Real Estate Finance and Investments

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Preface

Introduction to *Real Estate Finance and Investments*

This book prepares readers to understand the risks and rewards associated with financing and investing in both residential and commercial real estate. Concepts and techniques included in the chapters and problem sets are used in many careers related to real estate. These include investing, development financing, appraising, consulting, managing real estate portfolios, leasing, managing property, analyzing site locations, corporate real estate, and managing real estate investment funds. This material is also relevant to individuals who want to better understand real estate when making their own personal investment and financing decisions.

Real estate markets are impacted by many local, national, and international economic and demographic trends coupled with new technology that impact different sectors of these markets. It is more important than ever to be able to evaluate how these trends will impact the risk and return for lenders and investors. This requires an understanding of the legal issues that can impact the rights of lenders and investors, the characteristics of the various vehicles for lending and investing in real estate, the economic benefits of loans and investments, and how local economies may affect the investment performance of properties as well as the goals of lenders and investors. Managers of real estate funds need to understand how the risk of the fund may be changing and how current economic events might impact the future performance of the fund and the need to change allocations across property types and geographic areas.

This book is designed to help both students and other readers understand these many factors so that they can perform the necessary analysis and make informed real estate finance and investment decisions. As the book's title suggests, we discuss both real estate *finance* and real estate *investments.* These topics are interrelated. For example, an investor who purchases a property is making an investment. This investment is typically financed with a mortgage loan. Thus, the investor needs to understand both how to analyze the investment and how to assess the impact that financing the investment will have on its risk and return.

Similarly, the lender, by providing capital for the investor to purchase the property, is also making an investment in the sense that he or she expects to earn a rate of return on funds that have been loaned. Therefore, the lender also needs to understand the risk and return of making that loan. In fact, one of the risks associated with making loans secured by real estate is that, if a borrower defaults, the lender may take ownership of the property. This means that the lender also should evaluate the property using many of the same techniques as the investor purchasing the property.

Organization of the Book

From the above discussion, it should be clear that many factors have an impact on the risk and return associated with property investments and the mortgages used to finance them. This is true whether the investment is in a personal residence or in a large income-producing investment such as an office building.

Part I begins with a discussion of the legal concepts that are important in the study of real estate finance and investments. Although a real estate investor or lender may rely heavily on an attorney in a real estate transaction, it is important to know enough to be able to ask the right questions. We focus only on those legal issues that relate to real estate investment and financing decisions.

Part II begins with a discussion of the time value of money concepts important for analyzing real estate investments and mortgages. These concepts are important because real estate is a long-term investment and is financed with loans that are repaid over time. This leads to a discussion of the primary ways that mortgage loans are structured: fixed-rate and adjustable-rate mortgage loans.

Part III considers residential housing as an investment and covers mortgage loan underwriting for residential properties. This is relevant for individuals making personal financial decisions, such as whether to own or rent a home, as well as for lenders who are evaluating both the loan and borrower.

Part IV covers many topics related to analyzing income property investments. We provide in-depth examples that include apartments, office buildings, shopping centers, and warehouses. Many concepts also may be extended to other property types. These topics include understanding leases, demonstrating how properties are appraised, how to analyze the potential returns and risks of an investment, and how taxes impact investment returns. We also consider how to evaluate whether a property should be sold or renovated. Finally, we look at how corporations, although not in the real estate business per se, must make real estate decisions as part of their business. This could include whether to own or lease the property that must be used in their operations, as well as other issues.

While the first four parts of this book focus on investing or financing existing properties, **Part V** discusses how to analyze projects proposed for development. Such development could range from land acquisition and construction of many types of income-producing property to acquisition of land to be subdivided and improved for corporate office parks or for sale to builders of residential communities. This section also includes how projects are financed during the development period. Construction and development financing is very different from the way existing, occupied properties are financed.

Part VI discusses various alternative real estate financing and investment vehicles. We begin with joint ventures and show how different parties with specific areas of expertise may join together to make a real estate investment. We use, as an example, someone with development expertise who needs equity capital for a project. A joint venture is created with an investor who has capital to invest but doesn't have the expertise to undertake the development. We then provide a financial analysis for the investment including capital contributions from, and distributions to, partners during property acquisition, operation, and its eventual sale. In this section, we also discuss how both residential and commercial mortgage loan pools are created. We then consider how mortgage-backed securities are structured, issued against such pools, and traded in the secondary market for such securities. This also includes a discussion of the risks that these investments pose. **Part VI** also includes a discussion of real estate investment trusts (REITs). These public companies invest in real estate and allow investors to own a diversified portfolio of real estate by purchasing shares of stock in the company. We point out the advantages and disadvantages of investing in REITs compared to investing in real estate in the private equity market.

Finally, in **Part VII,** we discuss how to evaluate real estate in a multi-asset portfolio that includes other investments such as stocks and bonds. This includes understanding the diversification benefits of including real estate in a portfolio as well as ways to diversify within the real estate portfolio and the pros and cons of international investment. This is followed by a chapter on real estate investment funds that are created for high-net-worth individuals, endowments, and pension funds. We discuss different fund strategies and structures and how to calculate the returns for a fund and analyze the risk and performance of the funds relative to various industry benchmarks.

Wide Audience

From the above discussion, it is clear that this book covers many topics. Depending on the purpose of a particular course, all or a selection of topics may be covered. If desired, the course also may emphasize either an investor's or a lender's perspective. Alternatively, some courses may emphasize various industry segments such as housing and residential real estate, commercial real estate, construction and development, mortgage-backed securities, corporate real estate, or investment funds. In other words, this book is designed to allow flexibility for instructors and students to cover a comprehensive range of topics or to emphasize only those topics that are the focal point of a specific subject.

Changes to the 2024 Release

In addition to the usual updating and fine tuning of chapters throughout the text, a major addition to this release has been adding learning objectives to each chapter. The end-of-chapter questions and problems are cross-referenced to the learning objectives. This should help readers know what the key concepts and calculations are that they should understand in each chapter. This also helps instructors to prioritize the learning objectives that they want to emphasize for their students.

We also included a discussion of the use of security token offerings (STOs) that allow fractional ownership of a property or portfolio with ownership recorded on a blockchain. While it is too early to know how prevalent this ownership structure will become, it is important for readers to have a basic understanding of how it works. Finally, we added a new section in Chapter 23 that discusses debt funds.

Excel Spreadsheets and RealNex Software

This book is rigorous yet practical and blends theory with applications to real-world problems. These problems are illustrated and solved by using a blend of financial calculators, Excel spreadsheets, and specialized software designed to analyze real estate income property. Excel spreadsheets, provided on the book's website at **www.mhhe.com/bfy2024,** are an aid for students to understand many of the exhibits displayed in chapters throughout the text. By modifying these exhibits, students also may solve many end-of-chapter problems without having to design new spreadsheets. The book's website also contains additional helpful materials for students and instructors. Using a password-protected instructor log-in, instructors can find a solutions manual, test bank, and PowerPoint presentations.

Students can also register online to get free access to a cloud-based real estate valuation program called RealNex. We chose this program because it is very easy and convenient to use by anyone with an Internet connection (including iPads and other mobile devices). RealNex is used in several chapters to supplement the use of Excel spreadsheets when doing investment analysis and solving valuation problems. Once students (or professors) register, they will also have access to data files that replicate examples in the book. Students can register at the following website: **http://info.realnex.com/edu**

A Note on Rounding Readers should note that they may get slightly different answers when solving some of the examples in the book or the homework problems due to how they rounded numbers when doing the calculations. For example, a loan payment might be calculated as part of a solution and then rounded to two decimal places before using the payment to calculate the loan balance. The answer to the loan balance will differ from the answer that would be obtained if the loan payment had not been rounded before calculating the loan balance. For example, they used a financial calculator or Excel to calculate the loan payment and then used that result (with all its decimal places) to get the loan balance. These differences are normal.

Supplements

Several ancillary materials are available for instructor use. These include

- **Solutions Manual**—developed by Jeffrey Fisher, William Brueggeman, and Stephanie Yates.
- **Test Bank**—developed by Stephanie Yates and Matt Haertzen
- **PowerPoint slides**—developed by Stephanie Yates

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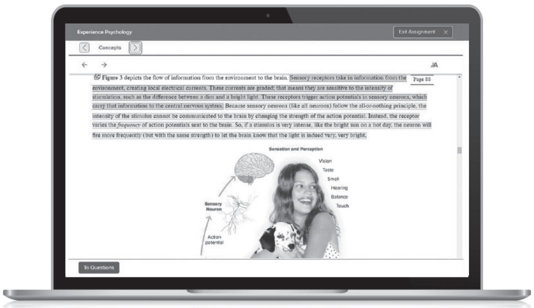

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