Chapter 4
The Real Estate Investment

Abstract The chapter deals with the characteristics of the investment property. The specific risks associated with the investment property are shown, as well as the advantages and disadvantages compared to other types of investment. The meaning of investment value is explained in general and, with reference to real estate investment, the parameters that affect this value are identified.

4.1 Features of the Property Investment

The investment involves the sacrifice of something in the present (not only economic resources) with the prospect of obtaining benefits in the future. These benefits can occur in three ways:

- An income stream;
- A return of capital;
- A psychic income (Baum and Crosby 2008), a feeling of satisfaction induced by the possession of an investment project.

The first two factors are those assets that underpin the investment analysis. The last factor cannot be measured in monetary terms, but its importance for the investor can also be significant. The psychic income assumes, in general, the form of prestige value that adds value to the quality of the investment property.

No discussion on the subject of investing in real estate can disregard a fundamental consideration: Each property is unique and therefore requires a specific analysis of its characteristics (in particular, those related to the place where it is located). However, the value of a real estate investment is influenced by elements that can be considered common to all types of operations of this sector. Some of these features have already been introduced above and are repeated in Fig. 4.1. The fixed position, already discussed, then determines that:

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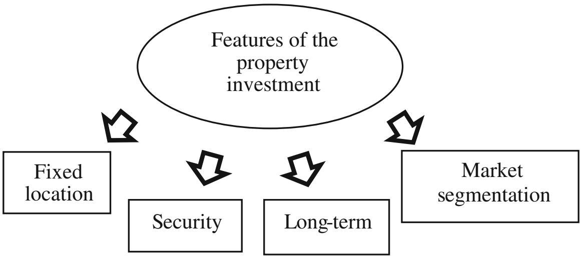

Fig. 4.1 Features of the property investment

- The marketability of the property is greatly reduced when compared to goods that can be easily transported from one market to another;
- The value is subject to any change of a political, economic and demographic nature that regards the market area in which the property is located.

Furthermore, the fixed location is one of the factors, along with the permanence of the land, which makes real estate the best guarantee for mortgage financing. These are important elements of the investment property, which by its nature involve rather large amounts of money. The use of financial instruments determines an additional cost to the investor.

The investment in real estate, in relation with to the permanence of the land and the long duration of the structures built on it, is considered a long-term investment. Precisely the longevity of the property as well as the features of the real estate market allows investors to assess, obviously not without risk, the present value of the income stream that the property will produce in the future.

Another characteristic of the real estate market that strongly influences investment decisions is the segmentation. The real estate market is a combination of submarkets divided by product type (apartments, commercial or industrial premises, etc.), by quality and by location. These sub-markets react promptly, but not in the same way, to changes in local economic and social activities.

Further elements that contribute towards the complexity is the lack of standardization of the product and the tendency of some operators to act in an intuitive way, paying little attention to formalized methods of study of financial feasibility. It is an attitude that feeds the market imperfection and does not give the option of checking, exploiting the advantages of a serious analysis, the risk involved in the investment.

The risk factor, despite the common idea of security associated with the investment property, greatly affects the feasibility and profitability of an operation. There are many risk classifications in the literature. One of these refers to the diagram of Fig. 4.2 (Sirota 2013).

The structure proposal is very simplified, but lists some of the most important risk factors to be taken into account in the choice of an investment. In the following paragraphs, the risk factor is better analysed.

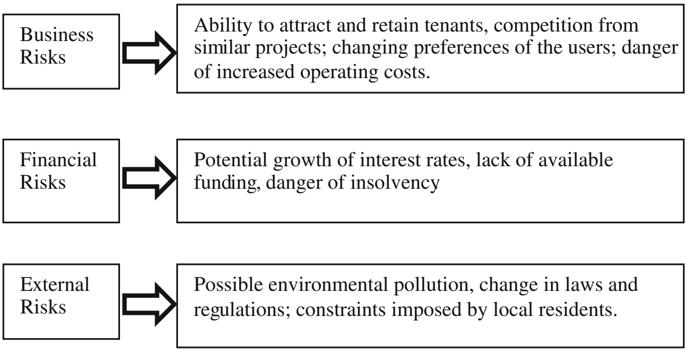

Fig. 4.2 Risk classification

4.1.1 Classification of Investments

The interventions of real estate development can be distinguished, depending on the financial characteristics, into three main classes: commercial, almost commercial, non-commercial (Fig. 4.3). The first category, which focuses on this exposure relates to those initiatives that aim to achieve a return in terms of income, or any other monetary benefit. The investments of a commercial nature against the performance of a set of activities and operations using a limited amount of resources will have to produce goods able to be absorbed advantageously by the market. It is therefore necessary to acquire a thorough knowledge of the quality and quantity of the product to offer, the price of use and exchange, marketing conditions, and future demand.

4.2 The Reasons for the Investment

The primary reason for investing in real estate is undoubtedly the almost absolute certainty of the preservation of the capital invested. It is observed that the values of the properties fluctuate according to the cycles of the local market; however, they still show a tendency to increase in the long term. Consequently, the real value of the capital invested, is guaranteed. A study on the Italian real estate market (Manganelli and Tajani 2010) has identified inflation as the macroeconomic variable that has the most influence on the dynamics of quotations related to the residential market. The relationship between the latter and the values of the residences is reversed, this confirms what has just been mentioned, namely that property is considered a good investment that will protect the capital from the phenomenon of inflation.

Another reason, complementary to the first, which in fact motivates each type of investment, is the expectation to make a profit on the investment.

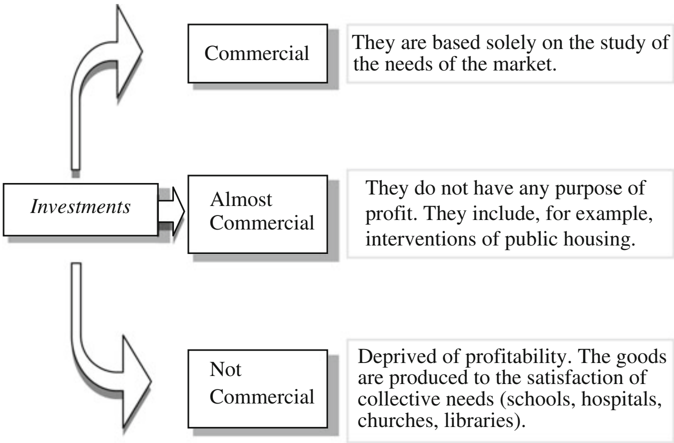

Fig. 4.3 Classification of investments

Thus, real estate investment can take on two forms. The first comes from the income stream that is obtained by renting the property. From gross income, derived from the payment of the fee, operating expenses necessary to maintain the value of the capital invested must be deducted. When the property is sold, the sale will allow for the recovery of the invested capital and a further gain following an increase in the real value of the property will be obtained at the end of the holding period. This gain (capital gain) is the second form of profit that the investor aims at.

Figure 4.4 shows that the first form of profit (rental income as a percentage of invested capital) is not very variable over time. The estimate of the cash income generated by the property can therefore be regarded as affected from a low degree of uncertainty. On the contrary, the rate of profit is very variable, and is related to the capital gain, which in particular economic conditions or if sales were to occur in the descending phase of the real estate cycle, could turn into a capital loss. This variability is therefore one of the elements that characterize the riskiness of the investment property.

4.2.1 Advantages and Disadvantages of Investment Property

Because of what has been described, one can deduce that the most important advantages of this form of investment are related to the ability to preserve capital by inflation, connected to a low risk profile, which has a good chance of funding being provided.

To these advantages, there should also be the possibility of investing in real estate to have a significant personal control over project management and capital invested. The investor; throughout the holding period, can and must make decisions about the best financing necessary for the acquisition of the property, the

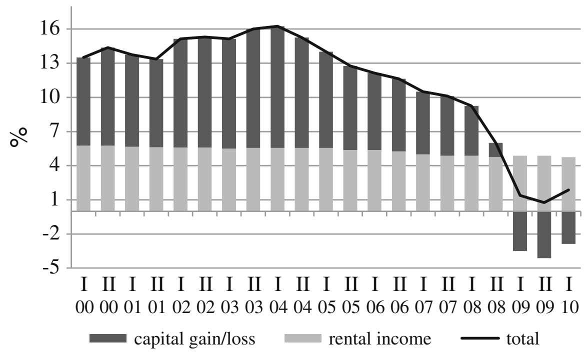

Fig. 4.4 Returns on investment in real estate

Fig. 4.5 Trends in real estate prices and stock market in Italy

administration that ensures the achievement of the objectives, the terms of the sale of the project, etc. The many variables that one can handle, allow to fully control the entire development investment.

Finally, among the reasons that can justify investment in real estate, especially for those who want to make their portfolio efficient, there is certainly a low correlation with other investment opportunities[1] (Fig. 4.5).

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[1] While on the stock market, data on returns and trading are widespread minute by minute, the price index and therefore the information on revenues from investment property is updated according to estimates on a weekly, monthly or semi-annual basis. This causes a leveling out of the performance of these indexes and makes it seem as though the real estate returns are less volatile than what they are shown to be, through a more frequent updating of the values. However, such comparisons, though flawed, are essential for decision-making in the management of a portfolio. In the United States, the strong involvement of institutional investors in the real estate business has greatly contributed to the development of methods for comparison between different types of performance. In any case, the success of these techniques is subject to the update rate of the data.

However, some disadvantages characterize investment in real estate. While it is true that real estate investing allows for a high personal control, on the other hand, the investor should be ready to have a more active role in managing the investment.

Another disadvantage is connected to the characteristics of the property (non-transferable and indivisible) and the resulting strong segmentation that reduces the size of the reference market. It may therefore occur that a property up for sale is not sold immediately. The real estate investment therefore has a poor attitude to be readily converted into cash and, as mentioned above, there are no certainties with respect to the final sale price; it may happen that the sale occurs with loss of value. This feature is called liquidity of the investment and it distinguishes this investment, little liquid, from other types of investment, which are carried out on very vast markets able to quickly absorb the trade orders.

Real estate is among the most common opportunities, the investment is distinguished by the lowest degree of liquidity.[2]

In addition to the lack of liquidity, investment in real estate has a negative feature: that of requiring the use of large amounts of money for the acquisition of property. While it is possible to resort to relatively important financial levers, this does not waiver the investor from the significant commitment of funds. The purchase costs are added to the considerable costs for market analysis and to the transaction costs.

Real estate should continuously be subjected to routine maintenance and repairs, in order to maintain the property's value over time. This involves expenses incurred but necessary to ensure an adequate flow of rents and subsequent to meeting the needs of the tenants. In other words, the real estate investment requires active participation by the investor. Such management can be transferred to a professional who is responsible for administering the property on behalf of the investor, but the expenditure for this service would affect the income stream.

The commitment of the owner may also occur through forms of personal involvement in dealing with tenants and/or with the administration building. It must be said that these relations are not always simple and rewarding, and indeed can become stressful, especially in situations of disagreement. Exposure to complaints of tenants and the problems of Property Management act as a deterrent to investment property.

Likewise, if on the one hand the risk profile of the investor in real estate properties is quite low, the need for strong employment of capital involves excessive concentration of risk. The same capital could be used in more investment opportunities thus differentiating the risk, or remaining in the same industry

[2] Fraser (1985) asserts that the importance of the liquidity factor is mitigated by the fact that the transactions are less frequent than those of the securities market; likely, however, the low frequency of the negotiations was due to reduced liquidity. On the issue of liquidity and how this feature of the housing market is related to the labor market and geographical mobility; see also Head and Lloyd-Ellis (2012).

Table 4.1 Executive summary of the characters of an investment property

Advantages/Benefits	Disadvantages/Costs
Good protection against inflation	High entry threshold
Risk/return profile intermediate between stocks and bonds	High costs of research for market analysis and high incidence of transaction costs
Low correlation with other forms of investment	Excessive concentration of risk
Large market size (segmented by size, intended use, geographic area, etc.)	Stiffness: the leases are long-term
Funding opportunities	Low liquidity
High degree of personal control	Constant commitment management

but amplifying the use of capital, one should be buying more "diversified" real estate for use and location to have an efficient portfolio.

Even the guarantee of a future income that varies slightly due to the fact that it is tied to a lease contract, which is usually long-term, reduces the risk in the financial analysis of the investment. On the other hand, under favourable economic conditions the same condition would force the loss of possible higher profits. Table 4.1 shows a summary of the aspects that distinguish the real estate investment.

4.2.2 The Value of Investments

The investment choice is the result of an evaluation. The latter, in turn, precisely because it is developed to support a choice, is an evaluation of economic convenience.

Evaluations of economic convenience are distinguished from the "estimates" the results of which are generally valid, that is, accepted by the majority of the market operators. However the evaluation of convenience always refers to the person who commissioned it (to his economic characteristics, to his attitude to risk, to his managerial skills, etc.), it is specifically valid and always involves a comparison between alternatives. Of course, the alternative may be configured with another investment opportunity or with zero alternatives; that is, decide not to invest.

The same property subject of the investment, when placed on the market for sale, is then subject to a valuation aimed at the prediction of the most probable market value. The seller is interested in knowing the equivalence between the property and the amount of money that will allow the exchange, on the valuation date (or in the near future), with an independent party interested in buying after adequate marketing, during which the parties (seller and buyer) act with equal capacity, prudently and without compulsion. Likewise, an investor interested in entering the same property in his portfolio will evaluate the convenience to buy.

This evaluation involves a comparison between the market value and the investment value. A particular investor attaches this value to a property for specific operational objectives.

The value of investments is therefore not related to the most probable market value. It measures the importance, for the investor, of the flow of benefits that the property will produce in the future; therefore, it reflects the assumptions that the investor makes about:

- The ability of the property to produce income;
- The most likely holding period;
- The final sale price;
- Taxation;
- The financing instruments available.

These factors influence the net benefits arising from the ownership of the property. Because some of these elements depend on the economic and fiscal investor's condition; the investment value is specific and different for every investor.

It corresponds to the highest price that the investor is willing to offer for the purchase of property as the result of an analysis that involves, along with the variables listed above, the expectation of profit.

The buyer, on the other hand, is opposed to the seller who considers the costs and benefits associated with the maintenance of the property or divestment. If the value of the buyer's investment V_b is higher than that of the seller V_s (Fig. 4.6), there are the conditions to materialize the sale of the property, at a price that will be placed within the range of fluctuation defined by V_b and V_s The final price (net of transaction costs) will depend on their ability to conduct the negotiations, but certainly both the seller and the buyer will benefit from the deal.

The investment value is the result of a decision process developed with reference to specific individuals that engage in the following parameters:

- Amount of future benefits expected;
- Distribution of benefits over time;
- Confidence in earnings forecasts;
- Willingness to take risks;
- Return of investment alternatives.

Thus, for a given level of demand for space (from which the prediction of the potential profitability ensues), the real estate investor can establish a maximum threshold price deemed appropriate for the purchase of property to which it is concerned. When this value is higher than the market price, the investor may find it convenient to include the property in his portfolio. On the contrary, he might decide to sell when prices rise above his investment value. Clearly, if there is a greater difference between the most likely market price and the value of individual investment, there will be a greater potential profit for the buyer and the seller. However, the factors that affect the value of investment (rents, operating expenses, income taxes, and cost of capital) also affect the most probable market value. That

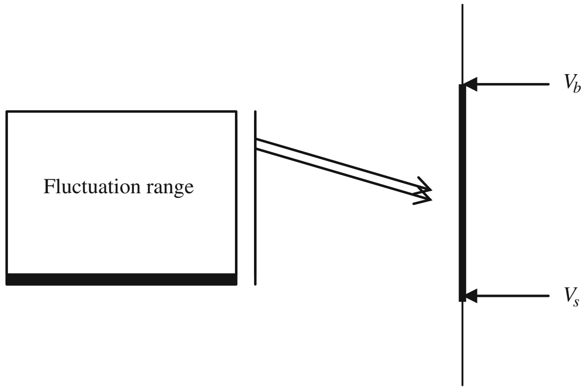

Fig. 4.6 The investment value

is to say that when the values of investment of market operators vary, buying activities cause movements in the same direction even in market values.

If the factors that influence investment values cause immediate changes in market values, the opportunities to achieve extraordinary profits decrease. However, if market values move with a certain delay, there will be more opportunities for profit.

The speed with which the market values react to changes to new information and to changes in demand is a measure of market efficiency. A market is efficient when all relevant information is an immediate effect in the prices. Those who work in an efficient market do not have the ability to make gains consistently above average. The possibility of extraordinary profits intervenes when few individuals know the relevant information.

4.2.3 Comparison with Other Types of Investment

The evaluation of an investment is—as mentioned—an evaluation of cost-effectiveness and as such involves a comparison with other alternatives or with zero-alternative. Before investing funds in the construction of a real estate project or purchase of a property, the investor should carefully consider the returns obtainable from other types of opportunities: bank deposits, stocks, bonds, government bonds, life insurance, etc. However, it should be stated that an immediate comparison between the returns obtainable from property investments and those of equities, bonds and other financial products, is hardly feasible, taking into account that the comparison should be developed, based on the characters that denote the level of investment risk. Among the financial products, government bonds are those to which a risk profile, very close to the ordinary real estate investor, is associated: they should also offer capital protection and the opportunity to make a profit. Nevertheless, an investment in property, capable of generating a certain annual profitability with the ability to recover capital at the end of the holding period, is only apparently similar to investing in government bonds. One must remember that real estate investment involves a higher level of risk. The increased risk is related to the daily management of the property, the likelihood of collecting the rents according to the expected amount and the scheduled time, the future possibilities of actually recovering the investment and other unforeseen circumstances.

The effort required to personally manage the investment, the lack of liquidity and higher risk therefore imply the convenience of this investment, as an alternative to investing in government bonds, only in the event of a higher return compared to the last.

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