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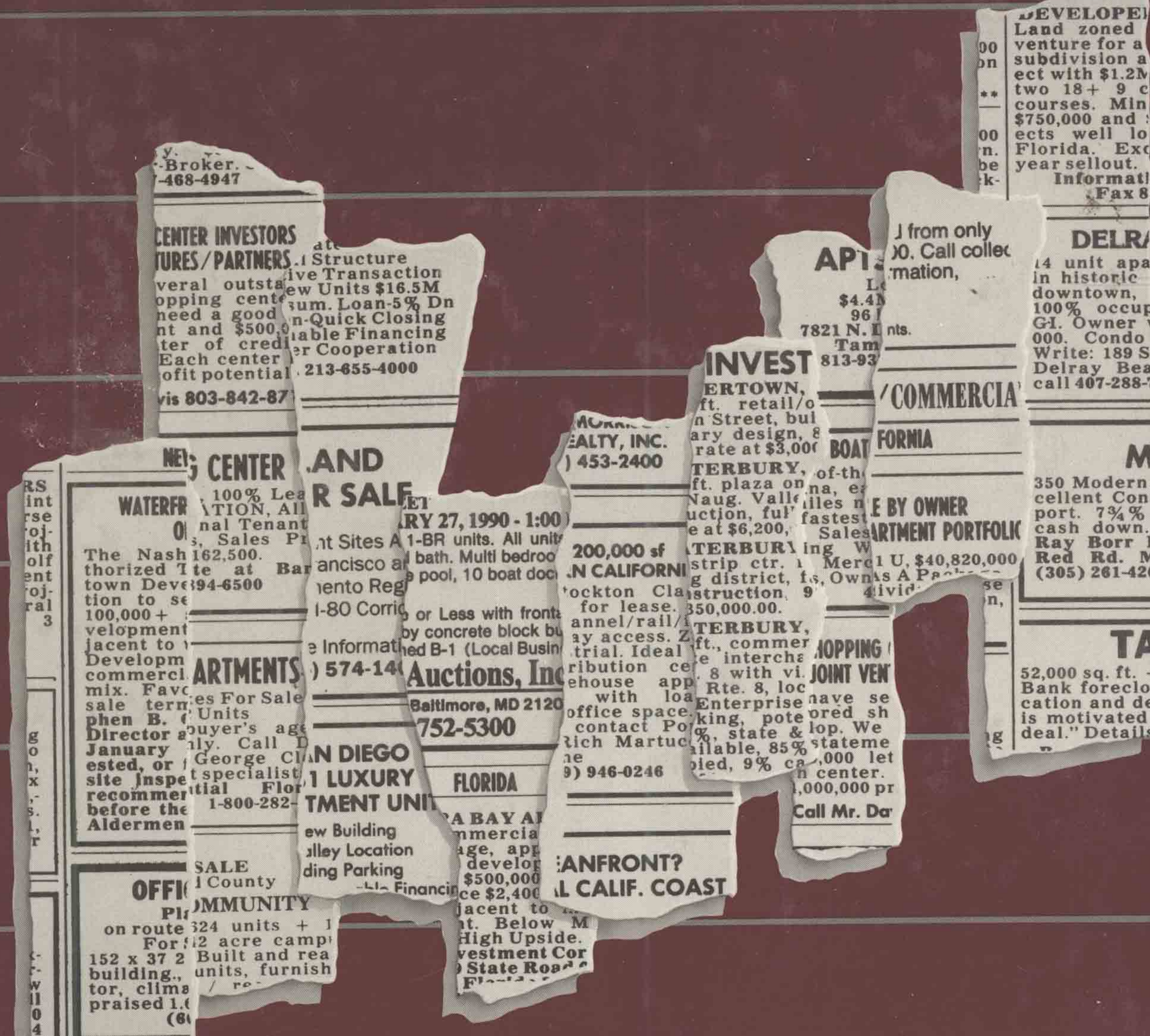
JERRY FERGUSON ▪ JAY HEIZER

Real Estate Investment Analysis



REAL ESTATE INVESTMENT ANALYSIS

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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 $5\frac{1}{4}''$ or $3\frac{1}{2}''$ 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 (residental and nonresidental)
- 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.

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Contents

PART I

Understanding Real Estate Investments

1

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.

direct investment

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

DIFFERENTIATING QUALITIES OF REAL ESTATE

Immobility

immobility makes location important

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

Topic	Chapter
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

real estate has 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.

physical life versus economic life

IRS estimates of economic 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.