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REAL ESTATE INVESTMENT ANALYSIS

JERRY FERGUSON
Virginia Commonwealth University

JAY HEIZER
Texas Lutheran University

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Senior editorial assistant: *Kelley Saunders-Butcher*



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PREFACE

Investing in real estate involves utilizing facts, theory, and judgment. You must know the facts about the benefits and drawbacks of investing in real estate and where to obtain accurate market information. You also must know financial theory so you can analyze investment opportunities in order to choose the one that not only offers the highest potential return but also best matches your financial objectives. Judgment is necessary to combine fact and theory and interpret the results of your analysis.

Real Estate Investment Analysis offers the right blend of facts, methods of analyses, and aids to decision making for students, real estate professionals, and potential investors. The book is intended to enable readers to reduce uncertainty and risk and to eliminate guesswork in making real estate investments.

The book includes a number of important topics and effective study aids, including the following:

1. In Part I, a special chapter on land use controls, Chapter 4, stresses the relation of land value to the uses permitted by government controls.
2. Part II of the book focuses on taxation of real estate income. Separate chapters are provided on taxation of special use investments, such as historical or low-income properties, and taxation of installment sales and real property exchanges.
3. Part III—Analyzing Investment Opportunities—utilizes a common example throughout the explanations of investment analysis. This technique makes it easier for readers to follow the example calculations throughout the chapters in this section.
4. The chapters in Part IV provide explanations of sales contracts and mortgage agreements that accentuate legal and practical considerations not apparent by reading the instruments themselves. Moreover, sample contracts illustrate provisions that you should include in purchase offers.
5. In Part V, a unique chapter on land speculation, Chapter 18, discusses readily available public documents that are the key to successful speculation. Moreover, the illustrative case shows the effect that financing has on the investment return.
6. Part V also provides complete explanations and illustrations of the uses of sensitivity analysis and probability analysis in selecting and managing real estate investments.
7. Chapter 19 provides a comprehensive explanation of the computer software that is packaged with this text. The programs remove the drudgery from the necessary mathematical calculations. The program disk needs no additional software, only a MS-DOS or PC-DOS operating system.

The *Real Estate Investment Analysis* software is available in either a 5¼" or 3½" disk format. It contains programs that can be used to solve the investment analysis calculations described in Chapters 3 through 12:

- Annual mortgage payments
- Depreciation (residential and nonresidential)
- Tax benefits
- Proceeds from sale
- After-tax cash flow
- Net present value
- Internal rate of return
- Leverage analysis

The margin notes throughout the book emphasize the following special features:

1. Tax laws are referenced throughout the book. In the early chapters, each explanation of a tax subject, such as *capital gain*, is assigned a number; in later chapters, where you can benefit by a review of that subject, the number appears in the margin note.
2. Tax pitfall danger signs in the margins highlight provisions of the tax code that can trap you into paying needless taxes.
3. Key terms in the chapters are highlighted in the margins, and the margin notes distill the main points of paragraphs for quick reference.
4. The computer symbol in the margin indicates which analysis problems can be solved with the accompanying software.

We have provided case problems and worksheets to give you opportunities to practice the analysis methods. Checklists and matching exercises at the ends of chapters allow you to monitor your progress in understanding the concepts presented in each chapter.

We believe that a good academic book does not have to be dull or impractical. The explanations and real-life examples simplify investment analysis methods and do not require previous real estate education or investment experience for understanding. Combined with tax and legal considerations, the analysis methods given in this book can reduce uncertainty in real estate investing by substituting knowledge for guesswork.

Acknowledgments: We thank Jack P. Friedman, Texas A&M University, and Douglas S. Bible, Louisiana State University–Shreveport, for their reviews and helpful comments on the text manuscript. We also thank Tim Bohmann and Kira Heizer for their review and evaluation of the software. Finally, we appreciate the editorial assistance of Kay Heizer and Janée Heizer as well as the clerical support provided by Raynel Lockard and Angelica Wilfong.

Contents

PREFACE xiii

PART I: UNDERSTANDING REAL ESTATE INVESTMENTS 1

1 Realizing the Differences 3

Differentiating Qualities of Real Estate	3
Advantages of Real Estate Investments	8
Chapter Review	10
Checklist	10
Key Terms and Matching Questions	10
Definitions/Important Points	11

2 Determining Real Estate Value 12

Real Value	12
Bases of Value	13
Expected Income Payments	15
The Faces of Risk	15
Risk Rating	20
Taxation of Income Payments	20
Comparable Investment Opportunities	21
Financing Terms	22
Liquidity	23
Chapter Review	24
Checklist	24
Key Terms and Matching Questions	25
Definitions/Important Points	25
Leverage Worksheet	26

3	Analyzing the Market	27
	Market Organization	28
	Market Segmentation	29
	Determinants of Market Demand	30
	Information Services	37
	Chapter Review	37
	Checklist	37
	Key Terms and Matching Questions	40
	Definitions/Important Points	40
4	Understanding Land Use Controls	41
	The Primary Principle	42
	Land Use Controls	42
	Court Intervention	50
	The Stakes of Rezoning	51
	Rezoning Alternatives	52
	Subdivision Regulations	54
	Building and Housing Codes	55
	Important Regulatory and Advisory Boards	56
	Investment in Special Use Real Estate	58
	A Caution	59
	Chapter Review	59
	Checklist	59
	Key Terms and Matching Questions	60
	Definitions/Important Points	60
	PART II: TAXING REAL ESTATE INCOME	63
<hr/>		
5	Learning Tax Law	65
	Reader's Guide to Chapter 5	65
	Establishing a Basis for Depreciation and Capital Gain	66
	The Components of Initial Basis	69
	Income	77
	Operating Expenses	81
	Limitations of the Analysis	89
	Chapter Review	90
	Checklist	90
	Key Terms and Matching Questions	90
	Definitions/Important Points	91
6	Taxing Special Use Property	92
	Purchase and Rehabilitation of Historic Properties	92
	Rehabilitation of Low-Income Housing	97

Vacation Homes and Partially Rented Dwelling Units	100
Taxation of Multiple-Owner Realty	105
Equity Sharing Plans	107
Chapter Review	108
Checklist	108
Key Terms and Matching Questions	109
Definitions/Important Points	109
7 Using Exchange and Installment Sales	111
Real Property Exchanges	111
Installment Sales	114
Nondealer Disposition (Total Deferred Payments Below \$5 Million)	115
Tax Laws: Final Comment	122
Chapter Review	122
Checklist	122
Key Terms and Matching Questions	123
Definitions/Important Points	123
Exchange Worksheet	125

PART III: ANALYZING INVESTMENT OPPORTUNITIES 127

8 Matching Investors to the Property	129
A Rating Guide	129
Undeveloped Land	130
Residential Rental Property	131
Professional Office Realty	132
Retail Stores and Businesses	133
Rental Condominium Units	134
Industrial Realty	135
Warehouses	135
Limitations of the Analysis	137
Chapter Review	137
Checklist	137
Key Terms and Matching Questions	140
Definitions/Important Points	140
9 Negotiating and Purchasing the Investment	141
Real Estate Brokerage	141
Realtors	142
Brokers' Duties to Buyers	146
The Sales Contract	150
Common Contract Provisions	154
A Sample Contract	156
Further Explanation of the Fred Smith Contract	156
Contract Alteration	160

Chapter Review	160
Checklist	160
Key Terms and Matching Questions	161
Definitions/Important Points	161

10 Estimating Costs of Acquisition, Operation, and Resale 163

Costs of Acquisition	163
Loan Closing Costs	167
Operating Expenses	171
Selling Expenses	175
Sales Taxes	178
Chapter Review	178
Checklist	178
Key Terms and Matching Questions	179
Definitions/Important Points	179

11 Analyzing the Cash Return 181

Cash Flow Analysis	181
The After-Tax Cash Flow Model	186
Limitations of Cash Flow Analysis	193
Chapter Review	194
Checklist	194
Key Terms and Matching Questions	194
Definitions/Important Points	194
Cash Flow Worksheet	196

12 Calculating a Rate of Return 197

Types of Returns	197
The Investment	198
Market versus Investor Rates	198
Present Value Analysis	203
Undiscounted Returns Analysis	210
A Final Note	213
Chapter Review	213
Checklist	213
Key Terms and Matching Questions	214
Definitions/Important Points	214
Case 12.1A: Investment	216
Case 12.1B: Net Present Value	218
Net Present Value Worksheet	219

PART IV: SECURING FINANCING 221

13 Negotiating the Loan 223

Lender Analysis	225
The Mortgage	230
The Mortgage Instruments	232
Nonuniform Provisions	239
Negotiated Provisions	240
Regulatory Legislation	242
The Commitment	245
Creative Financing	245
Variable-Rate Loans	249
Chapter Review	250
Checklist	250
Key Terms and Matching Questions	251
Definitions/Important Points	251
Supplement to Chapter 13: Market Study Checklist for Multifamily Project	252

14 Locating a Loan Source 254

Commercial Banks	254
Insurance Companies	257
Savings and Loan Associations	260
Savings Banks	260
Mortgage Bankers	261
Problems of Institutional Lenders	263
Other Sources of Mortgage Loans	266
Chapter Review	268
Checklist	268
Key Terms and Matching Questions	269
Definitions/Important Points	269

PART V: MANAGING THE INVESTMENT 271

15 Leasing the Investment 273

Problems and Legal Definitions	273
Residential Leases	275
Commercial Property Leases	282
Ground Leases	287
Chapter Review	287
Checklist	287
Key Terms and Matching Questions	288
Definitions/Important Points	288

16	Choosing Property Management	290
	Evolution of Property Management	290
	A Property Management Program	291
	Choice of a Firm or Manager	303
	Evaluating Performance	304
	Chapter Review	305
	Checklist	305
	Key Terms and Matching Questions	305
	Definitions/Important Points	306
17	Making Management Decisions	307
	Sensitivity Analysis	307
	Probability Analysis	312
	Selection of Probabilities	314
	Revision of Probabilities (Value of Additional Data)	315
	Chapter Review	317
	Checklist	317
	Key Terms and Matching Questions	318
	Definitions/Important Points	318
18	Speculating in Land	319
	The Speculator	319
	Role of the Speculator	320
	Recognizing the Human Factor	320
	Using Speculator Guides	322
	Learning the Rezoning Ropes	324
	Economic Analysis	324
	Chapter Review	329
	Key Terms and Matching Questions	329
	Definitions/Important Points	329
19	Using Computer Analysis	330
	Introduction	330
	Installation	330
	Data Entry	334
	Investment Analysis	337
	Exercises/Analysis	341
	Case 19.1: Condo Investment Analysis	342
	Case 19.2: Duplex Investment Analysis	343
	Appendix I	345
	Present Value Factors	345

Appendix II 348

Future Value of \$1.00 at Selected Interest Rates 348

Appendix III 350

Answers 350

Glossary 351

Index 360

Understanding Real Estate Investments

Realizing the Differences

After reading Chapter 1, you should understand

1. The ways real estate investments differ from other investments.
2. The relative advantages and limitations of real estate investments.

When you invest in real estate, you acquire a parcel of land, any buildings or other physical improvements on the land, the vegetation, accompanying mineral rights, and reasonable use of the space above and below the land. You also purchase rights to resell, lease, mortgage, or otherwise use the property to make money. Subject only to laws that protect the welfare of neighbors and the community, you are free to create as many ways as possible to increase your investment's earnings.

Only 6 percent of us directly acquire real estate as opposed to stocks, bonds, gold, and other investments because we believe real estate to be different—to require more expertise and management ability. In truth, real estate does have some different investment qualities that can work for you, not against you. *Real Estate Investment Analysis* is intended as an introduction to real estate investment and management, with the aid of computer programs. Figure 1.1 provides an outline of the topics covered in the text.

The first step is to understand the different, sometimes unique, characteristics of real estate investments.

direct investment

DIFFERENTIATING QUALITIES OF REAL ESTATE

Immobility

The foremost quality of real estate is its immobility, an obvious condition that yields some not so obvious effects. When no local market exists for the resale of bonds, stocks, gold, antiques, or other tangible or intangible property, you

immobility makes location important

<u>Topic</u>	<u>Chapter</u>
Real Estate Is Different	1
Understanding Real Estate Investments	2, 3, 4
Tax Implications	5, 6
Exchange and Installment Sales	7
Analyze Opportunities	8, 9
Investment Analysis	10, 11, 12
Loan Feasibility and Source	13, 14
Managing the Investment	15, 16, 17
Speculating	18
Using Computer Analysis	19

FIGURE 1.1. Topic Outline of the Text

can simply take them to another market—even outside the United States if necessary. Real estate, however, is not only a captive of the local economy but also of the neighborhood and surrounding property. The philosopher says, “No man is an island.” The real estate analyst says, “**The value of real estate is in its location,**” the meaning of which is the same: Neither people nor real estate investments exist alone. They affect and are affected by what is around them.

neighborhood
and locality must
be desirable

The site, the neighborhood, and the locality must have desirable economic features to (1) convince a developer that the intended use of the site will be profitable; (2) persuade a lender that the resulting improvement is at least worth the mortgage money; and (3) induce you to invest dollars. The land must attract a developer, capital investment, and tenants.

When you assess a potential real estate investment, you must look closely at the general location. Tenants are not willing to stay long in a decaying neighborhood. You seldom profit by remodeling without similar improvement in surrounding property. Resale value is often based more on general appreciation potential of the area than on present rental income of the property.

resale often
based
on location

Not only must real estate offer good rental income, but it also must lie within an economically healthy environment. You can assess this economic neighborhood by the following five guides:

1. Abandoned and boarded-up structures
2. Closed schools and other government buildings
3. Roads and street signs in need of repair
4. Littered yards and alleys
5. Partitioning of large older homes and buildings into smaller apartments and businesses

You should talk to immediate neighbors concerning the site of any contemplated investment. They can and usually do provide information about economic problems that the seller may be experiencing. The planning department of the local government can tell you of any projects for improvements in streets, lighting, parks or of other government expenditures designed to make the area more attractive.

Remember that because of real estate's immobility, you are investing in the future of the neighborhood as well as in the individual parcel of land.

Two Lives

Realty has both an economic and a physical life. The **economic life** ends when the return from the use of a parcel is less than the cost of its use. The *physical life* of the building is usually in excess of the economic life. At times, the cost of renovation cannot be recouped by higher rents; thus, it is often logical for owners to board up buildings and let them remain vacant. The very durability that makes real estate attractive can create an unwanted liability when the economic life ends and no profitable new use can be found. Conversely, the long physical life of a well-maintained building means you can get several economic lives from one investment. Rehabilitation, a change of tenant, and a different use of the building can create a new investment for you at lesser cost than acquiring another property.

real estate has
two lives

physical life
versus eco-
nomic life

Before 1981, the Internal Revenue Service (IRS) used the following periods as an estimate of economic life according to use of the building. Based on past experience, these periods reflect the actual expected years of economic life, during which income should exceed maintenance costs.

IRS estimates of
economic life