Why Real Estate Finance?

*Investment Real Estate: Finance and Asset Management, Second Edition* explores the major topics of financial analysis and asset management from the perspective of the professional real estate manager. Many successful real estate managers consider “financial analysis” to be a process that begins and ends with the *annual budget*. Budgets are indeed a critical component of a real estate manager’s role, which will be explored in detail; however, the role of the real estate manager continues to evolve and become more complex. Real estate managers today work in widely varying business environments. Within those environments, client needs have changed, and the sophistication of owners continues to grow as knowledge and information become more readily available through experience, technology, and networking channels. Real estate managers should be looked upon as one of several resources a client looks to for information, and the manager must always maintain a breadth of knowledge and applicable skills to be part of the analytical discussion.

Simply put, property owners have high expectations of real estate management professionals. Therefore, having a strong knowledge of finance is an advantage that can enhance relationships with clients. A steadily growing number of informational resources are available to investors, accountants, attorneys, appraisers, mortgage bankers, mortgage brokers, real estate brokers, and the real estate investment community as a whole, with varying levels of expertise in real estate finance. Real estate managers must have the requisite knowledge to participate in conversation, including synthesis and analysis of financial information, with other members of the real estate investment community, clients, and property owners.

Further, real estate management software has evolved—from single-purpose, single-user accounting programs to comprehensive multi-user suites that allow for input of data, full marketing and financial analyses, centralized data processing, and decentralized data input from many sources. Failing to understand a property from the perspective of investors and lenders will reduce a real estate manager to an operational specialist, unlikely to be granted a seat at the table with decision makers. Therefore, real estate managers play a key role in preserving and enhancing the earning power of a real estate investment, and ultimately an investment’s value. Experience, knowledge, and skills that are kept current are critical to being competitive and respected.

“How you perform as a real estate manager—NOI increases, vacancy decreases, and really looking at your budget fundamentals—has a direct impact on the value of your property. I would rather take a mediocre property and a top notch manager (preferably a CPM®) than a top notch property and a mediocre manager any day.”

– John D. Clayton, CPM®, Little Rock, Arkansas
OWNER’S GOALS AND OBJECTIVES

While most investment property owners seek to make a profit from their investment, each owner will have specific goals they wish to attain during the term of his or her investment. During conversations and interviews, real estate managers must gather information needed to identify an owner’s goals and objectives for a property.

Investors purchase income-producing real estate for two primary reasons: (1) speculation and (2) investment. Real estate speculation offers an investor the opportunity to take a high risk and potentially receive a high reward during a relatively short holding period. The return is typically achieved at the time of sale from the profit made in selling the property. Flipping of single-family homes and renovation on small commercial properties are examples of short-term, speculative investments. On the other hand, long-term investments typically extend for five years or more. The acronym “SPLAT” summarizes the following five fundamental investment objectives:

Safety (or capital preservation)—an owner may want to protect a principal investment by acquiring high-quality real estate that will hold its value over time. The property may not provide a strong return, but should retain its initial value. Simply being in a superior location may appreciate the value of some properties, even when the owner makes no further investments.

Periodic return (cash flow)—an owner may purchase or develop real estate to obtain a steady source of income over a specific period of time. The cash flow will provide a rate of return that can be compared to other investments and is enhanced by the tax shelter effects of the real estate, such as cost recovery or depreciation. The strength of a rent roll or market greatly affects the quality of the cash flow received.

Example

Sue Evans has been developing small office buildings for several years. As the developments are more successful, she has been paying down the mortgages on the property. Her goal is, upon retirement, to have little burden of debt and be able to rely on the income from the properties to fund her retirement. Altogether, Sue’s goal is to have a strong periodic return to make this happen.

Leverage (using borrowed funds)—the assumption with leverage is that the return on the real estate investment exceeds the cost of borrowed funds. By using leverage, an owner can control and increase property value with minimal capital.
Appreciation of capital appreciation (hedge against inflation)—during inflationary times, when wages are increasing, residents and tenants leasing real estate expect their rents to increase as well. This, in turn, creates a higher rent value and a higher value to the property.

Jeffrey Yates has a portfolio of numerous investments, including bank-issued certificates of deposit (CDs), treasury bills (T-Bills), publicly traded stocks and real estate. His strategy is to use the T-bills and CDs as a safe investment vehicle where the principal is always available. He trades stocks and likes the earnings when the market is strong, but does not like its volatility; however, his real estate investments tend to be very stable investments. Property values continue to increase, which build his financial wealth and give him tremendous flexibility to sell or refinance as his needs change.

Tax shelter (income tax advantage)—an owner may want to defer recognition of income through a deduction of cost recovery (or depreciation). It allows the owner to pay less income tax each year than might occur with alternative investments. Prior to the 1986 Tax Act, real estate was highly subsidized through tax policy. Tax benefits remain with real estate investment, but it is no longer a prime reason to buy real estate—explained further in later chapters.

Julia Williams has owned an office building for several years; it produces taxable income. She has the opportunity to purchase a multi-family building that is experiencing lower occupancy due to freeway construction in the area, which is projected to end in three years. It generates a moderate before tax cash flow (BTCF), and it is expected to rise significantly when construction ends. After cost recovery, the multi-family building will produce a taxable loss, which can offset the taxable income of the office building income, thus, improving her rate of return after tax.
In addition to these fundamental financial reasons for real estate investment, many investors also enjoy the pride of ownership from their income-producing properties. This pride motivation will normally own a high-profile, well-maintained building, and may display a name.

What distinguishes speculation from investment? Though the answer is not always clear, one distinct factor is cash flow. A property with a negative cash flow could be one used for speculation. This is the case when an investor buys a rental building with negative cash flow in anticipation of rehabbing or re-tenanting to provide higher returns. Due to the risk of speculation, the return is expected to be greater. An effective real estate manager understands the mix of the various relevant elements as they relate to an individual investor’s risk tolerance.

Once an owner’s goals are known, real estate managers use financial tools to make decisions or recommend courses of action that best meet the goals of a real estate owner. The following lists a few examples of questions that may be asked of real estate managers:

- What improvements will result in the highest rents?
- Can operating costs be reduced?
- Should an owner pay cash for improvements to a property or finance them?
- Is it a good time to consider refinancing a loan?
- How can the developer’s vision best be realized?
- What will next year’s operating expenses be?

Many property owners—especially investors with small portfolios or those who purchase real estate as an alternative investment—have difficulty articulating their goals. It is not uncommon for such owners to express goals that are difficult to quantify, such as:

- “I want to make money.”
- "I want full occupancy."
- "I don’t want to fund negative cash flows."

While remarks like these may give some guidance, it would be difficult for either a real estate manager or an owner to measure performance based on this type of statement. Therefore, real estate managers should attempt to obtain measurable financial goals from a property owner by asking specific questions related to investment objectives. Real estate managers must then be able to transform these expectations into quantifiable, measurable goals and understand how these impact property value. Once goals are quantified, managers have the necessary data to measure property performance and make operational refinements to best achieve goals and reassure ownership of his or her ability to build, maintain, and enhance the value of a real estate asset.
... when addressing the property owner's goals regarding his or her asset:

**The Asset**

- How long have you owned the asset?
- What was your purchase price and original equity? Do you have an estimate of your current equity?
- What are the terms of the existing loan?
- Do you have a recent appraisal?
- Have you completed or contemplate any recent capital improvements?
- Is there a capital improvement plan?
- The property inspection revealed some potential capital improvements, are you open to discuss these?
- What is your opinion of the physical condition of the asset?
- What is your perception of growth opportunities for the asset?
- How would you describe the on-site staffing culture of the property? Do you feel the current staff meets the needs of the asset?
- Do you have any preferences relative to marketing, such as maximum rent/revenue versus maximum occupancy?
- What are your financial goals of ownership?

**Investment Objectives**

- Based on current market conditions, we have estimated your equity to be $____ does that seem reasonable to you?
- What are your expectations for returns on/of your investment? Do you have any specific target returns you are expecting on your equity?
- Do you have access to capital to make any improvements, such as cash investments, or borrowed funds? If so, how would you evaluate such an improvement? (Payback? IRR? Value enhancement etc?)
- How long do you plan to hold the asset?
- Do you have an exit strategy?
- Do you expect to receive cash payments from the asset? What approximate amount? How frequently?
- To the extent we need to know, are there additional investors or stakeholders? If so, how is the equity stack organized, and will we have any direct responsibility to these investors?
THE ROLE OF THE REAL ESTATE MANAGER

The expert real estate manager not only analyzes data, but is the source of operational data. The real estate manager oversees the following items:

- Receipt and accounting of rents
- Budget development
- Maintenance arrangements
- Payment of operating expenses,
- Preparation of financial reports

Having an ability to prepare long-term operational and financial plans for a property requires a strong, working knowledge of real estate finance.

Real estate investment financial packages are analyzed with the fundamental assumption that a property is, or will be, under prudent and competent management. All other projections and assumptions are based upon this premise. The profession of real estate management is often taken for granted and treated as a commodity; however, it is far more than a commodity. Real estate management requires specific skills and knowledge, stewardship of resources, awareness of the market, understanding of buildings, and familiarity with the overall economy. Most of all, it is knowing the impact of various decisions on income and value of an investor’s property.

Operating properties with sound budgeting skills is a key component of success. Actions by real estate managers to maximize revenue, implement rent increases, and minimize vacancy while carefully tracking operating expenses and maintaining properties at market standards significantly influence outcomes. Working knowledge of financial management provides methods to gauge a real estate manager’s effectiveness to build, maintain, and enhance an asset’s value. That knowledge is a critical component of the long-term management plan, coupled with analytical skills, used to make recommendations for a property’s future success. Real estate management is more than analysis—it is the combination of analysis, synthesis, and implementation conducted at a property.
The principles of real estate finance provide a common language for analysis. Understanding the language of real estate finance not only makes communication among colleagues possible, but it also has a benefit to students and persons starting or expanding a career in real estate management. The skills used for financial analysis are transferable among disciplines. A person with a solid understanding of the financial principles of real estate and land economics can, with some additional training, be well suited to practice in any of the related real estate professions.

REVIEW QUESTIONS

1. What are the benefits of a real estate manager’s ability to complete financial analysis?
2. What are the two reasons why investors purchase income-producing real estate?
3. When purchasing properties for investment purposes, what are the five fundamental objectives that the owner expects to satisfy?
4. Why is it important to know an owner’s goals and objectives for a property?
5. What is the typical role of a real estate manager?