

# REAL PROPERTY INVESTMENT ANALYSIS

**Course Code: LaAd3082**

**Course credit:4**

# Unit 1: Nature of real Property Investment

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## Unit objectives

**After you complete this unit you will be able to;**

- Understand the concept of investment
- Describe idea of real estate investment
- Elaborate types of investment
- Discuss characteristics of real property investment

# 1.1 Introduction

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- Definition of Investment
- What do you mean by Investment?
  - We often speak of some sacrifice that we make as an "investment in the future."
  - Parents give up their time and resources now so that their children may go to college later.
  - Students (sometimes) give up concerts, parties, or other recreation to improve their academic outcomes later.
  - In both cases the individuals are judging that the value of what is gained exceeds the immediate cost being paid.
  - It is in this sense that we use the term investment

# Definition

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- The current commitment of funds for a **period of time** in order to **derive future payments** that will compensate the investor for:
  1. The time the funds are committed.
  2. The expected Inflation rate of that time.
  3. The uncertainty of the future payments.
- This rate of return that the investor demands for compensation as described above is known as the 'Required Rate of Return'
- You will invest when the expected rate of return is greater than the required rate of return.

# 1.2 Principles of Investment

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- The essential nature of any investment is the forgoing of a capital sum in return for a regular income over a period of time.
  - The prudent investor will consider the alternative types of investment by comparing each with the ideal investment
1. Security of capital in relation to ease of withdrawal

# Principles of investment...

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- The investor may, at some future date, need to transfer his investment back into cash at short notice
- 2. Security of income in relation to purchasing power.
  - Investors will wish to ensure that **the regular income can be maintained in the future.**
  - Income should increase sufficiently in the future to **counteract inflationary trends.**

# Principles of investment...

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3. Minimum **inconvenience** and **expense** in **management**
4. Minimum of **inconvenience and expense** in **selling**.
  - Investments in banks may be easily and cheaply converted into cash,
  - whereas conversion of those in **land and property** will prove to be more **costly and time-consuming**.

# 1.3 sources of investment

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The investor may have a number of alternative sources, such as

1. Banks and building societies
2. Stocks and shares
3. Unit Trust (mutual fund)
4. Land and property

# 1.4 The Idea of Investment

- Any decision that **involves significant costs now** for the sake of future **benefits**.
- We refer to such a **decision as an investment decision** and the value of the expected future benefits as investment *value*.
- Element of any investment decision
  - **the initial costs and**
  - **the value of the future benefits**
- investment decisions needs care- by their nature, they cannot be undone easily or without cost.

# The Idea of Investment...

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➤ What about the decision to purchase an expensive television set?

□ **Yes !**

➤ significant costs up front,  
➤ the benefits are spread over several years,

▣ In all of the cases the immediate **cost of an action** must be weighted against the (investment) value of **future resulting benefits**.

# The Idea of Investment...

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- True real estate decisions are about
  - acquiring,
  - financing,
  - using,
  - improving, and
  - disposing of actual real estate assets

# Investment value and Time

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- Real estate investment decisions- involve
  - present costs and
  - the value of future benefit
- So we must have a way of **converting future benefits to their equivalent value in immediate cash.**

# Investment Value and No monetary Effects

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- Even if the **costs and benefits** of an investment are no monetary-
  - the decision problem is still to weigh the costs against the value of the benefits.
- **no monetary:** real estate investment is the **choice of a home.**
- A home satisfies many needs beyond simple physical shelter, and many of these benefits are **very difficult to quantify.**
- The location of a home determines access to place of work, ...

# Incremental Investment value

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Incremental real estate investment decisions are quite common.  
Example

- **Homeowners Incremental Investment value**
- incremental decisions **regarding additions to an existing**
  - residence,
  - upgrading landscaping,
  - remodeling bathrooms,
  - remodeling a kitchen, or
  - rewiring
- ✓ **Compare the incremental value to the 'incremental costs involved..**
- ✓ In most cases, the cost of such home improvements can be quantified but it is more difficult is to quantity the value of the resulting benefits

# Incremental Investment value ...

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- The central benefit criterion is how the investment affects rental net income (income after expenses), and therefore value
- For example, an additional building would be expected to provide more space to rent and greater future net revenue.
- Many other **improvements** might make the **property more beneficial to tenants**, making them more willing to accept rent increases and perhaps less likely to move.
- Others may reduce operating expenses. For example, investments in improved fire safety or improved security may reduce the annual cost of hazard and liability insurance.

# Incremental Investment value ...

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- All of these kinds of **incremental investments** for income-producing properties have in common the objective of increasing net income. Thus,
  - ✓ **step 1:** in the analysis of incremental investments for commercial real estate **focuses on estimating the resulting increases in net revenue.**
  - ✓ **Step 2:** seeks to estimate the **cost of the improvement**, as in any investment analysis.
  - ✓ **Step 3:** of the analysis converts the **projected net revenue changes to incremental present value** so that they can be compared to their cost.
- If an analysis shows that the value of net revenue increases exceed cost, then the owner is made better off (wealthier) by engaging in the project

# 1.3 Types of investment

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## **Financial assets**

- Financial Assets are also known as paper assets.
- Financial assets contains a distinct promise.
- Some right is implied. Can be a right to certain or uncertain cash flow.
- Examples: Currency Notes, Equity, Bonds, Promissory notes and liability.

# Types of investment...

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## **Real estate investment**

- Real estate investments and financial investments are linked. The share issue of a firm finances the purchase of capital.
- The concern of this course real estate investment . It may be investment on the following property
  - ✓ Residential
  - ✓ Commercial
  - ✓ Industrial
  - ✓ Agricultural
- When you make an investment, it is important to consider the characteristics of the underlying real estate because the performance of those properties will impact the performance of your investment.

# Types of investment...

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- When you make **an investment**, it is important to consider **the characteristics of the underlying real estate** because the performance of those properties will impact the performance of your investment.
- When you're looking at the underlying real estate, one of the most important criteria (aside from location, location, location!) is the *type* of property

# Income-Producing and Non-Income-Producing Investments

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- There are four broad types of income-producing real estate:
  - ✓ offices,
  - ✓ retail,
  - ✓ industrial and
  - ✓ leased residential.
- There are many other less common types as well, such as
  - ✓ hotels, mini-storage,
  - ✓ parking lots

# Office Property

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- At its most fundamental level, the demand for office space is tied to **companies' requirement for office workers**, and the average space per office worker.
- The typical office worker is involved in things like finance, accounting, insurance, real estate, services, management and administration. As these "**white-collar**" jobs grow, there is greater demand for office spaces.

# Office Property...

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- Returns from office properties **can be highly variable** because the market tends to be sensitive to economic performance
- One downside is that office buildings have high operating costs, so if you lose a tenant it can have a substantial impact on the returns for the property.
- However, in times of prosperity, offices tend to perform extremely well, because demand for space causes rental rates to increase and an extended time period is required to build an office tower to relieve the pressure on the market and rents.

# Retail Property

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- The demand for retail space has many drivers. Among them are:
  - **location,**
  - **visibility,**
  - **population density,**
  - **population growth and**
  - **relative income levels.**
- from an economic perspective, retails tend to perform best in growing economies and when retail sales growth is high.
- Returns from Retails tend to be more stable than Offices, in part because **retail leases are generally longer and retailers are less inclined to relocate as compared to office tenants.**

# Industrial Property

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- Industrials are often considered the "stable" of the average real estate investor.
- Generally, they require
  - Smaller average investments,
  - Are less management intensive and
  - Have lower operating costs than their office and retail counterparts.
- There are varying types of industrials depending on the use of the building.

# Industrial Property...

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- Some important factors to consider in an industrial property would be
  - **Functionality** (for example, ceiling height),
  - **Location relative to major transport routes** (including rail or sea), building configuration,
  - **loading and the degree of specialization** in the space (such as whether it has cranes or freezers)

# Multi-family Residential Property

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- Multi-family residential property generally delivers **the most stable** returns, because
  - ✓ no matter what the economic cycle, people always need a place to live.
  - ✓ the loss of a single tenant has a minimal impact on the bottom line, whereas if you lose a tenant in any other type of property the negative effects can be much more significant
- commercial property types most operating expenses can be **passed along to tenants**.
- However in residential properties **-risk of increases in building operating costs is borne by the property owner for the duration of the lease**

# 1.4 Characteristics of Real Estate Investment

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- Physical control
- Durability
- High heterogeneity and price differentiation
- Limited market price
- High management requirements
- Inefficient market with high information asymmetries
- High transaction costs
- High capital requirements
- Low liquidity
- High Quality Segmentation
- High Location Segmentation

# Characteristics of Real Estate Investment...

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- Real estate provides a unique opportunity to earn superior investment returns
  - Fixed location implies each investment is unique
  - Long development period for new projects means markets are slow to adjust to new conditions
  - Private information can create profit opportunities
  - With development, you *create value*

# Advantage and Disadvantage of Real Estate as an Investment

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- Advantage
  - ✓ Good rate of return
  - ✓ Tax advantages
  - ✓ Hedge against inflation
  - ✓ Leverage : The use of borrowed funds to finance the purchase of an asset
  - ✓ Equity buildup
  
- Disadvantage
  - ✓ Illiquidity
  - ✓ Market is local in nature
  - ✓ Need for expert help
  - ✓ Management
  - ✓ Risk

**Thank you !!!**