Tenth Edition

Essentials of Real Estate Investment

David Sirota, PhD

Dearborn™
Real Estate Education

ESSENTIALS OF

REAL ESTATE INVESTMENT

TENTH EDITION

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ESSENTIALS OF REAL ESTATE INVESTMENT TENTH EDITION

Published by DF Institute, Inc., d/b/a Dearborn Real Estate Education
332 Front St. S., Suite 501
La Crosse, WI 54601

Printed in the United States of America
First printing
ISBN: 978-1-4277-4328-2 / 1-4277-4328-2
PPN: 1559-0110

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Introduction

In the introduction to the ninth edition of this text, Dr. David Sirota indicated that he was optimistic about an economic recovery. While in November 2012 unemployment was down to 7.9 percent nationally, in some states it is still over 10 percent and in some cities as high as almost 30 percent. Many industries are still depressed, many individuals have invaded their retirement accounts to pay for living expenses because they are underemployed, and the real estate market still has not "bounced back."

In January 2012, Ben Bernanke, Chairman of the Federal Reserve System, issued a white paper addressing the U.S. housing market and indicated that "restoring the health of the housing market is a necessary part of a broader strategy for economic recovery." With housing prices falling about a third from the 2006 peak and homeowners several trillion dollars underwater (debt in excess of value), more Americans are losing their homes, creating an excess supply, including a significant number of bank-owned or real estate–owned (REO) properties. In 2011 and 2012, approximately 100,000 homes per month have been placed on the foreclosure track.

So, what does all this mean?

Now is an excellent time to invest in real estate because prices are low, and interest rates are low, even if banks are being very selective screening potential borrowers. Record numbers of foreign investors have been putting their cash into U.S. real estate because of the "great deals" that are available. REITs are making a comeback, especially with foreign investors. The total market value of REITs jumped from $9 billion in 2009 to $451 billion in 2011. Homeowners who have negative equity may be able to refinance (and almost one million have) via the Home Affordable Refinance Program (HARP), or they have been able to modify their loans through the Home Affordable Modification Program (HAMP). There are also "pockets" of real estate recovery throughout the nation, which is promising. We can only hope that means that the real estate market has hit bottom and can look forward to expansion.

Democracy as a political system, when coupled with capitalism as an economic system, is based on the private ownership of real and personal property. Therefore, in the United States, individuals and corporations may own real property under the laws of this country. Such private ownership, known as the *allodial system*, allows for fee simple ownership, which expands the simple rights of property use and control during an owner's life to include the powerful right to designate to whom a property passes upon the owner's death. As a result, owners may effectively translate their work efforts into tangible real and personal property assets and thus accumulate an estate to enjoy and control into the future.

The desire to accumulate a measurably valuable estate and to generate a revenue stream is no doubt one major reason for the tremendous interest in the ownership of real property in this country. It appears that almost everyone gives high priority to the ownership of real estate, from the smallest condominium to the largest shopping center.

This tenth edition of *Essentials of Real Estate Investment* examines the current real estate market and describes the various opportunities for real estate investors. Real estate may provide a profitable alternative for an investor's portfolio with much of the income sheltered by deductions for operational costs, interest expenses, and depreciation.

This text is divided into two major sections—Principles and Practices—and the chapters are presented as follows.

SECTION A: PRINCIPLES OF REAL ESTATE INVESTMENT

- Chapter 1 introduces the nature of the real estate market and explores purposes for investing in real estate as an alternative to other forms of investment. It also describes the advantages and disadvantages of real estate investments.
- Chapter 2 provides an inventory of the various forms of real estate ownership, including individuals, groups, partnerships, trusts, and leaseholds.
- Chapter 3 describes the market and property analyses necessary to determine the feasibility of a real estate investment.
- Chapter 4 reviews the current income tax laws governing real estate investments. Included are a number of tax-sheltering alternatives.
- Chapter 5 examines the financial requirements necessary to measure the economic feasibility of a real estate investment.
- Chapter 6 completes Section A and investigates the financing alternatives for leveraging real estate investments. Included are discussions of the government's role in finance, sources of funds, types and forms of real estate loans, special loan provisions for investment financing, and default and foreclosure consequences.

SECTION B: PRACTICES OF REAL ESTATE INVESTMENT

- Chapter 7 begins a chapter-by-chapter examination of the various types of real estate available for investments. Here, descriptions of single lots and acreage are presented together with the special analyses these types of investments require.
- Chapter 8 examines the investment requirements for residential properties and includes single-family homes, multi-unit apartments, cooperatives, and condominiums.
- Chapter 9 explores investing in office buildings, including management requirements.
- Chapter 10 describes investments in commercial properties, including strip store buildings and small and large shopping centers.
- Chapter 11 presents the opportunities for investing in industrial properties, including industrial parks, warehouses, and lofts.
- Chapter 12 examines a variety of alternative real estate investments, including manufactured-home parks, motels, amusement parks, and housing for the elderly, among others.

Acknowledgements

David Sirota received his Ph.D. in Real Estate from the University of Arizona in 1971. He taught real estate subjects at many universities, including the University of Arizona in Tucson, Eastern Michigan University in Ypsilanti, National University in San Diego, California State University in Fullerton, and at one time headed the Department of Real Estate at the University of Nebraska in Omaha. Dr. Sirota has also written state licensing exam questions for the Arizona Department of Real Estate and ETS. He was involved as a consultant in the development of a congregate care center in Green Valley, Arizona, and acts in a consultant capacity for individuals and developers. He was a founding member of the Real Estate Educators Association (REEA), securing one of its first DREI designations.

The authors would like the thank Karen Stefano for reviewing this edition of the textbook. Karen Stefano is the co-author of the how-to business writing guide, *Before Hitting Send: Power Writing Skills For Real Estate Agents*. Her short fiction has appeared in *Tampa Review, The South Carolina Review*, and other journals. Her non-fiction work has appeared in *California Lawyer, Georgia REALTOR® Magazine*, and elsewhere.

Thanks also go out to those who have contributed to this and previous editions of this textbook: Karen B. Abbott, Thurza B. Andrew, Donald G. Arsenault, Jack R. Bennett, Paul S. Black, Richard Blyther, Robert Bond, William J. Cahaney, Gene Campbell, Ken Combs, Bo Cooper, Gerald R. Cortesi, Larry B. Cowart, Valleri J. Crabtree, Samuel P. DeRobertis, Jack Flynn, Peter C. Glover, Ronald Guiberson, Lloyd L. Hampton, Byron B. Hinton, James E. Howze, Carla J. Keegan, Sam Kiamanesh, Rick Knowles, Craig Larabee, Calvin Montgomery Sr., William E. Nix, William M. North Jr., Michael R. Phillips, Donald L. Pietz, Richard P. Riendeau, Jerry Rutledge, Jeff Siebold, Teresa Sirico, Walstein Smith Jr., James Sweetin, Steve Williamson, and Roger W. Zimmerman.

Section A

Principles of Real Estate Investment

Chapter 1

Introduction to Real Estate Investment

betterments
bundle of rights
buyer's market
cycle
demand
discretionary funds
easy money
fixity
forgoing
highest and best use
leveraging
liquidity
longevity
market segmentation
market value
permanence
personal property
property
real estate
real property
relative scarcity
risk
seller's market
sheltering
supply
sweat equity
tight money
value in use

LEARNING OBJECTIVES

When you've finished reading this chapter, you will be able to

- describe the nature of the real estate market,
- discuss the purposes of investing in real estate,
- list the advantages and disadvantages of investing in real estate, and
- explain the concept of sustainability.

Property is anything that can be owned. **Real estate** is defined as land and all natural and human-made improvements permanently attached thereto, and the rights appurtenant, including air and mineral rights. All other property is **personal property**. To own real estate is not only to possess the physical property but also to acquire certain legal rights to its continual peaceful use and redistribution. When we acquire real estate, we also acquire an accompanying **bundle of rights** in the property. These are the rights of use, possession, control, enjoyment, exclusion, and disposition, including the right to pass the property on by means of a will, and they change the definition of real estate to **real property**.

The ownership and control of real estate is a fundamental part of our lives. We depend on real property to provide us with shelter and to satisfy other basic needs. In our country these essential needs are met in various ways. Because technological achievements have advanced our living standards, we are no longer individually dependent on the ownership of land for the fulfillment of our basic needs. We rent or own an apartment or a house that is serviced by utility companies and financed by lending institutions. We work in office buildings, manufacturing plants, and shops, and we purchase our goods in stores, play in parks, and consume the products of far-off farms and ranches.

Many persons now have the financial capability to step beyond using real property to supply only their basic necessities. These individuals also acquire real estate as an investment, a creator and a storehouse of value that represents the conversion of their work efforts into a tangible, valuable asset.

A real estate investment can be described as the commitment of funds by an individual with a view to preserving and increasing capital and earning a profit. We all make investments of various kinds throughout our lives. We invest time, energy, and money in educating ourselves and our children, in purchasing cars, in obtaining good health care, in accumulating savings, and in pursuing other ventures necessary to ensure a better quality of life.

In many instances, investment also represents the **forgoing** of some present comforts in anticipation of future benefits. Forgoing instant gratification, although often painful, is necessary in the accumulation of the savings essential to the acquisition of investment property.

A real estate investment sometimes requires something as important as money—it often involves the application of personal time and effort. This hands-on approach to an investment is known as **sweat equity**.

Investment in real estate, however, extends beyond our everyday activities and concerns the commitment of free money, money accumulated in excess of funds required to secure life's necessities. This free money, often referred to as **discretionary funds**, can be viewed as money available for investment.

THE NATURE OF THE REAL ESTATE MARKET

Characteristics of Real Property Investments

Each parcel of real estate is unique and thus requires an individual investment analysis relevant to its specific locational attributes. However, all real property has certain common characteristics that affect its value. These characteristics include fixity, longevity, permanence, risk, and market segmentation.

Fixity. Real estate is fixed in location, which greatly restricts the scope of its marketability. As a result of this **fixity**, real estate values are affected by any political and economic activities occurring in the immediate vicinity.

Longevity. Real estate is generally considered to be a long-term investment because of the durability of the improvements and the permanence of the land. This quality of longevity enables investors to estimate, with some degree of reliability, the present value of a future stream of income from their properties.

Permanence. It is the attribute of **permanence** that forms the basis for our system of long-term mortgage-debt amortization. Investment in real estate usually involves relatively large dollar amounts that require complex financial arrangements. These complexities, in turn, require the expertise of lawyers, accountants, brokers, property managers, real estate consultants, and other specialists.

Risk. Real estate investment is a **risk**—a relatively high-risk venture that reflects the uncertainties of a somewhat unpredictable market. In fact, there is no readily identifiable, organized national market for real estate as there is for stocks and bonds. The realty market is a combination of local markets that react speedily to changes in local economic and political activities and somewhat more slowly to regional, national, and international events.

Market segmentation. The real estate industry also suffers from **market segmentation**. The fractured aspect of this unorganized and largely unregulated market is further complicated by the lack of standardization of the product and the fact that many of the market's participants react intuitively, giving little attention to formal feasibility or marketing studies. The real estate investment market is divided into submarkets such as retail, warehouse, residential, and others, compounding the complexity of investing. However, the investor who seeks qualified help and takes advantage of available protective measures can often mitigate some of the risks.

Besides these inherent characteristics of real property, many government activities also directly or indirectly influence property values. At the federal level, income tax laws are often confusing and frustrating. So is the government's regulation and control of money. This power effectively dictates the extent of real estate activity through manipulation of the supply as well as the cost of mortgage money.

Our various levels of government also function in numerous other ways to affect real estate property values. Environmental controls and impact studies add time and costs to the development of land—costs that are inevitably paid by consumers. Local political attitudes regarding zoning and growth restrictions act to raise the prices of properties already developed, effectively creating a monopolistic position for their owners.

Fueling these political attitudes is the antigrowth philosophy of citizens in some areas where property taxes and other public costs are rising at an alarming rate to serve an ever-increasing population. "Not in my backyard" has become the slogan in these troubled cities.

Decline of the Realty Market

In the early 2000s, the subprime mortgage market more than doubled its offerings of hybrid ARMs with artificially low initial payment schedules and other very liberal qualifying standards. Fannie Mae and Freddie Mac loans also became available in various forms using very liberal qualifying standards creating many risky loan products.

The overall housing market boom began to decline in 2006. The subprime market was the first to crash, but by 2007, Fannie Mae and Freddie Mac were also in trouble. Borrowers found themselves unable to pay their sharply increased mortgage payments as adjustable rate loans began to be reset at higher rates. Refinancing was no longer an option because realty values were declining and a slow market made it very difficult to sell. In September 2008, Fannie Mae and Freddie Mac were placed into conservatorship under the newly formed Federal Housing Finance Agency.

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act, the stimulus bill with the important elements of federal tax cuts, expanded unemployment benefits, and other social welfare provisions. On February 18, 2009, the President announced the formation of the Homeowners Affordability and Stability Plan to help families avoid foreclosures by restructuring or refinancing their delinquent mortgages. As a result, the following programs were created:

- The Home Affordable Modification Program (HAMP) is available to eligible holders of real estate that is either a residence or residential rental who are employed but unable to make their mortgage payment. Loans may be modified to create affordable payments in order for the lender to avoid foreclosure. In addition to modifications of Freddie Mac and Fannie Mae, also available are FHA-HAMP and VA-HAMP modifications.
- The Home Affordable Refinance Program (HARP) and HARP 2.0 are available to eligible Freddie Mac and Fannie Mae mortgage holders who are not behind on their payments but are unable to refinance at a lower interest rate because the value of their home has declined.
- Other programs have been made available through the Financial Stability Improvement Act of 2009 and include the following:
  - Principal Reduction Alternative (PRA)
  - Second Lien Modification Program (2MP)
  - FHA Home Affordable Modification Program (FHA-HAMP)

- USDA's Special Loan Servicing
- Veteran's Affairs Home Affordable Modification (VA-HAMP)
- Home Affordable Foreclosure Alternatives Program (HAFA)
- Second Lien Modification Program for Federal Housing Administration Loans (FHA-2LP)
- Home Affordable Refinance Program (HARP)
- FHA Refinance for Borrowers with Negative Equity (FHA Short Refinance)
- Home Affordable Unemployment Program (UP)
- Housing Finance Agency Innovation Fund for the Hardest Hit Housing Markets (HHF)

For more programs available to real estate owners and for specific eligibility, visit *www.makinghomeaffordable.gov/programs*.

Supply of and Demand for Real Estate

In the very broadest sense, the supply of land is unlimited. Although it is true that the earth represents a fixed supply, it is also true that this supply can be extended indefinitely by building under as well as over the land masses and the open seas. Still, there are huge expanses of land that remain unusable in their present state and/or are uninhabitable because of geophysical circumstances.

It is the **relative scarcity** of usable land, however, that is important to real estate as an investment vehicle. Relative scarcity is what establishes the basic value for real estate. The economic worth of property fluctuates with the effective demand for strategically located and thus, by definition, relatively scarce parcels of land. Even more important than the supply of and the demand for unimproved land are the interactions of these economic factors as they affect the existing stock of improved real estate.

One of the principal components of demand is population, not only in terms of numbers of people but also in terms of subgroupings according to age and income.

The current U.S. population topped 310 million in 2010 and is expected to grow to almost 439 million people by the year 2050. By the year 2050, 23.3 percent of the population will be under age 18; 34.2 percent will be between the ages of 18 and 44; 22.4 percent from 45 to 64; 15.8 percent from 65 to 84; and 4.3 percent 85 and older (see Figure 1.1).

Migrational trends and locational economic base analyses can be developed to estimate variations in the demand for real estate within a given area. Changes in location as well as changes in living patterns determine where there will be growth in demand for real property and what this demand will require in terms of housing and related real estate developments.

A **tight money** market occurs when interest rates are high and loans are difficult to find. An **easy money** market reflects low interest rates and lots of money available for real estate loans.

FIGURE 1.1 **Projections of the Population by Selected Age Groups and Sex for the United States: 2010 to 2050**

Sex and age	*(Resident population as of July 1. Numbers in thousands)*								
	2010	***2015***	***2020***	***2025***	***2030***	***2035***	***2040***	***2045***	***2050***
BOTH SEXES	***310,233***	***325,540***	***341,387***	***357,452***	***373,504***	***389,531***	***405,655***	***422,059***	***439,010***
Under 18 years	75,217	78,106	81,685	84,866	87,815	90,722	93,986	97,669	101,574
Under 5 years	21,100	22,076	22,846	23,484	24,161	25,056	26,117	27,171	28,148
5 to 13 years	37,123	39,011	40,792	42,490	43,858	45,170	46,743	48,664	50,697
14 to 17 years	16,994	17,019	18,048	18,892	19,796	20,496	21,126	21,834	22,728
18 to 64 years	194,787	200,597	204,897	208,678	213,597	221,266	230,431	239,933	248,890
18 to 24 years	30,713	30,885	30,817	32,555	34,059	35,695	37,038	38,234	39,538
25 to 44 years	83,095	85,801	89,724	92,612	95,242	97,962	101,392	106,366	110,862
45 to 64 years	80,980	83,911	84,356	83,510	84,296	87,608	92,000	95,333	98,490
65 years and over	40,229	46,837	54,804	63,907	72,092	77,543	81,238	84,456	88,547
85 years and over	5,751	6,292	6,597	7,239	8,745	11,450	14,198	16,985	19,041
100 years and over	79	105	135	175	208	239	298	409	601
16 years and over	243,639	255,864	268,722	282,014	295,595	309,084	322,265	335,328	348,811
18 years and over	235,016	247,434	259,702	272,585	285,688	298,809	311,669	324,389	337,437
15 to 44 years	126,644	129,351	134,078	139,325	144,157	149,051	154,301	160,992	167,455
MALE	***152,753***	***160,424***	***168,258***	***176,102***	***183,870***	***191,609***	***199,434***	***207,465***	***215,825***
Under 18 years	38,437	39,877	41,695	43,312	44,808	46,281	47,937	49,806	51,789
Under 5 years	10,779	11,278	11,671	11,996	12,341	12,797	13,338	13,876	14,374
5 to 13 years	18,945	19,900	20,806	21,670	22,363	23,028	23,825	24,801	25,834
14 to 17 years	8,713	8,699	9,218	9,646	10,104	10,456	10,773	11,129	11,581
18 to 64 years	97,024	100,005	102,240	104,231	106,768	110,578	115,101	119,754	124,120
18 to 24 years	15,675	15,746	15,670	16,536	17,295	18,119	18,792	19,389	20,041
25 to 44 years	41,882	43,287	45,278	46,682	47,924	49,224	50,881	53,339	55,563
45 to 64 years	39,467	40,972	41,292	41,013	41,549	43,236	45,428	47,026	48,516
65 years and over	17,292	20,542	24,323	28,560	32,294	34,749	36,396	37,905	39,917
85 years and over	1,893	2,163	2,344	2,652	3,284	4,387	5,481	6,609	7,458
100 years and over	15	21	29	40	51	62	81	114	172
16 years and over	118,739	124,858	131,170	137,604	144,117	150,569	156,900	163,233	169,831
18 years and over	114,316	120,547	126,563	132,790	139,062	145,328	151,497	157,658	164,037
15 to 44 years	64,141	65,509	67,863	70,447	72,801	75,196	77,767	81,084	84,294
FEMALE	***157,479***	***165,116***	***173,128***	***181,349***	***189,634***	***197,922***	***206,221***	***214,594***	***223,185***
Under 18 years	36,780	38,229	39,990	41,555	43,007	44,441	46,050	47,863	49,785
Under 5 years	10,320	10,798	11,175	11,488	11,820	12,259	12,779	13,296	13,775
5 to 13 years	18,178	19,111	19,985	20,821	21,495	22,142	22,918	23,863	24,864
14 to 17 years	8,281	8,320	8,830	9,246	9,693	10,039	10,353	10,704	11,147
18 to 64 years	97,763	100,592	102,657	104,447	106,829	110,687	115,329	120,179	124,769
18 to 24 years	15,037	15,139	15,147	16,019	16,764	17,576	18,246	18,845	19,497
25 to 44 years	41,213	42,514	44,446	45,930	47,318	48,738	50,511	53,027	55,299
45 to 64 years	41,513	42,939	43,065	42,498	42,747	44,373	46,573	48,308	49,974

FIGURE 1.1 **Projections of the Population by Selected Age Groups and Sex for the United States: 2010 to 2050 (continued)**

FEMALE	***157,479***	***165,116***	***173,128***	***181,349***	***189,634***	***197,922***	***206,221***	***214,594***	***223,185***
65 years and over	22,937	26,295	30,481	35,348	39,798	42,794	44,842	46,551	48,630
85 years and over	3,859	4,130	4,253	4,587	5,461	7,063	8,717	10,376	11,583
100 years and over	65	84	106	134	156	177	217	295	429
16 years and over	124,900	131,006	137,551	144,410	151,477	158,515	165,365	172,095	178,980
18 years and over	120,700	126,887	133,139	139,795	146,627	153,482	160,171	166,731	173,400
15 to 44 years	62,503	63,841	66,215	68,878	71,356	73,855	76,535	79,908	83,161

Source: U.S. Census Bureau

Supply can sometimes be viewed as a function of **demand** when the bidding on scarce properties forces prices upward. Serving effective demand and anticipating its impact is a real estate supplier's most important skill, one that industry professionals and investors are vigorously pursuing with increasing degrees of sophistication in order to perfect investment strategies. Because most real estate developments involve a time lag, which exists because of the time it takes to prepare raw land and construct new buildings, shrewd investors constantly study the market to anticipate demand.

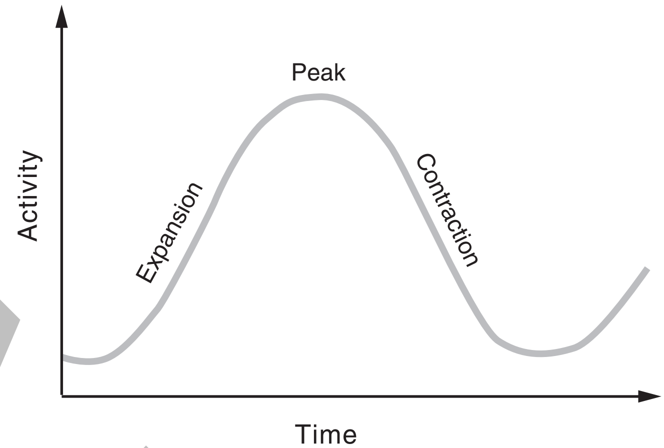
Often, supply itself may be viewed as an accelerator of demand. The imposition of growth controls, building moratoriums, and/or stringent environmental controls seriously inhibits the increase of new housing stock and puts the full pressures of demand on existing property owners. These owners then enjoy a virtual monopoly which affects rental rates and property prices. Thus, the available stock of improved real estate itself establishes the design, quality, price, and terms for the consumer.

Real Estate Cycles

Keeping in mind the cause-and-effect relationship between supply and demand, we can now examine the cyclical nature of the real estate market. A real estate **cycle** (see Figure 1.2) is frequently described as either a **buyer's market** or a **seller's market**. A buyer's market indicates a surplus of supply and a downward price trend, favoring the purchaser. In a seller's market, supply is short and demand is high—prices are forced upward by the competitive market situation.

Because the term *cycle* implies repetitive, ongoing fluctuations in price, the buyer's and seller's markets are equal and opposite partners in the cycle. Thus, we can begin at any stage of a real estate cycle to examine the total cycle's fluctuation. If we enter a cycle somewhere near its peak, we can observe a shortage of supply, high prices as a result of competitive bidding, and, logically, high concurrent profits for sellers. Such high profits act to attract new investors who wish to capitalize on the opportunities, and it is reasonable to assume that new construction will take place, regardless of costs. With new buildings available as additional inventory to satisfy demand, the market cycle will level temporarily and then start to fall until supply exceeds demand. At this point, the cycle has reached its valley, and conditions are those of a buyer's market.

FIGURE 1.2 **Real Estate Cycles**



Other catalysts can affect a cycle, acting to speed it up or slow it down, to raise or lower its peaks and valleys. Included among these catalysts are tax reforms, interest rate fluctuations, a depression or recession, or even a national crisis such as the tragedy of 9/11, to name only a few.

The inherent imperfections of the real estate market contribute to the perpetuation of the cyclical trend. Lack of communication among real estate building contractors, coupled with the time lag between the start-up and the completion of buildings, is a major factor in this problem. Another problem arises when contractors base a decision to build on gut feelings instead of market research. Real estate tends to have a longer contraction phase than other types of industry. A manufacturer of appliances may lay off workers and cut back production to ride out a contraction in the market. The owner of an office building still has the same amount of space to lease and therefore may stay in contraction longer.

Entering the market at the peak of a cycle involves planning, possible rezoning, and financing, as well as labor and material acquisitions in anticipation of construction. When building continues at a feverish pace to capture the profits of backlogged demand, little thought is given to overbuilding until the inevitable occurs and supply exceeds demand.

Now the situation is reversed, with few buyers and many alternative properties from which to choose. A concomitant lowering of prices results until little, if any, profits are left. Building ceases and market conditions continue at a low point until the excess supply is absorbed, at which time the market begins to move toward the peak again.

Despite the cyclical short-run fluctuations in any real estate market, property values, in general, rise over the long term. However, this trend is based on a summarization of activities involving many properties. Any individual property may react cyclically or counter-cyclically to the general activities of the marketplace, much as individual stocks gain or lose value within the stock exchange. Real estate investors are cautioned to consider each purchase carefully from both its micro and macro positions in the realty market. Investors must be aware of the long-term aspect of real estate investments.

Value Theory of Real Estate

Although all of the foregoing economic principles are important for potential real estate investors to keep in mind, in the final analysis investors will be primarily concerned with the value of one particular property. Real estate has value only as one in a series of alternative investment opportunities. Value is, in reality, in the eye of the beholder, the occupier, or the user.

A seller's value is, more often than not, a reflection of personal and slightly sentimental feelings. Undoubtedly, the buyer or agent will have an entirely different opinion of the value of that particular property. Likewise, an insurable value, a condemnation value, and a taxable value, among others, may all indicate a different dollar amount for the same property.

In theory, the value of a parcel of real estate is interpreted to be **market value**, or its value as established in an exchange. As such, market value is defined as that price which a knowledgeable buyer will pay and a knowledgeable seller will accept for a property that has been exposed for sale to the market for a reasonable length of time and with neither buyer nor seller acting under duress or enjoying any advantage, financial or otherwise. Most real estate transactions will require an estimate of the market value of the property involved.

However, market value, as estimated by the seller, appraiser, or perhaps a real estate broker, may differ substantially from market price, which clearly is established by what the buyer will actually pay for the property.

When determining the value of a particular property at a specific point in time, an evaluator has several basic principles of value to use as guides. The principle of substitution contends that no rational, economical person would pay more for one property than for another of like design, quality, and utility. This principle is the basis for the cost approach and the comparable sales approach to estimating the market value of real property and usually establishes the uppermost limit of a property's market value.

The principle of balance identifies the problems that result from an oversupply or undersupply of a particular type of real estate. For instance, too many condominiums of the same size, design, and price in one area would act to depress the values of all of these properties within the market.

The principle of contribution states that the value of an addition to a property is a function of its contribution to the overall profitability of the property, not just its construction cost.

The principle of conformity states that homogeneity in design and quality creates the most reasonable value for a property, while a property that is dramatically different from or nonconforming to its surroundings is invariably lowered in value.

The principle of anticipation stipulates that most investors make their investment decisions based on the measurement of the present value of an anticipated net income stream. This principle is the basis of the income capitalization approach to realty evaluation.

The principle of **highest and best use** is fundamental to estimating the value in use of a real estate investment. This principle is defined as that legal and possible use that is most likely to produce the greatest net return from a property over a given period of time.

In addition to its market value, real estate also has a **value in use**. This is the value on which a number of real estate investors rely and a value that could differ from the property's market value. For instance, compare the market value of a property currently used as a parking lot with its potential value as the site for a highrise office building. Thus, value in use is that use of the property that may or may not be its highest and best use.

As discussed earlier, value is primarily a function of the interactions of supply and demand. A relatively scarce but desirable item's value may increase specifically because of its scarcity and desirability. It must also be remembered that change is ever-present, thus affecting attitudes concerning desirability and value.

Real estate is considered to be just such a relatively scarce and desirable item. Its value is in a constant state of change because of a myriad of continuously operating social and economic forces. Estimators of real estate value must be acutely alert to three stages of change in property values:

1. Integration—a condition of developing value when building new
2. Equilibrium—a condition of stable value during the holding period
3. Disintegration—a condition of declining value during the aging process

A property's value is affected by the prevailing stage of change in its city or neighborhood. Because property cannot be moved, it may go through this evolutionary cycle many times during its economic life.

PURPOSES OF INVESTING IN REAL ESTATE

To Preserve Capital

A primary reason for investing in real estate is the preservation and possible enhancement of the capital invested. Generally, owners have enjoyed rising property values over the years. Consequently, the capital value of the investment is preserved or increased by appreciation. It is precisely for this reason that real estate investments are described as hedges against inflation. Theoretically, the values of real estate fluctuate with local market cycles, but real estate values tend to rise over the long term.

A real estate investment may build up additional equity for its owner through reduction of the mortgage debt. The periodic repayments of the principal amounts owed on existing financing increase equity in property. This increasing equity can be secured for reinvestment either by refinancing the mortgage or by selling the property, depending on the market. In fact, one of the more important benefits of investing in real estate is this ability to reuse the capital through periodic, tax-free refinancing, while at the same time preserving the value of the investment. In addition, the owner's equity in an investment may be raised by increasing the amount of the *net operating income* (NOI), which invariably raises the total value of the investment.

Although the problems associated with tenants are legendary as well as endless, tenants often improve the properties they occupy to enhance their living environment. These **betterments** tend to increase a property's value and are often left behind when the tenant moves. This not only preserves an owner's capital investment but actually enhances it, sometimes substantially.

To Earn a Profit

Fundamentally, all investors in real estate seek a profit on the money they invest. By definition, an investment of any kind is a commitment of funds with the intention of preserving capital and earning a profit. For real estate investors, these profits assume two forms. The income stream from the tenants' rents should generate one kind of profit. The gross amount of rent should be adequate to pay for all of the fixed and variable operating expenses of the property, with enough remaining to show a return on the investment. Thus, an investor anticipates that the income will provide a steady cash profit while the invested capital remains protected over time. When the property is sold, this investment will be recovered intact or, better still, a gain will be made. This gain reflects the increase in the property's value during the time it was held and is the second form of profit that can be earned by a real estate investor.

Before committing any funds, an investor should analyze carefully the returns available from opportunities other than the purchase of real estate. For instance, a viable alternative to investing in a real estate venture is to deposit money into a government security paying interest each year. The annual interest, or profit (before taxes) that would be earned on this investment becomes a benchmark against which to measure the anticipated profitability of an alternative investment. The principal can be withdrawn from this security at a specific time, so it meets the requirements of an investment: preservation of capital and generation of a profit.

If we analyze a real estate investment that shows an annual return (before taxes), with the possibility of recovering the full investment within some identifiable future time period, we see a situation parallel to the government security. However, unlike this security, there is a greater degree of risk associated with real estate investments. This risk includes the likelihood of actually being able to collect the rents in the amounts and at the times anticipated and the chances of fully recovering the investment in the future. In addition, unforeseeable problems might occur over time.

Thus, the profit from a real estate investment should not be considered equal to this same profit from a government security. Something extra must be earned to offset the greater risks that are so much a part of realty ownership. In addition, to compensate for lack of liquidity, real estate investments must develop even larger returns. Unlike other investments, real estate is often difficult to sell at a specific point in time. Therefore, to be viable, a real estate investment should be designed to develop a relatively higher rate of return (profit) than is available from other safer, more liquid investment opportunities.

To Enjoy Tax Relief

Under the current income tax code, unlike many other investments, the income derived from rental real estate can be sheltered substantially to diminish the income tax liability and thus enhance the bottom-line return.

After all income from a rental property is accumulated for the year, the expenses incurred to develop this income may be deducted, effectively **sheltering** this amount from income taxes. Sheltering income simply means having the income deemed as either nontaxable as in the deduction of expenses or as tax-deferred as in cost recovery (depreciation) deductions. These expenses include all operating costs such as management fees, property taxes, utility expenses, repairs, maintenance, advertising, bookkeeping, and others as required. In addition, the interest paid on existing real estate loans is deductible, as are allowable amounts of depreciation. Thus, the gross income derived from rentals is effectively reduced to a net amount that is then subject to the imposition of income taxes at the taxpayer's bracket.

In addition, real estate tax investments are normally made for extended periods of time and, as such, enjoy the tax advantages available under long-term capital gains (other than depreciation recapture) when the investment is sold for a profit.

The full ramifications of the current tax laws, as they apply to investment decision making, will be examined in later chapters.

ADVANTAGES OF INVESTING IN REAL ESTATE

Any list of available avenues of investment will include stocks, bonds, savings certificates, life insurance policies, commodities, consumer merchandise, and real estate. The investment opportunities in real estate include open land, vacant lots, farm acreage, industrial properties, houses, apartment buildings, stores, shopping centers, office buildings, clinics, recreational projects, mineral deposits, securities, manufactured-home parks, condominiums, and airspace. Competition for the dollars available for investment is high, and each opportunity has its own particular advantages and disadvantages. The general advantages of investing in real estate, however, include its relatively high-yield possibilities, leveraging opportunities, tax flexibilities, and the retention of a high degree of personal control over the capital invested.

Relatively High Yields

Bottom-line yields in excess of 20 percent are not unusual for many real estate investments. Yields can even exceed this amount, reaching infinity in those cases where 100 percent or more leverage—using borrowed funds to purchase property—has been achieved. More common, though, are realty investments that regularly develop 10 to 15 percent annual returns over the life of the investment. These profits reflect the opportunities that exist in real estate and, when compared to average yields on other types of investments, explain its popularity.

The return on a savings investment is the rate of interest paid by the bank or savings association. These rates currently run up to 5 percent, depending on the type and duration of deposit. These are before-tax yields, which are eroded by the taxes paid, in accordance with the investor's particular tax bracket. Stocks often pay dividends that average about 5 percent of the value of the investment; but unlike savings, for which the amount of deposit remains constant over time, the value of the stocks fluctuates in the market. As a result, an element of risk is introduced for a stock investor who analyzes yield in terms of dividends received plus growth in value. If this growth is 5 percent per year and the shareholder receives 5 percent in dividends, the yield is 10 percent before taxes.

Bond yields fluctuate, sometimes dramatically, as a function of the money market. A bond owner may earn 7 percent interest but may have to take a discount when selling in a market at more than 7 percent. Some bonds, such as municipals, are tax exempt, and their yields are commensurately lower, depending on the bond's rating.

It is axiomatic in real estate investment that high profits are positively correlated with high risk. Although yields on real estate investments do fluctuate from time to time and from property to property, there are guidelines on which objective decisions may be based. For instance, despite the fractured quality of the general real estate market, there are fairly definable submarkets. One such submarket is apartment projects. Depending on location, number of apartments in the complex, and their size and decor, an investor can usually find comparable projects, research competitive rents, and estimate the income possible from an anticipated investment. This analysis and others will provide data on which an objective decision concerning the profitability of the investment can be based. There are similar submarkets for houses, stores, office buildings, shopping centers, and other forms of real property.

Leveraging Opportunities

Although most lenders allow a purchaser to borrow up to 50 percent of the value of securities such as stocks and bonds, real estate offers an investor the highest **leveraging** opportunities of any investment alternative. Many realty transactions require 20 percent to 40 percent of a property's value as a cash down payment, while others have 10 percent, 5 percent, or even no down-payment requirements. A few investors, after completing some highly sophisticated financing strategies, may even be able to enjoy the benefits of arranging their real estate investment portfolios with greater than 100 percent leverage and end up with cash in their pockets.

High-leverage situations include transactions involving carryback mortgages, land leases, subordination, joint ventures, syndication, sale-leasebacks, wraparound mortgages, participation mortgages, and other creative real estate ownership and financing arrangements. These concepts and their applications, among others, will also be examined in upcoming chapters.

Income Tax Flexibility

Real estate allows its owner a high degree of tax flexibility, due in large part to the application of depreciation allowances and the ability to deduct the premises' operating costs from the gross income collected.

High Degree of Personal Control

Real estate investments provide the opportunity for a high degree of personal control. Purchase terms can be designed to reflect specific financial circumstances. Often, rents can be arranged to anticipate changes in future realty cycles. Various bookkeeping techniques can be adopted to reflect individual needs as they change over time. Property can be periodically refinanced to capitalize on the equity accumulated. The investor usually retains the power to decide on when, how, and to whom the investment will be sold, under terms that satisfy personal economic requirements.

DISADVANTAGES OF INVESTING IN REAL ESTATE

There are no perfect investments. An investor who prefers the guaranteed safety offered by U.S. government securities is required to forgo high yields to achieve this safety. An investor who is interested in the relatively high yields offered by real estate will have to sacrifice a certain amount of safety and **liquidity** and be willing to take a more active personal role in managing such an investment.

The disadvantages associated with real estate investments include relatively poor liquidity, large capital requirements, constant management, being a "landlord," and a relatively high degree of risk.

Relatively Poor Liquidity

Although real estate is usually easy to purchase, it is frequently difficult to sell, with little certainty about the final sales price. Unlike the stock and bond markets, where there are almost always buyers to be found if the price is low enough, sometimes real estate cannot even be given away, let alone sold at a reasonable price. For example, in good times owners would be reluctant to sell, while in bad times everyone wants to sell at the same time, significantly reducing the property's marketability.

Large Capital Requirements

Contributing to the poor liquidity of real estate income property are the relatively large sums of money needed for property acquisition, maintenance, and reserves. Despite the high leveraging opportunities that exist in this field, a sound investment must be backed by adequate operating capital to protect it in the event of unforeseen major crises. An unexpected reversal in the economic cycle of a community could result in a high number of vacancies and, at the same time, eliminate any possible market for disposing of the suddenly declining investment property.

Necessity of Constant Management

Everything about real estate, as in most other areas of present-day living, is expensive. At current rates for repairs, everyday maintenance is costly, to say nothing of required replacement of worn-out items. Major maintenance expenditures such as a new roof, plumbing, or electrical systems can easily amount to thousands of dollars.

Constant property maintenance is an absolute necessity for improved real estate investments. Buildings need careful attention, including perpetual nailing, patching, painting, and replacement of worn parts to satisfy tenants and ensure continuing rental cash flows. In addition, the hallways, elevators, and grounds also require routine upkeep.

In other words, a real estate investment requires more active participation on the part of the individual investor than do most other investment opportunities. This management activity may be passed along to a professional management agent or service, but then the income from the property must be sufficient to justify the cash paid for these services.

Landlordism

Most real estate investments require that the property owner enter into some form of personal involvement with the professional manager and/or the tenants. These interpersonal relationships are often warm and rewarding, but they can also become distressing, especially when a manager must be dismissed or a tenant evicted. People are often deterred from investing in real estate because, as landlords, they are exposed to tenants' complaints and the problems of managing property, and this factor should be included in the acquisition decision.

Risk

Finally, it must be clearly understood that there are substantial risks involved when investing in real estate. It is true that there are risks in every field of endeavor, even in our daily activities. Still, it is important to reiterate that investing involves decision making: a choice of what you should buy; when and where you should buy; and, most significantly, whether you should invest at all.

What makes real estate investment so hazardous is the number of agencies and events beyond the investor's control that influence its success; for example, the unpredictability of the income tax code may be enough of a detractor to discourage some investors. We also cannot ignore the vicissitudes of the financial markets as interest rates fluctuate in response to the natural laws of supply and demand, as well as to the imposition of monetary controls by the Federal Reserve System ("the Fed").

Add the other disadvantages, enumerated previously, and you can draw a clear warning that although real estate investment carries with it the potential for large rewards, there are indeed substantial risks involved. Yet even in real estate there are varying degrees of risk. Investing in an office building with a successful and profitable track record that has a number of tenants on long-term leases presents less risk than investing in a proposed building with no history to consider.

SUSTAINABILITY

In today's world, sustainability is also a factor when developing real estate. According to the U.S. Environmental Protection Agency (EPA), sustainability is based on a simple principle: everything that we need for our survival and well-being depends, either directly or indirectly, on our natural environment. The EPA is the government's environmental watchdog. To that end, many government contracts include sustainability clauses. The Internal Revenue Code also includes incentives for energy efficiency. For more information, visit *www.fedcenter.gov/programs/sustainability/*.

SUMMARY

In economic terms, land is considered a relatively scarce commodity, although from a practical point of view, land is infinite in supply because it can be developed into the air and underground. Still, most of the earth's population gathers tightly in the great cities of the world, congregating where the jobs are. Thus, there is an ever-increasing demand for a limited supply of desirable real estate. This pressure of demand acts to force the prices of available real estate to new heights.

Real estate market activities fluctuate as a function of supply and effective demand. When the top of the cycle has been reached, with high prices reflecting high profits, the entry of new builders acts to add to the supply and to reduce the prices and profits accordingly, resulting in a reversal of the cycle. The microcycle is local in character, while the long-term cycle shows an ever-increasing value for real estate over time.

In addition to the demands of a growing population, artificial limitations on the supply of real property add to the increasing costs of real estate. Concerns with pollution have led to environmental controls that limit new construction. Political attitudes regarding controlled growth have also inhibited construction in many areas of the country. Natural gas and water shortages, sewer inadequacies, central city decline, and resultant suburban expansions all have placed substantial burdens on current property owners to support their local governments on an ever-shrinking tax base.

Despite all these obstacles, real estate investors continue to seek profitable projects. Attempting to anticipate demand and, in some areas of this country, actually creating demand by the very design of their projects, real estate developers are: adjusting the sizes of homes; rethinking the frills in office buildings; providing the magnetism necessary to attract customers to shopping centers; and creating new concepts in planned unit developments, manufactured-home parks, office parks, and industrial parks. All of this is in an effort to bring a usable product to a receptive market.

The measurement of a property's value is a function of its utility, its ability to generate income in the future, and its position in a spectrum of alternative investment opportunities.

Value often is based on subjective, intuitive interpretations, although a body of principles has been developed to describe property value in more objective terms. These principles include those of substitution, highest and best use, balance, contribution, conformity, and anticipation, and they describe the function of value in conjunction with the activities of a rational, economic investor.

Basically, people invest in real estate with a view toward preserving capital and earning a profit. Real estate investments offer relatively higher yields, greater leveraging opportunity, greater income tax–sheltering strategies, and a higher degree of personal control than most other types of investments.

On the other hand, real estate is definitely illiquid when compared with stocks and bonds. It also requires a commitment to personal involvement in management, either with a professional manager or with the tenants themselves. The role of landlord has probably turned many away from the profit opportunities available in real estate investments.

DISCUSSION TOPICS

1. Investigate the economic conditions of your community and identify the point in the real estate cycle at which you believe it to be.
2. Identify a specific neighborhood in your community and estimate where it is on the development spectrum: integration, equilibrium, or disintegration.

REVIEW QUESTIONS

1. From a rational point of view, an investor in real estate must consider all of the following analysis aspects *EXCEPT*
   a. yield.
   b. risks.
   c. pride.
   d. value.

2. Real estate investments should be considered first and foremost from the viewpoint of the
   a. economic soundness of the project.
   b. unique financing techniques available.
   c. tax shelter opportunities.
   d. unlimited growth potential.

3. Real estate investments have all of the following advantages *EXCEPT*
   a. high yields.
   b. leverage.
   c. liquidity.
   d. personal control.

4. Which one of the following statements is *TRUE* regarding the characteristics of real estate?
   a. It has a central and controlled market.
   b. It is a short-term asset.
   c. Each parcel is similar to each other parcel.
   d. Its market condition is seldom in balance with supply and demand.

5. Supply and demand theory indicates that if they both increase at the same rate, prices will
   a. go up.
   b. go down.
   c. first go up and then go down.
   d. remain constant.

6. A "buyer's market" indicates all of the following *EXCEPT*
   a. excess supply.
   b. lower prices.
   c. high demand.
   d. flexible terms.

7. Which of the following approaches to value reflects the actual price that a knowledgeable buyer will pay?
   a. Value in use
   b. Highest and best value
   c. Appraised value
   d. Market value

8. To increase the use of leverage when buying a real estate investment is to
   a. decrease its yield.
   b. increase its risk.
   c. decrease its operating expenses.
   d. increase its beginning book basis.

9. Because of the fractured quality of the market, a real estate investment is frequently considered highly
   a. profitable.
   b. illiquid.
   c. transferable.
   d. valuable.

10. When properties in blighted areas start attracting investors, they are entering a period of
    a. integration.
    b. equilibrium.
    c. disintegration.
    d. urban renewal.

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ISBN-13: 978-1-4277-4328-2
ISBN-10: 1-4277-4328-2
9 781427 743282
Reorder No.: 1559-0110