

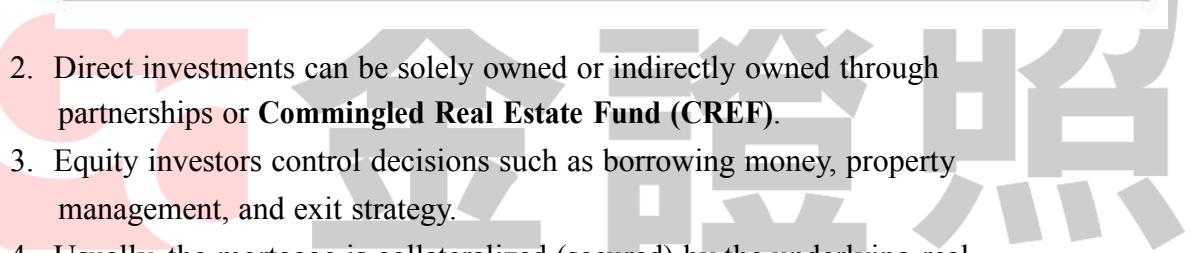
Study Session 13 Alternative Investments

Reading 38: Private Real Estate Investments

LOS a. classify and describe basic forms of real estate investments;

1. Basic Forms of Real Estate Investment

Exhibit 1		Examples of the Basic Forms of Real Estate Investment	
	Equity	Debt	
Private	Direct investments in real estate. This can be through sole ownership, joint ventures, real estate limited partnerships, or other forms of commingled funds.		Mortgages
Publicly traded	Shares of real estate operating companies and shares of REITs		Mortgage-backed securities (residential and commercial)

- 
2. Direct investments can be solely owned or indirectly owned through partnerships or **Commingled Real Estate Fund (CREF)**.
 3. Equity investors control decisions such as borrowing money, property management, and exit strategy.
 4. Usually, the mortgage is collateralized (secured) by the underlying real estate. The lender has a superior claim over an equity investor in the event of default.

LOS. b describe the characteristics, the classification, and basic segments of real estate;

1. **Heterogeneity:** No two properties are exactly the same.
2. **High unit value:** The unit value is significantly higher than stocks and bonds.
3. **Active management:** Private real estate investment requires active property management (e.g. maintenance, negotiating leases and collection of rents).
4. **High transaction cost:** Buying and selling real estate is costly (including appraiser, lawyers, brokers and construction personnel).
5. **Depreciation and desirability:** Building wear out over time and may become less desirable.

6. **Cost and availability of debt capital:** Real estate values are usually lower when interest rates are high and debt capital is scarce.
7. **Lack of liquidity:** Real estate is illiquid.
8. **Difficulty in determining price:** Because of heterogeneity and low transaction volume, appraisals are usually necessary to assess real estate values.

Los c. explain the role in a portfolio, economic value determinants, investment characteristics, and principal risks of private real estate;

Los l. explain the role in a portfolio, the major economic value determinants, investment characteristics, principal risks, and due diligence of private real estate debt investment;

1. Why Invest in Real Estate

- (1) Current income
- (2) Capital appreciation
- (3) Inflation hedge
- (4) Diversification
- (5) Tax benefits

2. Risks

- (1) Business conditions
- (2) Long lead time for new development: New development projects typically require a considerable amount of time from the point the project is first conceived until all the approvals are obtained, the development is complete, and it is leased up. During this time, market conditions can change considerably from what was initially anticipated.
- (3) Cost and availability of capital
- (4) Unexpected inflation
- (5) Demographic factors
- (6) Lack of liquidity: Illiquidity means both a longer time to realize cash and also a risk that the market may move against the investor. A quick sale will typically require a significant discount.
- (7) Environmental issues
- (8) Availability of information
- (9) Management expertise
- (10) Leverage

Los d describe commercial property types, including their distinctive investment characteristics;

1. Office:

- (1) Demand is heavily dependent on job growth, especially in industries that are heavy users of office space like finance and insurance.
- (2) **Gross lease:** The **owner** is responsible for the operating expenses.
- (3) **Net lease:** The **tenant** is responsible for the operating expenses.
- (4) **Combined:** The owner might pay the operating expenses in the first year of the lease. Thereafter, any increase in the expenses is passed through to the tenant.

2. Industrial:

- (1) Demand is heavily dependent on the overall economy.
- (2) Demand is also affected by import/export of the economy.
- (3) **Net leases** are common.

3. Retail:

- (1) Demand is heavily dependent on consumer spending. (overall economy, job growth, and saving rates.)
- (2) Retail tenants are often required to pay additional rent once sales reach a certain level.
- (3) **A percentage lease or percentage rent:** Retail tenants are often required to pay additional rent once sales reach a certain level.
(Minimum rent + percentage rent)

4. Multi-family.

- (1) Demand depends on population growth, especially in the age demographic that typically rents apartments.
- (2) Demand is also affected by the cost of buying versus the cost of renting, which is measured by the **ratio of home prices to rents**.

Los. e compare the income, cost, and sales comparison approaches to valuing real estate properties;

1. Real Estate Appraisals

- (1) **Cost approach:** A buyer would not pay more for a property than it would cost to purchase land and construct a comparable building. The cost approach is most useful when the subject property is **relatively new**.
- (2) **Sales comparison:** A buyer would pay no more for a property than others are paying for similar properties. The sales comparison approach is most useful when there are **a number of properties similar** to the subject that have **recently sold**. (single-family homes)