales Comparison Approach	226
Income Capitalization Approach	228
Direct Capitalization	230
Direct Capitalization—A Note of Caution	232
Discounted Present Value Techniques	233
Selection of a Discount Rate (r)	234
Using Approximations to Estimate Reversion Values	236
Extending the Present Value Approach: A Note on Land Values	239
A Note on Volatility in Land Prices	240
“Highest and Best Use” Analysis	240
Mortgage-Equity Capitalization: An Extension of Approaches to Valuation	241
Cost Approach	243

Appendix: Reconciliation of the Sales Comparison and Income Capitalization Approaches	251
Reconciliation: Sales Comparison and Income Capitalization Approaches	251
Exploring the Relationships between Changing Market Conditions, Cap Rates, and Property Values	252
A Closing Note on Cap Rates and Market Conditions	256
A Word of Caution—Simultaneous Effects of Real Market Forces and Interest Rates on Property Values	256

9 Introduction to Leases, Projecting Cash Flows, and Investment Value 257

Leases	257
General Lease Terms for Specific Property Types	258
Financial Contents of Leases	259
Effective Rent	263
Income Potential—Real Estate Assets	267
Vacancy	268
Valuation of a Lease Fee Estate	269
Basic Investment Analysis—Apartment Properties	270
Basic Investment Analysis—Office Properties	274
Summary	277
Basic Investment Analysis—Retail Properties	278
Basic Investment Analysis—Warehouse Properties	282

10 Investment and Risk Analysis 287

Motivations for Investing	287
Real Estate Market Characteristics and Investment Strategies	288
“The Real Estate Cycle”	288
Investment Strategies	290
Making Investments: Projecting Cash Flows	290
Office Building Example	290
Base Rent	293
CPI Adjustment	294
Expense Stops	295
Net Operating Income	296

Expected Outlays for Replacements and Capital Improvements	298
Introduction to Debt Financing	298
Introduction to Investment Analysis	299
Measures of Investment Performance Using Ratios	299
Estimated Sale Price	301
Before-Tax Cash Flow from Sale	302
Measures of Investment Performance Based on Cash Flow Projections	303
Summary of Investment Analysis Calculations	305
Risk Analysis	306
Comparing Investment Returns	306
Types of Risk	307
Due Diligence in Real Estate Investment Risk Analysis	309
Sensitivity Analysis	311
Partitioning the <i>IRR</i>	312
Variation in Returns and Risk	314
Taxation of Income-Producing Real Estate	319
Taxable Income from Operation of Real Estate	319
Depreciation Allowances	320
Loan Points	321
Tax Liability and After-Tax Cash Flow	321
Taxable Income from Disposal of Depreciable Real Property	322
After-Tax Investment Analysis	322
After-Tax Cash Flow from Operations	323
After-Tax Cash Flow from Sale	324
After-Tax <i>IRR</i>	325
Effective Tax Rate	325
After-Tax <i>NPV</i>	326
A Note about Passive Losses	326
Special Exceptions to PAL Rules	328

11 Financial Leverage and Financing Alternatives 332

Introduction to Financial Leverage	332
Conditions for Positive Leverage—Before Tax	333
Conditions for Positive Leverage—After Tax	337
Break-Even Interest Rate	338
Leverage and the Incremental Cost of Debt	340

Risk and Leverage	341	Use of the Limited Partnership in Private and Public Syndicates	381
Underwriting Loans on Income Properties	343	Use of Corporate General Partners	381
Market Study and Appraisal	343	Private versus Public Syndicates	382
Borrower Financials	343	Accredited Investors—Regulation D	382
The Loan-to-Value Ratio	344	Regulation of Syndicates	383
The Debt Coverage Ratio	344	Investment Objectives and Policies	383
Other Loan Terms and Mortgage Covenants	345	Promoters' and Managers' Compensation	384
Alternatives to Fixed Rate Loan Structures	347	Investor Suitability Standards	384
Participation Loans	348	Federal and State Securities Authorities	385
Lender Motivations	348	Joint Ventures	385
Investor Motivations	349		
Participation Example	349	13 Disposition and Renovation of Income Properties	388
Sale-Leaseback of the Land	353	Disposition Decisions	388
Effective Cost of the Sale-Leaseback	354	A Decision Rule for Property Disposition	389
Interest-Only Loans	357	IRR for Holding versus Sale of the Property	391
Accrual Loans	357	Return to a New Investor	393
Structuring the Payment for a Target Debt Coverage Ratio	359	Marginal Rate of Return	394
Convertible Mortgages	359	Refinancing as an Alternative to Disposition	398
Lender's Yield on Convertible Mortgage	360	Incremental Cost of Refinancing	399
Comparison of Financing Alternatives	361	Refinancing at a Lower Interest Rate	399
		Renovation as an Alternative to Disposition	400
12 Partnerships, Joint Ventures, and Syndications	367	Renovation and Refinancing	403
Introduction: What Is a Syndicate?	367	Rehabilitation Investment Tax Credits	405
Use of the Limited Partnership in Private and Public Syndicates	368	Low-Income Housing	406
Private Syndication Problem			
Illustrated	369	14 Financing Corporate Real Estate	409
Financial Considerations—Partnership Agreement	369	Lease-versus-Own Analysis	410
Operating Projections	371	Leasing versus Owning—An Example	410
Statement of Before-Tax Cash Flow (BTCF)	372	Cash Flow from Leasing	411
Calculation of Net Income or Loss	372	Cash Flow from Owning	412
Calculation of Capital Gain from Sale	372	Cash Flow from Owning versus Leasing	413
Capital Accounts	373	Return from Owning versus Leasing	414
Distribution of Cash from Sale of Asset	374	Importance of the Residual Value of Real Estate	415
Calculation of After-Tax Cash Flow and ATIRR on Equity	374	The Investor's Perspective	417
Partnership Allocations and Substantial Economic Effect	377	A Note on Project Financing	417
Capital Accounts and Gain		Factors Affecting Own-versus-Lease Decisions	419
Charge-Backs	378	The Role of Real Estate in Corporate Restructuring	424
		Sale-Leaseback	425

- Refinancing 428
- Investing in Real Estate for
 - Diversification 428
- Appendix: Real Estate Asset Pricing and
 - Capital Budgeting Analysis: A
 - Synthesis 430
 - Introduction 430
 - Mortgage-Equity Approach 431
 - Weighted-Average Cost of Capital—
 - Alternative 1 431
 - Weighted-Average Cost of Capital—
 - Alternative 2 431

PART IV

FINANCING PROPOSED PROJECTS

15 Financing Project Development 433

- Introduction 433
- The Development of Income-Producing
 - Property—An Overview 433
- Market Risks 434
- Project Risks 435
- Project Development Financing—An
 - Overview 436
- Lender Requirements in Financing Project
 - Development 438
- Loan Submission Information for Loan
 - Requests—An Overview 439
- Standby Commitments 442
- Contingencies in Lending
 - Commitments 442
- The Construction or Interim Loan 444
- Methods of Disbursement—Construction
 - Lending 445
- Interest Rates and Fees 445
- Additional Information for Interim Loan
 - Submission 445
- Requirements to Close the Interim
 - Loan 446
- The Permanent Loan Closing 447
- Project Development Illustrated 447
 - Project Description and Project Costs 447
 - Market Data and Tenant Mix 453
 - Pro Forma Construction Costs and Cash
 - Flow Projections 454
- Feasibility, Profitability, and Risk—
 - Additional Issues 457

- Profitability before and after Taxes 457
- Sensitivity Analysis, Risk, and Feasibility
 - Analysis 461

16 Financing Land Development Projects 467

- Characterization of the Land Development
 - Business 467
- The Land Development Process—An
 - Overview 469
- Acquisition of Land—Use of the Option
 - Contract 469
- Financing and Development 471
- Lender Requirements in Financing Land
 - Development 472
- Detailed Cost Breakdowns 473
- General Contracts and Subcontracts 473
- Residential Land Development Illustrated 475
 - Market Conditions and Site Plan 476
 - Estimating Development Cost and Interest
 - Carry 479
 - Estimating Release Prices per Parcel
 - Sold 487
 - Loan Request and Repayment
 - Schedule 487
- Project Feasibility and Profitability 488
 - Project IRR and Net Present Value 490
 - Entrepreneurial Profits 490
 - Sensitivity Analysis 492

PART V

REAL ESTATE CAPITAL MARKETS AND SECURITIES

17 The Secondary Mortgage Market: Pass-Through Securities 495

- Introduction 495
- Evolution of the Secondary Mortgage
 - Market 495
- Early Buyers of Mortgage Loans 496
- The Government's Role in Market
 - Development 496
- The Secondary Market after 1954 497
 - FNMA's Changing Role 498
 - The Housing and Urban Development Act
 - of 1968 498

The Government National Mortgage Association	499	Residential Mortgage-Related Securities: Some Closing Observations	551
Mortgage-Backed Securities and the GNMA Payment Guarantee	499	Commercial Mortgage-Backed Securities (CMBSs)	552
The Federal Home Loan Mortgage Corporation	500	Rating Commercial Mortgage-Backed Securities	555
Operation of the Secondary Mortgage Market	500	Mortgage-Related Securities and REMICs	558
Direct Sale Programs	501	REMICs: Other Considerations	559
The Development of Mortgage-Related Security Pools	502	Appendix: Duration—An Additional Consideration in Yield Measurement	562
Mortgage-Backed Bonds	503	Effective Duration	564
Pricing Mortgage-Backed Bonds	504	Problem	564
Subsequent Prices	505		
Mortgage Pass-Through Securities	507	19 Real Estate Investment Trusts (REITs)	565
Important Characteristics of Mortgage Pools	509	Introduction	565
Mortgage Pass-Through Securities: A General Approach to Pricing	513	Legal Requirements	565
Mortgage Pass-Through Payment Mechanics Illustrated	515	Tax Treatment	568
Prepayment Patterns and Security Prices	517	Violation Penalties and Status Termination	568
Prepayment Assumptions	518	Types of Trusts	568
The Effects of Prepayment Illustrated	520	Equity Trusts	568
Security Prices and Expected Yields	521	The Investment Appeal of Equity Trusts	569
Market Interest Rates and Price Behavior on Mortgage Pass-Throughs	522	Importance of FFO (Funds from Operations)	570
A Note on MBBs and MPTs	523	REIT Expansion and Growth	572
		Important Issues in Accounting and Financial Disclosure: Equity REITs	575
18 The Secondary Mortgage Market: CMOs and Derivative Securities	526	Tenant Improvements and Free Rents: Effects on FFO	576
Introduction	526	Leasing Commissions and Related Costs	576
Mortgage Pay-Through Bonds (MPTBs)	526	Use of Straight-Line Rents	576
Collateralized Mortgage Obligations	527	FFO and Income from Managing Other Properties	577
CMOs Illustrated	528	Types of Mortgage Debt and Other Obligations	577
CMO Mechanics	530	Existence of Ground Leases	578
CMOs: Pricing and Expected Maturities	537	Lease Renewal Options and REIT Rent Growth	578
CMO Price Behavior and Prepayment Rates	539	Occupancy Numbers: Leased Space or Occupied Space?	579
CMO Tranche Variations	542	Retail REITs and Sales per Square Foot	579
Derivatives Illustrated	542	Additional Costs of Being a Public Company	579
Yield Enhancement	546		
IO and PO Strips	546		
Convexity	548		
Residential Mortgage-Related Securities: A Summary	549		

The Investment Appeal of Mortgage REITs	580
Financial Analysis of an Equity REIT Illustrated	581

20 Real Estate Investment Performance and Portfolio Considerations 587

Introduction	587
The Nature of Real Estate Investment Data	587
Sources of Data Used for Real Estate Performance Measurement	588
REIT Data: Security Prices	588
Hybrid and Mortgage REITs	588
NCREIF Property Index: Property Values	590
Data Sources for Other Investments	590
Cumulative Investment Return Patterns	590
Computing Holding Period Returns	591
Comparing Investment Returns	593
Risk, Return, and Performance Measurement	594

Risk-Adjusted Returns: Basic Elements	595
Elements of Portfolio Theory	596
Calculating Portfolio Returns	597
Portfolio Risk	598
Portfolio Weighting: Trading Off Risk and Return	601
Real Estate Returns, Other Investments, and the Potential for Portfolio Diversification	603
Portfolio Diversification: EREITs and Other Investments	604
Public versus Private Real Estate Investments	605
Real Estate Performance and Inflation	606

Appendix A Annual Compound Interest Tables	609
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Appendix B Monthly Compound Interest Tables	625
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CHAPTER

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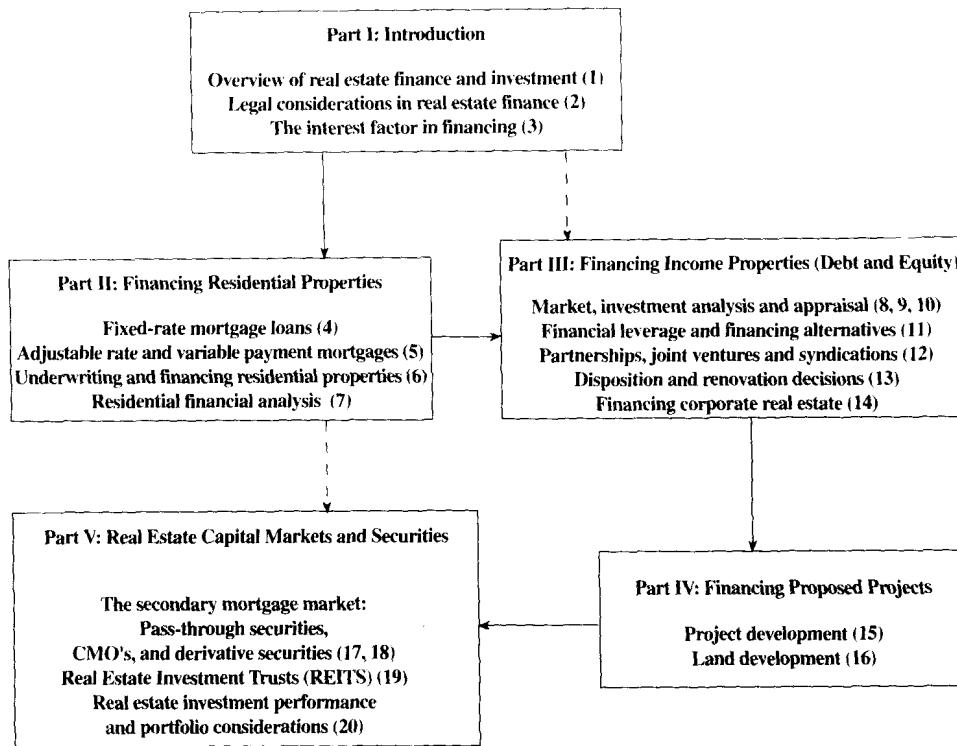
OVERVIEW OF REAL ESTATE FINANCE AND INVESTMENTS

Real estate finance and investments is a field of study that requires an understanding of many important subjects: property law, mortgage underwriting practices, mortgage insurance programs, financial analysis, valuation principles, federal income tax laws, investment analysis, real estate development, and capital markets. This book is intended to provide the reader with a foundation in each of these areas. It is oriented toward the student who has had some exposure to basic finance—and perhaps real estate principles—and desires a more advanced treatment of the subject. The emphasis of the book is real estate financial and investment analysis. However, at various points in the text we give descriptions of important institutional characteristics, which complement our analysis with insights into business practice.

This chapter provides an overview of the contents of the book. The subjects addressed throughout form the basis for much of what is needed for professionals who are in or about to enter the field of real estate finance. Although the breadth of coverage may seem to include very diverse topics, these topics contain analytic approaches and methodologies that can be transferred to many different problem areas. Students may find that they have a much better understanding of basic finance after they have learned to apply it to real estate.

Exhibit 1-1 is a flowchart of the organization of the book, its major parts, and the chapters within those parts. The student will obtain the necessary background for each chapter by reading the chapters in numerical order. However, there are other ways to progress through the material, particularly for the more advanced student. For example, a course of study emphasizing real estate finance could proceed from Part II, “Financing Residential Properties,” to Part V, “Real Estate Capital Markets and Securities” with emphasis on mortgage-backed securities. Similarly, a course of study focusing on income property financing and investment could proceed from Part I directly to Part III.

Part IV is important for courses of study that illustrate the differences between the analysis of existing and proposed (construction and land development) projects. Techniques used to evaluate and finance these projects differ significantly. The student who wants to proceed from Part II or Part III directly to Part V can do so without any loss of continuity.

EXHIBIT 1-1 Chapter Flowchart—Real Estate Finance and Investments**Introduction**

Part I provides the background information necessary for an in-depth study of real estate finance and investment. Many readers may already be familiar with this material. Chapter 2 contains a summary of important legal considerations in real estate finance while Chapter 3 reviews compound interest calculations that form the basis for mortgage calculations and much of the financial analysis throughout the remainder of the text.

When transactions involving a specific good or service occur repetitively in a free market economy, a number of institutional and legal arrangements evolve to standardize and facilitate this activity. Financing real estate is no exception. When the acquisition or development of residential or commercial properties is financed, the nature of the borrower's interest in the property, which is generally used as security for a loan, must be identified and acceptable to the lender who advances the funds. Real estate transactions are significant in economic magnitude and societal importance. Many interests in real estate can be either conveyed or used as security for lending. Our legal system has evolved to accommodate commercial activities related to the vast number of transactions that occur in our economy. For example, to be legally valid, real estate transactions must meet the following requirements: They have to be documented, put in writing, and take the form of a contract. Commitments made to finance these transactions are also documented, usually in the form of a mortgage and a note. Mortgages identify the property that is used to secure a

loan and contain promises made by the borrower to fulfill certain other obligations to the lender. Notes identify the amount of indebtedness between lender and borrower and the terms of repayment.

Chapter 2 contains a summary of the rights and interests in real estate that may be conveyed or used as security for mortgage loans. Covered in more detail are the legal nature of mortgages and the contents normally included in most mortgages. Because changes in property law are most important at the state and local levels, the nature of interests acquired by lenders and the remedies available to them should borrowers default will vary from state to state and among localities. While the scope of this book makes it impossible to compare the differences between states, we can distinguish the major differences in mortgage contracts. Further, various covenants (promises) commonly included in mortgage agreements are described in some detail. Much of the necessary documentation in residential financing has been standardized to facilitate the eventual sale of many mortgages in the secondary mortgage market. Finally, foreclosure and alternatives to foreclosure by the lender are explored and discussed in some detail.

The review of compound interest (time value of money) calculations in Chapter 3 includes understanding compounding (future value) and present value (discounting) calculations. The basic mathematics of compound interest and discounting are reviewed for annual as well as other, particularly monthly, compounding periods needed for mortgage calculations.

Financing Residential Properties

We often take home ownership and mortgage financing of residential properties for granted. However, not until after the Great Depression of the 1930s did Congress take the responsibility for improving housing standards and providing the framework for the vast system of housing finance that we know today. The mortgage insurance programs of the Federal Housing Administration (FHA) followed by the mortgage and guarantee programs of the Veterans Administration (VA) put into place mechanisms for vastly reducing default losses on loans made to households seeking mortgage financing. These programs provided lenders with sufficient protection to encourage them to make mortgage loans in substantial volume.

Part II covers many important topics in residential financing. Exhibit 1–2 outlines the many considerations that borrowers and lenders must make when borrowers seek residential financing. The process involves deciding on the type of mortgage with respect to the pattern of repayment (i.e., fixed or adjustable interest rates) and whether a conventional mortgage loan or a mortgage with FHA insurance or a VA guarantee should be chosen. These decisions are sometimes complex, particularly when one chooses between fixed and adjustable interest rates and compares closing cost requirements. Chapters 4 through 6 contain a detailed analysis of these topics for all types of mortgages with emphasis on loan selection and underwriting.

Deciding how a property should be financed at the time of acquisition is important, but other considerations at that time and subsequently are also important to most borrowers. Chapter 7 deals with these issues:

1. Computing the effective cost of financing, including loan fees and charges. This methodology allows for a comparison of loans with different terms such as the interest rate, fees, and maturity.

EXHIBIT 1-2 Residential Mortgage Financing (borrower and lender considerations)

<i>Stage I: Loan Selection</i>	<i>Stage II: Loan Underwriting</i>	<i>Stage III: Loan Closing</i>
A. Type of mortgage 1. Fixed interest rate 2. Adjustable interest rate 3. Other B. Type of mortgage insurance/guaranty 1. None—conventional loan 2. Private insurance 3. FHA 4. VA	A. Verification of income/assets 1. Determination of payment-to-income ratios 2. Credit history 3. Other savings and assets B. Appraisal of property value 1. Relationship to loan amount 2. Determination of maximum loan-to-value amount	A. Documentation 1. RESPA 2. Federal Truth in Lending B. Transfer of title 1. Deed to buyer 2. Funds to seller from buyer and lender

2. Computing the marginal or incremental cost of acquiring additional loan amounts (i.e., 75 percent, 80 percent, 90 percent, 95 percent of value). This analysis will help the buyer decide whether to make a large or small down payment when acquiring a property.
3. Calculating the benefits and costs of refinancing. This decision must be made when interest rates decline after a loan has been made. The borrower must usually decide whether benefits from savings due to lower payments will exceed the costs that must be paid to undertake refinancing.
4. Comparing financing options provided by a lender or the option of assuming a mortgage previously made by the seller. These alternatives, coupled with the possibility of acquiring second mortgage financing, are also of concern to borrowers.
5. Identifying the many different tax treatments that apply to interest deductions for each type of mortgage. This task is necessary because a borrower has many mortgage payment alternatives to consider.

Financing Income-Producing Properties

Part III (Chapters 8 to 14) provides an in-depth look at some of the more important aspects of financing and pricing income-producing properties. Exhibit 1-3 provides an outline of the topics and techniques used to analyze income properties. The outline is a logical progression of steps that an investor would take when (1) acquiring a property, (2) considering the tax consequences of the transaction, (3) deciding what type and how much, if any, financing to use in making the acquisition, and (4) attempting to gauge the amount of risk taken for a specific type of property and how that risk could change with the application of financial leverage.

The above four areas are usually undertaken when the investor purchases a property at a specific price; that is, the investor is usually asking, "If I pay a specific price for the property and I use a certain amount of debt, what will be my rate of return on