REAL PROPERTY
Land and anything attached including space under, on and over the surface

IMPROVEMENTS
Things attached to the land (fixtures)

LEASE
Agreement between a property owner landlord-lesser and tenant-lessee that transfers the rights of use and possession (but not ownership) of the property to the tenant in exchange for rent payments

REAL ESTATE PURCHASE AND SALE AGREEMENT
Purpose - to provide the rules governing the parties’ rights and duties during the time between the agreement to transfer title and the actual transfer

LETTER OF INTENT
- A letter signed by the parties summarizing agreement on the main business points of a transaction
- Purpose is to avoid the expense and time associated with preparing a formal purchase and sale agreement
- May or may not be legally binding

ESCROW
- A property is said to be “in contract” or “in escrow” when a sales contract is signed;
- To “open” escrow means to deliver the agreement to the escrow holder;
- To “close” escrow means to complete the transaction successfully
- The buyer is said to “control” the property because the seller is legally obligated to sell the property but the buyer typically has the ability to terminate the contract for some period of time

DEPOSIT, EARNEST MONEY DEPOSIT
- Monetary deposit made by the buyer, usually applied to the purchase price, at the close of escrow
- Usually deposited with the escrow holder at the time of or soon after execution of the contract
- Usually refundable until the buyer decides to purchase the property; it is said that a deposit “goes hard” when it becomes non-refundable
- A deposit is said to “pass through” when it is released to the seller prior to the close of escrow
- If the buyer defaults, seller normally keeps the non-refundable deposit as liquidated damages

DUE DILIGENCE PERIOD, FEASIBILITY PERIOD, CONTINGENCY PERIOD
- Period of time stated in the contract during which the buyer examines/investigates the property to determine whether he/she wants to buy it
- Contract contingencies – specified conditions in a contract that relieve the parties of their promises to perform; Common contingencies:
  - Financing and other approvals
  - Title
  - Inspection and repair
  - Environmental

FEASIBILITY ANALYSIS
- Formal or informal, an early step in the real estate investment process
- Attempt to estimate the probability of success of a specific proposed course of action
- Involves estimating the amount and timing of required cash expenditures and expected cash inflows, and an assessment of the degree of confidence that attaches to the estimates;
- This implies a careful and explicit statement of objectives against which the expected consequences of a proposed course of action can be measured
- It implies also that a specific course of action fits the constraints imposed by the physical, financial, and social environment in which the course of action will be carried out
- Rather than a single specific course of action, several alternative courses may have been identified; feasibility analysis seeks to determine whether all, none, or some of the alternatives offer an acceptable probability of achieving minimum investor objectives

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“Feasible”
- Reasonably probable to achieve individual or organizational goals
- Physically possible given site constraints
- Legally feasible given constraints of laws, regulations and land use restrictions
- Financially feasible given constraints imposed by those who supply capital (debt and equity)

Feasibility analysis problems
- Site in search of a use
- Use in search of a site
- With predetermined funds, investigate alternative investment opportunities

Steps In Feasibility Analysis

Identify and define limitations explicitly and early
- All economic activity is undertaken with the handicap of limited resources, and these constitute a constraint on the range of alternatives that are feasible
- Values, goals and objectives also place limitations, as do attitudes toward bearing risk
- Physical characteristics of sites limit the range of improvements they will support or the nature of activity they will tolerate
- Society, through ordinances (zoning codes, building codes, fire codes, housing codes, etc) and regulatory oversight places limits by stating what must be done and what may not be done at specific sites

Assess physical and legal aspects of the site

Estimate demand
- Determine required amenities, and users’ basic space requirements
- Depending on the type of improvements, determine the need for transportation, accessibility, services, taxes, etc

Analyze competitive (present and future) space to estimate rents, vacancies, and appreciation rates

Estimate the cost of construction, alteration, rehabilitation or fix-up, as proposed in the initial concept, and the cost of facility operations

Estimate the cost of financing for various possible combinations of equity and debt financing packages

Estimate the absorption rate—the rate at which vacant units will be rented

Develop a schedule of cash inflows and outflows

Evaluate the anticipated cash flows for adequacy, given the investor’s minimum acceptable rate of return and the degree of risk the investor is prepared to accept

Format for a Feasibility Report

The report’s organization should reflect its purpose; It should be designed to facilitate its use, not to satisfy some predetermined concept of appropriateness

Sample format:
- Title page—identifies the nature of the report, the property involved, and the analyst who prepared the report
- Table of contents—designed to facilitate finding specific material within the report; May be omitted on very short reports
- List of tables and exhibits—when the report contains numerous tables, a separate list should follow the table of contents
- Executive summary—a brief and succinct summary of key information, findings and conclusions; May be in outline or narrative form
- Scope and limitations—specifies the extent of the investigation and clearly describes any unsubstantiated premises or assumptions, such as the physical nature of the soil, the legal character of the property title, or any other pertinent item that the analyst did not personally verify
- Regional and city analysis—presents information about the region and the city that bears directly on the feasibility question; Each piece of information presented should be related directly to the feasibility analysis
Location and site analysis—includes physical characteristics such as width and depth, topography, drainage, etc., and relevant legal characteristics (easements, zoning, setback requirements, and so on) that might limit the feasible uses of the site.

Market analysis—explains overall market conditions for the type of property being considered and the direction and strength of market trends, including supply and demand analysis.

Financial analysis and cash flow projections—reports on projected after-tax cash flow to equity investors, and appropriate investment indices such as operating ratio, payback period, and debt service coverage. Investment risk is also evaluated in this section.

Conclusions and recommendations—summarizes findings in key areas such as security and risk, current cash flow prospects, future cash flow and appreciation, investment liquidity, income tax consequences, etc., and presents a set of recommendations.

REAL ESTATE INVESTMENT ANALYSIS

Has lagged behind mainstream finance and investment analysis. Real estate investors have traditionally recognized the intrinsic value of real estate and have ignored more sophisticated analysis.

Modern approach treats real estate as a capital asset desired for the stream of benefits (cash flows) it is expected to produce.

Measurable returns available from investments

Advantages of real estate investment

Disadvantages of real estate investment

Types of real estate investors—active vs passive

Active

Those who acquire direct title to real property and either oversee the property themselves or hire professional management firms to handle day-to-day management chores.

Passive

Those who place money with professional money managers who in turn acquire interests in real property or who acquire shares in corporations or partnerships that hold real property interests; Passive investors make no operating decisions.

Types of investors—equity vs debt

Equity

- An ownership interest (may include a leasehold interest) in a property.
- Similar to stockholders of a corporation; Those who invest in stock are said to invest in equities.

Debt

- A financial claim on a property evidenced by a promissory note.
- Usually secured by a mortgage or deed of trust (similar to bond holders of corporation).

Differences

- Legal rights associated with a property.
- Order of claims in a liquidation situation.
- Equity holders are subordinate to debt holders and therefore are exposed to more risk.

INVESTMENT MANAGERS AND ADVISORS

Investment manager - any company or individual that assumes discretion over a specified amount of real estate capital, invests that capital in assets via a separate account, co-investment program or commingled fund, and provides asset management.

Alignment of interests—term describing the desire of investors for their managers to have no conflicts of interest leading to co-investment requirements.

Advisor: A broker, consultant or investment banker who represents an owner in a transaction; Advisers may be paid a retainer and/or a performance fee upon the close of a financing or sales transaction.

Portfolio manager—position responsible for a group of assets, typically for the benefit of a third party; Tends to operate at the strategic level, focusing on issues such as portfolio's performance, risk and return objectives, makeup and management, and market conditions.
REAL ESTATE INVESTMENT PERFORMANCE

- A scarcity of real estate yield data has made comparisons between real estate and alternative assets unreliable.
- Findings have varied widely due to different premises employed by researchers.
- The most frequent conclusion has been that over an extended period real estate tends to generate returns roughly comparable to those available from common stocks, while offering significantly greater predictability of returns.

CONCEPTS AND DEFINITIONS

- Most probable selling price—a probabilistic estimate of the price at which a future transaction will occur.
- Market value—(value in exchange) the price that a willing buyer will pay and a willing seller accept, both being fully informed and with the sale property exposed for a reasonable period; The conditions of a fair market transaction:
  - Typically motivated parties
  - Well informed parties
  - Market exposure
  - Payment in cash
  - No special circumstances
- Four essential elements of value:
  - Demand—the willingness and ability to purchase
  - Utility—usefulness; ability to instill a desire for possession
  - Scarcity—of limited supply
  - Transferability
- Neither cost nor price is an element of value
  - Market value vs price—price equals value when the “fair market” conditions are met
  - Market value vs cost—cost equals value when improvements are new and of the highest and best use
- Forces affecting value:
  - Physical considerations—qualities of the physical property, transportation and access (“linkages”), proximity to services and desirable uses, amenities, balance of land uses, etc.
  - Social considerations
  - Political considerations—tax and assessment rates, zoning and land use restrictions, etc.
  - Economic considerations—population, employment, income, property investment, etc.

Investment value

The value of a property as an investment to a present or prospective owner; Reflects the individual investor’s unique assumptions about the future ability of a property to produce revenue, the likely holding period, selling price, tax consequences, risk, available financing, and all other factors that affect expected net benefits of ownership.

Estimating investment value

An investor is buying a set of assumptions about the ability of a property to generate cash flows over the expected holding period and the likely market value of the property at the end of the holding period; Four steps:

- Estimate the stream of expected benefits
- Adjust for timing differences in expected streams of benefits from investment alternatives
- Adjust for differences in perceived risk associated with alternatives
- Rank alternatives according to the relative desirability of the perceived risk-return combinations they embody

Value of an investment property is the sum of the debt and equity positions

Differences in Valuations