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INTRODUCTION TO REAL ESTATE

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Real estate is generally defined as land and all things that are permanently attached to it. These attachments include improvements made to add to the value of the land, such as irrigation systems, fence, roads, or buildings. When buyers purchase real estate, in addition to acquiring the physical land and its improvements, they acquire other specific rights related to that real estate. These rights include the right to control, exploit, develop, occupy, improve, pledge, lease, sell, or assign the real estate. These rights apply not only to the physical land and improvements but also to the ownership of all that are below and above the ground. These ownership rights normally can be separately leased or sold to interested parties; thus landowners can separately sell the space above a certain height on a particular piece of land. This space is normally called an air right. However, it is important to note that the use and transfer of air rights can be restricted or regulated by state and local laws.

TYPES OF REAL ESTATE ASSETS

Generally, a piece of land can be improved into different types of real estate assets. These improvements can be classified into seven different types of real estate:

1. Improved nonbuilt land
2. Residential properties
3. Commercial office properties
4. Industrial properties

5. Retail properties
6. Hotels
7. Mixed use properties

Improved Nonbuilt Land

In economics and business, land is described as one of the four factors of production. (The other factors include labor, capital, and entrepreneurship.) The value of land is derived from the demand for land for production of goods and also for the demand for goods and services created from improvements made to land. For example, the demand for rice requires the cultivation of the seed in farmland to grow the rice. Likewise, the demand for cars requires the need to build factories to produce the cars, and land is needed to build these factories. Therefore, even an empty land is an asset with measurable and in many cases significant value. Thus, a vacant land can be improved through proper irrigation and access roads for farming or with structures for the production of goods and services.

Residential Properties

Shelter is a basic necessity of life. In order to obtain it, residential properties must be constructed. The type of residential properties predominant in a particular area depends on factors such as availability of developable land, population and population growth, zoning laws, local government policies, and access to transportation, among others.

There are primarily four types of residential property:

1. Single-family and small multifamily properties
2. Garden apartment buildings
3. Mid-rise apartment buildings
4. High-rise apartment buildings

Single-Family and Small Multifamily Properties Single-family residential properties are found mostly in suburban areas and usually are occupied by one family. Such houses normally would have a living room, bedrooms, kitchen, bathroom(s), and maybe a family room. They are usually occupied by the property's owner or rented out to a tenant. This type of residential property is not usually found in a central business district (CBD) because it requires more land space per family living unit than other types of residential properties, and they are usually more affordable in a suburban area.

A small multifamily residential property is similar to a single-family residential property but with more than one unit. Because of the multiple-unit structure, each unit is rented out to different individuals or families. These small multifamily properties can be between two and four separate units. In some cases the owner occupies one of the units and rents the other units to tenants. This type of residential property is also predominant in suburban areas and sometimes is also found in urban areas. In some cases it can be found near CBDs.

Garden Apartment Buildings Garden apartment buildings usually are located in suburban areas and contain individual attached apartment units. They usually are built horizontally and normally are made up of three to four stories. In suburban areas, retirement homes and some condominiums and cooperative houses are built in this form. A typical garden apartment complex can have between 40 and 400 units. This type of residential property is more common in the suburbs because it requires significant land space due to the horizontal nature of the structures.

Mid-Rise Apartment Buildings Mid-rise apartment buildings are more commonly found in urban areas. They are usually higher than 5 stories and can be up to 10 stories. In cities, mid-rise apartment buildings can be structured as condominiums and cooperatives properties. Unlike garden apartment complexes but similar to high-rise apartment buildings, mid-rise apartment buildings require relatively small land space. But the cost of land, even relatively small parcels, often is very expensive.

High-Rise Apartment Buildings High-rise apartment buildings are usually towers built in urban areas. High-rise apartment buildings make effective use of the high cost of land in cities. High-rise buildings are usually taller than 11 stories. In major cities, such as London, New York, Tokyo, and Toronto, it is not uncommon to find 50-story high-rises. The construction costs of these towers are enormous. High-rises contain significant numbers of apartment units, certainly more than mid-rise apartment buildings.

Commercial Office Properties

Commercial office properties are properties constructed for commercial office activities. These properties can be found in both urban and suburban environments and are occupied by businesses for conducting business activities; however, they are predominantly found in CBDs. Office properties are usually classed either as A, B, or C. These classifications have no specific rules or criteria, and classifications in different cities vary; thus, what is classed as a Class A building in Dallas might have a different classification in Washington, D.C. However, some of the factors that affect a building's classification include amenities, type and condition of the elevator, lobby finishing, electrical and mechanical engineering efficiencies, adoption of modern energy concepts, design of the building, age, proximity to transportation, and tenant mix.

Generally, a Class A building is better in terms of the factors mentioned above than a Class B building in the same market. Class A buildings tend to be close to major transportation hubs; are new or relatively new, and have modern designs; have modern electrical and mechanical engineering systems; have modern heating, ventilation, and air-conditioning (HVAC) systems; and usually have major companies as tenants, among other attributes. Class B buildings tend to have fewer amenities than Class A buildings. They may have older electrical and mechanical systems and may be located farther away from main transportation hubs. Class B buildings also may have a mixture of major companies and less-known companies as tenants. Class C properties are much older buildings that have not undergone any major renovations for a long time. They also have older electrical and mechanical systems that lack current technological efficiencies. Most often Class C buildings are occupied by numerous, less-well-known companies with relatively small spaces rented to many tenants.

Industrial Properties

Industrial properties include manufacturing plants and warehouse facilities. These properties usually are built horizontally and are very large in size. Sometimes they are custom built to meet the specific needs of tenants due to the nature of the manufacturing process or the type of equipment used.

Industrial properties usually have simple structural designs with open space and very high ceilings. Some might have unique floor, wall, HVAC, or roofing specifications. The actual structure depends on the needs of the tenants. It is not unusual to find a manufacturing facility of up to 1 million square feet of horizontal space or a warehouse facility of the same size.

Industrial properties usually are located away from residential areas and urban cities. Due to amount of land required to construct these structures and also due to zoning restrictions, mostly they are located where land costs are relatively cheap. In some cases, the waste from these facilities can be unfit for normal living environments. In some areas, only certain locations far away from residential areas are zoned for industrial activities.

Retail Properties

Retail properties in general are built near residential neighborhoods and commercial districts. There are different types of retail properties; the most common types are:

- Convenience centers
- Neighborhood shopping centers
- Community shopping centers

- Regional shopping centers/malls
- Superregional shopping centers/malls
- Specialty centers
- Lifestyle centers
- Power centers
- Off-price outlets and discount centers/malls
- Strip commercial
- Highway commercial

The main differences among these types of retail properties are the size of the buildings and the nature and type of tenants. On one extreme are the convenience centers, which are usually less than 30,000 square feet; on the other extreme are the regional and superregional malls, which could be over 1 million square feet of shopping space. Exhibit 1.1 summarizes the attributes of each of these types of retail properties.

Exhibit 1.1 Types of Retail Properties

Type	**Tenantry**	**Size**	**Trade Area**
Convenience center	Stores that sell convenience goods (e.g., groceries, pharmaceutical); not anchored by a supermarket	Less than 30,000 sq. ft.	Less than 5-minute driving time
Neighborhood shopping center	Stores that sell convenience goods and stores that provide personal services (e.g., dry cleaning, shoe repair); a supermarket is often the principal tenant	30,000 to 150,000 sq. ft. of gross leasable area; 4 to 10 acres	Less than 5-minute driving time; 1 to 1 $\frac{1}{2}$-mile range; 5,000 to 40,000 potential customers
Community shopping center	Stores that sell convenience goods, personal services, and shopper goods (e.g., apparel, appliances); a junior department store or off-price/discount store is often the principal tenant; other	100,000 to 300,000 sq. ft. of gross leasable area; 10 to 30 acres (includes minimalls)	5- to 20-minute driving time; 3- to 6-mile range; 40,000 to 150,000 potential customers

(*continued*)

Exhibit 1.1 (Continued)

Type	Tenantry	Size	Trade Area
	tenants include variety or super-drugstores and home improvement centers		
Regional shopping center	Stores that sell general merchandise, shopper goods, and convenience goods; one or more department stores are the principal tenants	300,000 to 1,000,000 sq. ft. of gross leasable area; 30 acres; contains one or more department stores of at least 100,000 sq. ft.	20- to 40-minute driving time; 5- to 10-mile range; 150,000 to 400,000 potential customers
Superregional shopping center	Stores that sell general merchandise, apparel, furniture, home furnishings, and services as well as recreational facilities	Over 800,000 sq. ft. of gross leasable area; contains at least three major department stores of at least 100,000 sq. ft each	In excess of 30-minute driving time; typically 10- to 35-mile range; over 500,000 potential customers
Specialty, or theme center	Boutiques and stores that sell designer items, craft wares, and gourmet foods; a high-profile specialty shop is often the principal tenant; festival malls and fashion centers are types of theme centers	Same range as a neighborhood or community shopping center	Similar to that of a regional shopping center
Lifestyle centers	Stores that sell upscale home furnishing, women's fashion, department stores and restaurants	300,000 to 500,000	Similar to regional shopping center
Power center	A minimum of three, but usually five or more, anchor tenants that are dominant in their categories	Typically open-air centers of more than 250,000 sq. ft.; almost all space designed for large tenants	A minimum of 15 miles—typically a 20-minute range and a population of 400,000 to 500,000

Off-price outlet and discount center	Name-brand outlet stores and/or wholesales grocery and hadware stores	60,000 to 400,000 sq. ft.	Similar to superregional center
Strip commerical (a continuous row or strip along a main thoroughfare)	Convenience stores, fast-food restaurants, car dealerships, and service stations	Varies according to trade area	Neighborhood or community
Highway commercial	Motels, restaurants, truck stops, service stations; may stand as a single establishment within a cluster of other highway-related service facilities	Varies	Passing motorists in need of highway-related servies

Source: Stephen F. Fanning, *Market Analysis for Real Estate* (Chicago: Appraisal Institute, 2005), p. 192.

Hotels

There are numerous types of hotel properties, and they are classified based on the level of service, amenities, and size of the property. The four most common classifications are:

1. Full-service hotels
2. Boutique hotels
3. Extended-stay hotels
4. Motels

Full-Service Hotels Full-service hotels provide guests with a variety of services, such as room service, restaurants on site, valet parking, spas, swimming pools, gymnastics centers, meeting rooms, and convention facilities. Some full-service hotels also have retail shopping and gift stores. Some examples of full-service hotels include Mandarin Oriental, Waldorf-Astoria, Marriott, and Hilton Hotels, among others. These hotels are usually big in size; some are 100,000 square feet or more. Many full-service hotels are well known due to their advertising budgets, services they provide, and amenities. In some cases these hotels are hotel franchises.

Boutique Hotels Boutique hotels provide limited service compared to full-service hotels. They are mostly small in size and do not offer services such as convention facilities, restaurants, or room service or other amenities found at full-service hotels. Boutique hotels usually are less known and usually have smaller advertising budgets than full-service hotels.

Extended-Stay Hotels Extended-stay hotels aim to be a home away from home. Each unit is designed with a larger room to feel homey, and they usually contain small kitchens complete with kitchen utensils. Customers often choose this type of hotel when they plan to stay for weeks or longer. Some examples include Hampton Inn & Suites, Embassy Suites, and Comfort Suites.

Motels Motels are usually small lodging properties whose doors face a parking lot and/or common area with small rooms, with free parking targeting business travelers and tourists looking to spend a few nights. Motels offer very limited services; their rates usually are cheaper than all types of hotel accommodations. Most motels are located close to major highways and attraction centers. Motels usually do not provide services such as convention centers, spas, room service, or restaurants.

Mixed Use Properties

Mixed use properties are innovative concepts in real estate development. They contain a combination of two or more of the different types of properties mentioned earlier. Such properties can be hedges during down cycles in a particular real estate market. A mixed use property may have a residential component, a retail component, and a hotel component all in one. Some mixed use properties contain an office component, a retail component, and a hotel component. A mixed use property could be made up of any combination of the different types of real estate that is appropriate for that particular market. Mixed use has been very popular recently, especially in urban areas such as London, New York, Chicago, and Washington, DC, and Tokyo.

COMMON INDUSTRY TERMS

As we move from this introductory chapter of the book, we will encounter numerous new terms that are mostly familiar to professionals in real estate. To facilitate easier understanding for folks new to the industry, it is prudent to offer definitions of some common terms used by professionals in the real estate industry. Obviously this list is not all inclusive, but it is a great start to become familiar with the industry.

Accounting The process of identifying, measuring, recording, classifying, summarizing, and communicating financial and economic transactions and events to enable users to make informed decisions.

Accounts Payable A type of liability arising from the purchase of goods and services from suppliers or vendors on credit.

Accounts Receivable A type of asset arising from the sale of goods and services to customers on credit.

Amortization An accounting term used to describe the periodic writing off of an asset over a certain timeframe or the periodic repayment of a loan over a specified timeframe. Example: A landlord incurred $60,000 of attorney fees for drafting a tenant lease with a lease term of 5 years. Accounting principles require that the amount should be capitalized and amortized into expense over the lease term; thus, the monthly amortization expense would be ($60,000/60 months) $1,000.

Appraisal An opinion about the market value of a property at a specific date. Appraisals usually are determined by licensed professionals.

Assets In general, "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."[1] More simply, they can be thought of as properties and resources owned by an entity. Assets can be tangible such as land, buildings, furniture, and equipment or intangible such as acquired copyrights, trademarks, and patents. Assets are further classified as current or noncurrent depending on whether they can be converted into cash or used up within one year or one operating cycle, whichever is longer.

Balance Sheet A financial statement that shows an entity's financial position at a point in time, such as at the end of a month, quarter, or year. A balance sheet has three main parts: assets, liabilities, and owners' equity. The components of these three main parts are listed on the balance sheet based on their relative liquidity. For example, cash balances are listed before accounts receivable, and accounts receivable are listed before inventories.

Bankruptcy A term used to describe a party's inability to pay its liabilities as they become due. A bankruptcy is granted through a court proceeding and is filed under various bankruptcy codes, such as Chapters 7, 11, and 13. Each of these chapters has very different implications.

Budget A formal plan set by management for forecasted business activities in future periods against which actual business activities would be evaluated. It enables the actual operations of an entity to be compared to management objectives.

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1. Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements* (Norwalk, CT: 1985), paragraph 25.

Capitalization Rate (Cap Rate) The rate at which future cash flows are converted to a present value amount. This amount is usually expressed in percent. This rate is sometimes used in the valuation of real estate. A cap rate is commonly calculated using the formula:

$$\text{Cap Rate} = \text{Annual Net Operating Income/Cost (Purchase Price)}$$

Central Business District (CBD) The central commercial and business center of a city. CBDs usually are where the major firms are located and are densely populated. CBDs usually are more accessible with better transportation systems than other parts of a city.

Condominium (Condo) A collection of individual home units in which the units are owned individually but there is joint ownership of common areas and facilities. A residential condominium can be viewed as an apartment that the resident owns instead of rents. Usually there is no structural difference between a condominium and an apartment. Thus, by looking at a building you can't differentiate whether it is a condominium or apartment. The key difference between them is mostly the legal structure that defines a condominium as a form of ownership. Note also there are nonresidential condominiums as well, such as hotels, industrials, commercial, and retail condominiums.

Controller An entity's chief accounting officer. The controller of an organization supervises the accounting, internal control, and financial reporting activities of an organization.

Cooperative Property (Co-op) A property that is owned by a legal entity; each shareholder is granted the right to occupy one unit of the real estate. Shareholders pay rent to the corporation. They do not own the real estate but own shares of the real estate ownership entity.

CPA Certified Public Accountant. A person holding this designation has passed a qualifying examination and met all the educational and work experience requirements of the profession to practice as a public accountant.

Creditor An entity that is owed money.

Debt Coverage Ratio (DCR) The ratio of net operating income (NOI) to the annual mortgage payment. This ratio is normally used in evaluating an entity's ability to fulfill its debt obligation.

Debtor An entity that owes money to others.

Debt Service The periodic repayment of a loan by the borrower to the lender. Periodic debt service may include only interest or could be interest and principal, depending on the loan agreement.

Deed A written instrument that evidences the transfer of title from one party to another. The party transferring the title is called a grantor; the party receiving title is called the grantee.

Default A party's failure to fulfill its obligation under any agreement. Examples include nonpayment or late payment of rent by a tenant, landlord's failure to provide agreed-upon services to the tenant, and debtor's failure to make agreed-on debt service payments.

Dividend A return received by a shareholder on an investment. Dividends can be paid in the form of cash, shares, or properties. Dividends paid in the form of cash are referred to as cash dividends, dividends paid in the form of shares are referred to as share dividends, and those paid in the form of property are referred to as property dividends.

Effective Gross Income (EGI) The expected rental income to be collected after adjusting for vacancies and reserves for uncollected rents.

Eminent Domain The right of the government to take private property for public use upon payment of fair compensation to the owner. This right is regarded as the inherent right of the government. With this right the government can take over people's homes for purposes that qualify as public use.

Equity Represents ownership interest in a real estate asset or securities. In real estate ownership financed with debt, the owner's equity is the difference between the real estate value and the loan balance.

Financing Costs Costs incurred by a borrower in obtaining a loan. Examples of loan costs are application fees, origination fees, loan points, and filing fees.

Foreclosure The legal process in which the mortgagee (lender) exercises its right under the loan agreement to force the sale of a mortgaged property upon a default by the mortgagor (borrower). A foreclosure proceeding is conducted through the legal system.

Fund from Operation (FFO) A commonly used term by real estate investment trusts (REITs) to measure cash flow from the entity. It is also used as a measure of operating effectiveness of a REIT and regarded in the real estate industry as a better measure of performance than earnings. It is calculated as: net income plus depreciation and amortization minus gain from sales of real estate.

Future Value The value in the future for funds deposited today. Example: The value one year from today of $905 deposited at a bank earning an interest rate of 10 percent is $1,000.

Gentrification The remodeling of old homes to modern concepts and the conversion of properties from one use to another in a particular neighborhood. Examples include the conversion of rental apartments to condominiums, conversion of hotels to condominiums or to cooperative properties, or vice versa.

Gross Building Area (GBA) The total area of all floors measured from the exterior of the building and including the superstructure and the substructure basement.

Gross Rentable Area (GRA) The total floor area intended for tenants' occupancy and use. Basements, hallways, and stairways are included in this area.

Income Statement Also called the statement of operation. Shows the financial performance of an entity over a period of time, such as during the month, quarter, or year.

Inflation A general increase in the price level of goods and services in an economy. It is generally regarded as an erosion of the purchasing power of money. Inflation is normally expressed in percent per annum.

Inflation Risk The risk that inflation will reduce the purchasing power of a certain amount of money over time.

Internal Rate of Return (IRR) One of the measures of an investment's performance and is expressed as a percent. The inputs on an IRR calculation include the invested amount, the cash flows, and the reversion value. An IRR is sometimes described as the discount rate at which invested capital has a zero net present value.

Interest Represents the cost of borrowed funds and is expressed in percent per annum. The amount paid for borrowed funds is called the interest cost, and the amount received for funds lent is called interest income.

Lease A legal agreement between a lessor and a lessee that gives the lessee the exclusive right to use the lessor's property in return for rent for an agreed time period. A lease should, at a minimum, include the name of the parties, a description of the leased premises, terms of the lease, and the signature of the parties.

Lessee The party that leases a property from another party. This party is usually the tenant. The lessee has the right to exclusive use of the property for an agreed-on period. The rights of the lessee are derived from the lease agreement and from the applicable law.

Lessor The party that grants its exclusive right to use to another party. This is usually the landlord and owner of the leased property.

Liabilities What an entity owes others. Liabilities can be classified as current or long-term liabilities. Current liabilities are those liabilities that are due within one year or one operating cycle, whichever is longer. Long-term liabilities are liabilities with due dates longer than one year or one operating cycle. Liabilities are listed on the balance sheet according to the due dates, with those due within the year or operating cycles listed first before, for example, those due in 10 years.

Loan Commitment Letter Letter from a lender committing to provide a specific loan amount to a borrower for a specific purpose and for specified terms within a given period of time. A loan commitment letter can serve as evidence from a real estate purchaser to the seller of the purchaser's ability to close on the deal.

Loan-to-Value Ratio (LTV) The ratio of the mortgage loan to the property's value.

Lien The right to take and hold or sell the property of a debtor as security for a debt provided by a lender.

Mortgage An instrument that evidences the lender's security interest in a debt-financed property.

Net Income The net earnings of an entity over an accounting period. It is presented in an income statement and is determined by deducting all costs and expenses of the period from total income of the period.

Net Loss The amount at which all costs and expenses of the period are higher than total income of the period. A net loss occurs when an entity is not profitable. It is basically the opposite of a net income and it is also presented in an income statement.

Net Operating Income (NOI) The amount left after deducting operating expenses from gross income. This amount does not include depreciation, amortization, or debt service payments. NOI is widely used as a measure of operating profitability of a property.

Net Rentable Area (NRA) The amount of space rented to a lessee, excluding the common areas of the property.

Present Value The value today of a payment due in the future. Example: The value of $1,000 due 1 year from today discounted at the rate of 10 percent and compounded monthly is $905.

Prime Rate The lowest interest rate that banks charge their best and largest customers on short-term borrowed funds.

Refinancing The replacement of an old loan with a new loan by a borrower from the same or a different lender with more favorable loan terms.

Rent The amount agreed between the lessee and lessor to be paid by the lessee in exchange for use of the lessor's premises. Rent can be expressed as a dollar amount or as dollars per square foot.

Retainage In a construction project, represents a portion of the amount due under a construction contract that has not been paid by the owner to the contractor pending completion of the project in accordance with plans and specifications.

Retained Earnings The accumulation of net earnings that were not distributed as dividends to the shareholders. Retained earnings are presented in a balance sheet and the statement of changes in shareholders' equity.

Secured Interest A lender's interest on a mortgage used to finance the purchase or refinancing of an asset. A secured interest gives the lender the right to foreclose on the mortgage in the event of default by a borrower.

Securitization The pooling of mortgages together and offering them as securities in the capital market. The underlying mortgaged properties therefore serve as collateral for these securities.

Statement of Cash Flows A financial statement that shows how cash came in and went out of an entity during an accounting period.

Statement of Changes in Shareholders' Equity A financial statement that presents a summary of all transactions that affected equity during an accounting period. In a sole proprietorship, this is referred to as the statement of changes in owner's equity.

Time Value of Money The concept that $1 today is worth more than $1 in the future because of the interest factor since if you deposit $1 today in a bank, that $1 will earn interest over time.

Title A term commonly used to link the owner(s) of a real estate to the real estate itself. It is the bundle of rights that the real estate owner(s) have in the real estate. In some cases this term is also used to refer to the legal document that evidences ownership of real estate.

Title Insurance A type of insurance that protects the holder of a title against claims to the title or obtaining bad title in a transaction.

Townhouse A single-family residential property that is attached to another property, usually another townhouse. Each unit is separately owned.

Underwriting The process undertaken by a lender to decide whether credit should be extended based on the creditworthiness of the borrower and the condition and value of the property to be used as collateral.

Workout The various action plans agreed to between a defaulted debtor and creditor(s). A workout agreement details the rights and obligations of each party necessary to enable the creditor(s) to get full or partial refund of their loan to the debtor.

Zoning Restrictions by the government on land use. With zoning, the government regulates the type of buildings that can be developed in certain areas. Example: Some areas can be zoned for residential, commercial, industrial, or mixed use. Zoning can also be used to restrict the height of buildings in a given geographic area.