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Buying Property Requires a Plan

Investment by Design

By Wayne E. Etter

Evaluating the potential of a proposed real estate investment requires a carefully designed, analytical plan. By logically arranging a series of questions, a plan can be developed that minimizes the chance of overlooking an important fact about the property.

Questions are answered through a careful evaluation of the specific data assembled for the analysis. When there is a lack of data, no further consideration should be given to the proposed real estate investment until the data are available; the temptation to ignore the question must be resisted. Of course, prior to beginning the analysis, the investor must establish criteria for evaluating whether or not an answer to a question is satisfactory. Although there can be any number of questions, they can be considered under four broad categories.

Determine Market Support

The presence of sufficient market support is determined by analyzing the supply and demand for space within a defined market area. Factors that define market areas vary according to property type; a retail space market is defined differently than an office space market. In no case are market areas defined simply by drawing circles having radii of one or two miles. Within a defined market area, the supply and demand for space for particular market segments is then identified.

What types of space are available in the market? How much space of each type is available in the market? What types of space users are in the market now? What types of space are in demand? What changes in the demand for space are foreseen? What is the underlying cause of the expected change in future demand? Is an expected increase in the demand for space related to the expansion of businesses within the market area that will require additional office space? Or, is an expected increase in the demand for retail shopping space related to an increased residential population in the market? When will there be a need for additional space?

By answering these questions, **the investor can determine if there is an unmet need for space** in the market area. If so, the research should conclude with an estimate of the number of square feet of space required and the price users are willing to pay for it.

Marketing research usually is thought of in connection with new developments. Developers, lenders and investors want to know if there will be sufficient demand for the to-be-built space. But marketing research can play an equally important role when an investor is considering changing a property's existing use or when an investor is considering investing in a property when the use will remain the same.

How does "choosing a good location" differ from marketing research? Good locations are important and are based on the needs of particular activities. For instance, certain commercial activities require minimum lot sizes along a major arterial street with particular kinds of ingress and egress. Additional requirements may include easy access to wholesalers, shippers, customers or market centers. Locating such a site does not automatically make it suitable for the activity, however. **There must be adequate demand for the space; a good location cannot assure demand.**

What are the benefits of good marketing research? Obviously, identification of an unmet need increases the probability of success. Professor James A. Graaskamp suggested the identification of an unmet need provides a competitive edge for the investor that can result in a fully leased property – perhaps at a premium rent. This competitive edge provides the best defense against future properties entering the market – satisfied tenants are less likely to move to a competing property. Because a property's value is a function of its ability to generate rent, an increased rent results in an increased value. Ultimately, the investor will enjoy a greater rate of return from the identification of an unmet need.

In addition, marketing research can protect against the consequences of the competitive price cutting that takes place in overbuilt markets. Although reducing the rental rate in an overbuilt market may cause some additional space to be leased, the lower rate also may result in less total rent being collected. For example, decreasing the rental rate for retail space will bring some additional space users into the market, but it is unlikely to result in substantial numbers of entrepreneurs deciding to enter the retail business or encourage existing retailers to expand. These decisions will depend on factors other than the price of retail space.

Furthermore, because all other owners will likely decrease their rental rates as well, the rental income of all owners will decline if the average market rental rate declines sufficiently. Thus, price cutting by the owners of vacant retail space in such a market will neither significantly increase the demand for space nor provide the investor with a superior competitive position. Good marketing research can help an investor avoid overbuilt

markets. If there are no strong indications that the investment under consideration will fill an unmet need, it should not be given further consideration.

Test Financial Feasibility

The investor, having established that a particular property will fill an unmet need, next tests the project's financial feasibility. **If the property can generate adequate net operating income to support sufficient debt to finance the property and provide a satisfactory cash return to the developer-investor, the project is financially feasible.** This is a test of the property's ability to generate adequate cash in the short run. Making this determination requires answers to questions such as: How much will the project cost? How much rent will the project produce? What are the expected operating expenses? How much net operating income will the project generate? Given current market conditions and lending requirements, how large a loan will the net operating income support? And, given the estimated cost of the project and the desired equity contribution of the developer-investor, can the project be financed? A project's financial feasibility is best explained as a balance among the:

- property's expected cost,
- property's expected operating performance,
- lender's requirements and mortgage market conditions and
- investor's required before-tax, cash-on-cash return.

If there is a proper balance among these factors, the property should generate enough rent to pay all the operating expenses, to repay the debt used to finance the property and meet the investor's expected cash return. Properties that do not meet this test have little promise even when there is a demand for the space. **And, when properties promise little in the short run, it is risky to assume that they will improve in the long run.** If, however, an investor determines there is both a demand for the space and the property is financially feasible, the analysis moves to long-term considerations,

Is After-tax Return to Equity Sufficient?

The expected after-tax rate of return from a real estate investment is determined by the expected benefits of the investment – after-tax cash flow and appreciation – and the cash required to purchase the property. **The expected rate of return can then be compared with the minimum return the investor requires to undertake the investment.** The investor's required return is established by examining the returns available from other investments having a similar level of risk.

A proper calculation of the rate of return involves the use of present value techniques so that the rate will reflect both the amount and timing of the cash inflows and outflows. This rate is known as the internal rate of return.

Why must the project's after-tax internal rate of return be considered even if the project is financially feasible? The investor's required return, as used in the determination of financial feasibility, is based on a single year's before-tax income – it is a short-term measure and does not encompass the period during which the investment is expected to be held. As a consequence, the investor must consider the effect of taxes, financing and future events on the property; this is the essential contribution made by the after-tax internal rate of return calculation.

Real estate is particularly affected by future events because of its characteristics: large economic size, physical immobility and long economic life. In short, a property investment involves a relatively sizable dollar investment that cannot be moved and that must generate income during a long period. Thus, successful real estate investing involves making decisions about the future level of rents, operating expenses, appreciation rates and tax laws. These, in turn, depend on the rate and direction of urban growth, price inflation, international events, political events and so forth.

As the information is gathered, the investor necessarily will be addressing questions about risk. Risk exists in all projects, but some are more risky than others. The degree of risk depends on the difference between expected and actual outcomes. If the expected outcome is guaranteed, then the risk is negligible; if there is substantial uncertainty about the expected outcome, then the risk is great. For a single project, the best way to reduce risk is to improve the analysis of the variables that produce the project's expected rate of return. In this way, the spread between expected and actual outcomes can be minimized.

As the scope of discounted cash flow analysis is examined, one of its prime benefits becomes clear. **In gathering the data required to make the analysis, much will be learned about the investment under consideration.** Estimating the rate of return may be secondary to the knowledge gained from gathering the information. Nevertheless, the prospective investment must promise a satisfactory rate of return or its consideration should be abandoned.

Compare Value to Cost

The investment value of any asset is equal to the present value of its future cash flows, discounted at the appropriate rate. A property's investment value is not the same as fair market value or loanable value. It is the value that an investor determines after establishing a set of investment requirements and expectations about the property; this value is compared to a property's offering price or cost to see if it exceeds the cost of the property.

The investor anticipates cash benefits in the form of after-tax cash flow and appreciation. The lender generally receives a mortgage payment in an amount agreed upon in advance but also may expect a share of other benefits such as rents, cash flow or appreciation. It usually is assumed that the amount loaned is equal to the present value of the lender's expected benefits discounted at the lender's required rate of return (generally the face interest rate of the loan). **A property's investment value is equal to the present value of all the cash benefits expected by the equity investor, discounted at the investor's required rate of return, plus the amount of the mortgage.**

The property's investment value is based on all the projections, assumptions and so forth that have been made by the equity investor and the lender. In addition, the required rate of return and the specific tax rates are taken into account. Thus, the investment value is for a particular property and for a particular set of circumstances. Because it is not an estimate of fair market

value, there is no reason to expect that the property can be purchased for the estimated investment value. Rather, this is the value of the property under a particular set of circumstances, and if unreasonable assumptions, projections and so forth are made, the investment value calculated for a particular investor may be different from the property's market price.

However, the terms of purchase, financing or a particular investor's tax situation can increase the property's investment value. **This may explain why one investor may be willing to pay more for a property than another: the assumptions used and the terms available produce a higher estimate of investment value.** Nevertheless, if the property's investment value does not equal or exceed its cost, the property should not be purchased.

Conclusion

As the investor progresses through the analysis, the property's suitability as an investment will be established. If the answer to any one of the questions is negative, the analysis should be abandoned. There is no logical reason to proceed to any of the remaining questions. Furthermore, positive answers to one or more of the questions should not induce the investor to disregard a negative answer to the next question. By adhering to a carefully designed analytical plan, an investor can maximize the probability of choosing real estate investments that will prove successful in the long run.

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