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TWELFTH EDITION

ESSENTIALS OF REAL ESTATE INVESTMENT

Dearborn
Real Estate Education

Essentials of Real Estate Investment

Twelfth Edition

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ESSENTIALS OF REAL ESTATE INVESTMENT TWELFTH EDITION

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CONTENTS

INTRODUCTION

The introduction to the 9th edition of this text expressed optimism about an economic recovery from the Great Recession. The introduction to the 10th edition of this text declared it an excellent time to invest in real estate because prices and interest rates were low, even if banks were being very selective screening potential borrowers.

That optimism proved to be warranted and the investment advice well-founded. In August 2015, the unemployment rate was down to 5.1% nationally, and by October 2018. it was down to 3.7%. Other economic indicators are strong, and economists predict continued job creation, which will fuel consumer spending, and in turn, entice businesses to hire and invest more.

All of this translates into optimistic news for the U.S. housing market. As of mid-2015, existing home sales (which make a comparatively large proportion of all home sales) had surged to their highest level since November 2009. According to the National Association of REALTORS®, existing sales climbed 5.1% month over month to an annual rate of 5.35 million sales. In May 2018, the U.S. had the fastest pace of homes sold relative to the inventory when months' supply was 4.1 months. In 2008, the U.S. had the slowest relative pace when it would have taken 10.8 months to sell the supply of homes on the market at the prevailing sales pace. Then in September 2018, existing-home sales declined after a month of stagnation in August. REALTORS® report "low inventory" and "interest rate" as the major issues affecting transactions in September 2018.

Democracy as a political system, when coupled with capitalism as an economic system, is based on the private ownership of real and personal property. Therefore, in the United States, individuals and corporations may own real property under the laws of this country. Such private ownership, called the *allodial system*, allows for fee simple ownership, which expands the simple rights of property use and control during an owner's life to include the powerful right to designate to whom a property passes upon the owner's death. As a result, owners may effectively translate their work efforts into tangible real and personal property assets, and thus, accumulate an estate to enjoy and control into the future.

The desire to accumulate a measurably valuable estate and generate a revenue stream is no doubt one major reason for the tremendous interest in the ownership of real property in this country. It appears that almost everyone gives high priority to the ownership of real estate—from the smallest condominium to the largest shopping center.

This 12th edition of *Essentials of Real Estate Investment* examines the current real estate market and describes the various opportunities for real estate investors. Real estate may provide a profitable alternative for an investor's portfolio, with much of the income sheltered by deductions for operational costs, interest expenses, and depreciation.

This text presents the units as follows.

- Unit 1 introduces the nature of the real estate market.
- Unit 2 explores purposes for investing in real estate as an alternative to other forms of investment. It also describes the advantages and disadvantages of real estate investments.
- Unit 3 discusses the importance of leverage.

- Unit 4 provides an inventory of the various forms of real estate ownership, including individuals, groups, partnerships, trusts, and leaseholds.
- Unit 5 describes the market and property analyses necessary to determine the feasibility of a real estate investment.
- Unit 6 reviews the current income tax laws governing real estate investments. Included are a number of tax-sheltering alternatives.
- Unit 7 discusses the time value of money.
- Unit 8 examines the financial requirements necessary to measure the economic feasibility of a real estate investment.
- Unit 9 explores applications to property tax.
- Unit 10 investigates the financing alternatives for leveraging real estate investments. Included are discussions of the government's role in finance, sources of funds, types and forms of real estate loans, special loan provisions for investment financing, and default and foreclosure consequences.
- Unit 11 is an examination of the various types of real estate available for investments: land, residential, office buildings, commercial properties, industrial properties, and special investment opportunities.
- Unit 12 explores managing the investment property, including differences in management needs, based on the type of property being managed.
- Unit 13 summarizes the transaction from contract to closing.

ACKNOWLEDGMENTS

David Sirota received his Ph.D. in Real Estate from the University of Arizona in 1971. He taught real estate subjects at many universities, including the University of Arizona in Tucson, Eastern Michigan University in Ypsilanti, National University in San Diego, and California State University in Fullerton, and at one time, headed the Department of Real Estate at the University of Nebraska in Omaha. Dr. Sirota has also written state licensing exam questions for the Arizona Department of Real Estate and ETS. He was involved as a consultant in the development of a congregate care center in Green Valley, Arizona, and acts in a consultant capacity for individuals and developers. He was a founding member of the Real Estate Educators Association (REEA), securing one of its first DREI designations.

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Thanks also go out to those who have contributed to this and previous editions of this textbook: Karen B. Abbott, Thurza B. Andrew, Donald G. Arsenault, Jack R. Bennett, Paul S. Black, Richard Blyther, Robert Bond, William J. Cahaney, Gene Campbell, Ken Combs, Bo Cooper, Gerald R. Cortesi, Larry B. Cowart, Valleri J. Crabtree, Samuel P. DeRobertis, Jack Flynn, Peter C. Glover, Ronald Guiberson, Lloyd L. Hampton, Byron

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UNIT 1

Real Estate Investment Characteristics

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Describe the nature of the real estate market.

KEY TERMS

bundle of rights
buyer's market
cycle
demand
disintegration
easy money
equilibrium
fixity
highest and best use
integration
longevity
market segmentation
market value
permanence
personal property
property
real estate
real property
relative scarcity
risk
seller's market
supply
tight money
value in use

INTRODUCTION

Property is anything that can be owned. **Real property**—also called **real estate**—is defined as land and all natural and human-made improvements permanently attached thereto, and the rights appurtenant, including air and mineral. All other property is **personal property**. To own real estate is not only to possess the physical property but also to acquire certain legal rights to its continual peaceful use and redistribution. When we acquire real estate, we also acquire an accompanying **bundle of rights** in the property. These are the rights of use, possession, control, enjoyment, exclusion, and disposition, including the right to pass on the property by means of a will.

THE NATURE OF THE REAL ESTATE MARKET

Characteristics of real property investments

Each parcel of real estate is unique, and thus, requires an individual investment analysis relevant to its specific locational attributes. However, all real property has certain common characteristics that affect its value. These characteristics include fixity, longevity, permanence, risk, and market segmentation.

Fixity

Real estate is fixed in location, which greatly restricts the scope of its marketability. As a result of this **fixity**, real estate values are affected by any political and economic activities occurring in the immediate vicinity.

Longevity

Real estate is generally considered to be a long-term investment because of the durability of the improvements and the permanence of the land. This quality of **longevity** enables investors to estimate, with some degree of reliability, the present value of a future stream of income from their properties.

Permanence

It is the attribute of **permanence** that forms the basis for our system of long-term mortgage-debt amortization. Investment in real estate usually involves relatively large dollar amounts that require complex financial arrangements. These complexities, in turn, require the expertise of lawyers, accountants, brokers, property managers, real estate consultants, and other specialists.

Risk

Real estate investment is a relatively high-**risk** venture that reflects the uncertainties of a somewhat unpredictable market. In fact, there is no readily identifiable, organized national market for real estate as there is for stocks and bonds. The realty market is a combination of local markets that react speedily to changes in local economic and political activities and somewhat more slowly to regional, national, and international events.

Market segmentation

The real estate industry also suffers from **market segmentation**. The fractured aspect of this unorganized and largely unregulated market is further complicated by the lack of standardization of the product and the fact that many of the market's participants react intuitively, giving little attention to formal feasibility or marketing studies. The real estate investment market is divided into submarkets such as retail, warehouse, residential, and others, compounding the complexity of investing. However, the investor who seeks qualified help and takes advantage of available protective measures can often mitigate—or, minimize—some of the risks.

Besides these inherent characteristics of real property, many government activities also directly or indirectly influence property values. At the federal level, income tax laws can provide incentives or disincentives for particular types of investments. Some of those laws can change rapidly, while others remain stable for years and even decades. The government's regulation and control of money effectively dictates the extent of real estate activity through manipulation of the supply, as well as the cost of mortgage money.

Our various levels of government also function in other ways to affect real estate property values. Environmental controls and impact studies add time and costs to the development of land—costs that are inevitably paid by consumers. Local political attitudes regarding zoning and growth restrictions act to raise the prices of properties already developed, effectively creating a monopolistic position for their owners.

Fueling these political attitudes is the antigrowth philosophy of citizens in some areas where property taxes and other public costs are rising at an alarming rate to serve an ever-increasing population. "Not in my backyard," usually shortened to "NIMBY," has become the slogan in these cities.

Changing nature of the realty market

In the early 2000s, the subprime mortgage market more than doubled its offerings of hybrid adjustable-rate mortgages (ARMs) with artificially low initial payment schedules and other very liberal qualifying standards. Such loans were called *subprime* because the borrowers did not qualify for the prime lending rates available to those who are more credit-worthy. Fannie Mae and Freddie Mac loans also became available in various forms using very liberal qualifying standards, thereby creating many risky loan products. Exotic mortgage insurance and mortgage bundling and resale products further obscured and shifted default risks onto unsuspecting secondary market purchasers. Without personal risks, mortgage originators became ever more aggressive, loaning more than 100% of property values to anyone capable of signing their names to the documents. Easy access to money drove real estate prices higher and higher. The overall housing market boom began to decline in 2006. The subprime market was the first to crash, but by 2007, Fannie Mae and Freddie Mac were also in trouble. Borrowers found themselves unable to pay their sharply increased mortgage payments as adjustable-rate loans began to be reset at higher rates. Refinancing was no longer an option because realty values were declining, and a slow market made it very difficult to sell. In September 2008, Fannie Mae and Freddie Mac were placed into conservatorship under the newly formed Federal Housing Finance Agency.

Over the next several years, a variety of federal programs and tax incentives made it easier for borrowers to modify their home mortgage loans, obtain debt forgiveness without tax liability, and remain in rental housing despite foreclosure of the underlying mortgage. Most of the programs have now expired, but elements of each have been incorporated into other programs as a type of safeguard against another potential crash.

Programs such as those allowed many borrowers to keep their homes in spite of the financial conditions of the Great Recession. The resulting confidence—security in having home ownership—helped consumers increase retail spending after even modest improvements in the economy. Increased retail spending spurred investment real estate construction and redevelopment. The improving economy meant increasing demand for recession-era foreclosure housing available at steep discounts. That supply dwindled, housing demand increased, new construction started again, jobs in the construction industry and its suppliers saw dramatic growth, more people were employed and could afford housing and retail goods, and so on. The real estate cycle had turned. President Donald Trump's election in 2016 created wild exuberance in some circles and spurred the release of long-hoarded investment dollars. Barring an unforeseen catastrophic event, the realty markets seem firmly in recovery mode.

Supply of and demand for real estate

In the very broadest sense, the **supply** of land is unlimited. Although it is true that the earth represents a fixed supply, it is also true that this supply can be extended indefinitely by building under and over the landmasses and open seas, and by fractionalizing ownership interests into time-shares. Still, there are huge expanses of land that remain unusable in their present state or are currently uninhabitable because of geophysical circumstances.

It is the **relative scarcity** of usable land, however, that is important to real estate as an investment vehicle. Relative scarcity is what establishes the basic value for real estate. The economic worth of property fluctuates with the effective **demand** for strategically located and, thus, by definition, relatively scarce parcels of land. Even more important than the supply of and the demand for unimproved land are the interactions of these economic factors as they affect the existing stock of improved real estate.

One of the principal components of demand is population, not only in terms of the number of people, but also of subgroupings according to age and income.

The current U.S. population topped 326 million in 2018 and is expected to grow to more than 398 million by the year 2060 (see Figure 1.1).

Migrational trends and locational economic-base analyses can be developed to estimate variations in the demand for real estate within a given area. Changes in location, as well as changes in living patterns, determine where there will be growth in demand for real property and what this demand will require in terms of housing and related real estate developments.

Figure 1.1: Projections of the Population by Selected Age Groups and Sex for the United States: 2016 to 2060

Projected Age Groups and Sex Composition of the Population

Projections for the United States: 2020-2060

Main series. Table 2

(2016 base population. Resident population as of July 1. Numbers in thousands)

	2016	2020	2025	2030	2035	2040	2045	2050	2055	2060
Total	**323,128**	**332,639**	**344,234**	**355,101**	**364,862**	**373,528**	**381,390**	**388,922**	**396,557**	**404,483**
Under 18 years	73,642	73,967	74,654	75,652	76,664	77,131	77,561	78,225	79,148	80,137
Under 5 years	19,927	20,439	20,868	20,976	20,993	21,106	21,319	21,610	21,914	22,144
5 to 13 years	36,954	36,780	37,074	38,051	38,453	38,568	38,715	39,049	39,532	40,090
14 to 17 years	16,761	16,748	16,712	16,625	17,217	17,457	17,527	17,566	17,701	17,903
18 to 64 years	200,241	202,621	204,354	206,311	210,201	215,571	220,995	225,023	227,794	229,670
18 to 24 years	30,844	30,380	30,554	30,612	30,519	31,369	31,943	32,126	32,229	32,467
25 to 44 years	85,147	88,843	92,328	94,370	95,368	95,067	96,054	97,459	98,727	100,230
45 to 64 years	84,250	83,398	81,472	81,329	84,314	89,135	92,998	95,437	96,838	96,973
65 years and over	49,244	56,052	65,226	73,138	77,997	80,827	82,835	85,675	89,615	94,676
85 years and over	6,380	6,701	7,450	9,074	11,793	14,430	16,953	18,561	18,913	19,019
100 years and over	82	92	120	140	156	196	270	386	486	589
16 years and over	257,955	267,049	278,019	287,784	296,814	305,159	312,637	319,519	326,291	333,323
18 years and over	249,485	258,672	269,580	279,449	288,199	296,397	303,829	310,697	317,410	324,346
15 to 44 years	128,658	131,781	135,459	137,476	138,804	139,551	141,173	142,786	144,252	146,140
Male	**159,079**	**163,904**	**169,738**	**175,174**	**180,070**	**184,481**	**188,575**	**192,577**	**196,661**	**200,871**
Under 18 years	37,609	37,779	38,144	38,656	39,163	39,397	39,613	39,948	40,416	40,917
Under 5 years	10,187	10,446	10,662	10,717	10,725	10,782	10,890	11,039	11,194	11,310
5 to 13 years	18,861	18,789	18,947	19,438	19,641	19,698	19,771	19,939	20,184	20,467
14 to 17 years	8,561	8,545	8,535	8,501	8,797	8,918	8,952	8,971	9,038	9,140
18 to 64 years	99,677	101,111	102,293	103,596	105,811	108,760	111,697	113,897	115,366	116,291
18 to 24 years	15,819	15,526	15,591	15,637	15,605	16,029	16,316	16,405	16,452	16,569
25 to 44 years	42,753	44,837	46,795	47,970	48,528	48,348	48,846	49,576	50,217	50,952
45 to 64 years	41,105	40,748	39,906	39,990	41,678	44,382	46,534	47,916	48,697	48,770
65 years and over	21,793	25,014	29,301	32,921	35,096	36,324	37,265	38,731	40,879	43,663
85 years and over	2,225	2,418	2,780	3,463	4,564	5,590	6,599	7,246	7,408	7,477
100 years and over	16	21	30	38	43	55	77	110	137	168
16 years and over	125,801	130,396	135,900	140,781	145,309	149,560	153,461	157,134	160,780	164,537
18 years and over	121,470	126,125	131,593	136,518	140,907	145,083	148,962	152,629	156,245	159,954
15 to 44 years	65,045	66,768	68,806	69,995	70,733	71,078	71,893	72,722	73,458	74,384
Female	**164,049**	**168,735**	**174,497**	**179,927**	**184,792**	**189,047**	**192,815**	**196,345**	**199,896**	**203,612**
Under 18 years	36,033	36,187	36,510	36,996	37,500	37,733	37,948	38,277	38,732	39,220
Under 5 years	9,740	9,993	10,205	10,259	10,268	10,324	10,429	10,572	10,721	10,834
5 to 13 years	18,093	17,992	18,128	18,613	18,812	18,870	18,945	19,110	19,348	19,623
14 to 17 years	8,200	8,203	8,177	8,124	8,421	8,539	8,575	8,595	8,663	8,763
18 to 64 years	100,564	101,510	102,061	102,715	104,390	106,811	109,298	111,125	112,428	113,379
18 to 24 years	15,025	14,854	14,962	14,975	14,914	15,340	15,627	15,721	15,776	15,898
25 to 44 years	42,395	44,006	45,533	46,400	46,840	46,718	47,207	47,883	48,511	49,278
45 to 64 years	43,145	42,650	41,565	41,340	42,636	44,753	46,463	47,521	48,141	48,203
65 years and over	27,451	31,037	35,926	40,216	42,901	44,503	45,569	46,943	48,736	51,013
85 years and over	4,155	4,283	4,670	5,611	7,229	8,840	10,354	11,315	11,506	11,543
100 years and over	66	71	89	102	113	141	193	276	348	422
16 years and over	132,154	136,653	142,118	147,003	151,505	155,599	159,176	162,385	165,511	168,786
18 years and over	128,015	132,547	137,987	142,931	147,292	151,314	154,867	158,069	161,164	164,392
15 to 44 years	63,613	65,013	66,653	67,481	68,071	68,473	69,280	70,064	70,794	71,756

Note: 2016 is the base population estimate for the projections.

Projected Age Groups and Sex Composition of the Population: Main Projections Series for the United States, 2017-2060. U.S. Census Bureau, Population Division: Washington, DC.

Source: U.S. Census Bureau, Population Division
Original Release Date: March 2018
Revised Release Date: September 2018

Source: U.S. Census Bureau

A **tight money** market occurs when interest rates are high and loans are difficult to find. An **easy money** market reflects low interest rates and lots of money available for real estate loans.

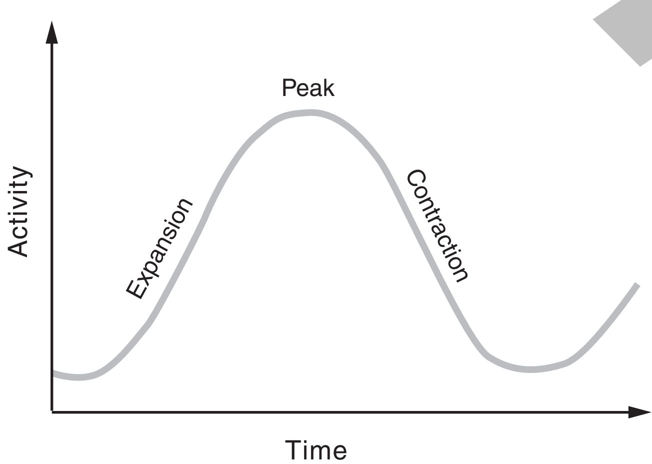
Supply can sometimes be viewed as a function of demand when the bidding on scarce properties forces prices upward. Serving effective demand and anticipating its impact is a real estate supplier's most important skill, one that industry professionals and investors are vigorously pursuing with increasing degrees of sophistication to perfect investment strategies. Because most real estate developments involve a time lag, which exists because of the time it takes to prepare raw land and construct new buildings, shrewd investors constantly study the market to anticipate demand.

Often, supply itself may be viewed as an accelerator of demand. The imposition of growth controls, building moratoriums, and stringent environmental controls seriously inhibits the increase of new housing stock and puts the full pressures of demand on existing property owners. These owners then enjoy a virtual monopoly that affects rental rates and property prices. Thus, the available stock of improved real estate itself establishes the design, quality, price, and terms for the consumer.

Real estate cycles

Keeping in mind the cause-and-effect relationship between supply and demand, we can now examine the cyclical nature of the real estate market. A real estate cycle (see Figure 1.2) is frequently described as either a **buyer's market** or a **seller's market**. A buyer's market indicates a surplus of supply and a downward price trend, favoring the purchaser. In a seller's market, supply is short and demand is high; thus,prices are forced upward by the competitive market situation.

Figure 1.2: Real Estate Cycles



Because the term *cycle* implies repetitive, ongoing fluctuations in price, the buyer's and seller's markets are equal and opposite partners in the cycle. Thus, we can begin at any stage of a real estate cycle to examine the total cycle's fluctuation. If we enter a cycle somewhere near its peak, we can observe a shortage of supply, high prices as a result of competitive bidding, and, logically, high concurrent profits for sellers. Such high profits act to attract new investors who wish to capitalize on the opportunities, and it is reasonable to assume that new construction will take place, regardless of costs. With new buildings available as additional inventory to satisfy demand, the market cycle will level temporarily and then start to fall until supply exceeds demand. At this point, the cycle has reached its valley, and conditions are those of a buyer's market.

Other catalysts can affect a **cycle**, acting to speed it up or slow it down and to raise or lower its peaks and valleys. Included among these catalysts are tax reforms, interest rate fluctuations, a depression or recession, or even a national crisis such as 9/11, to name a few.

The inherent imperfections of the real estate market contribute to the perpetuation of the cyclical trend. Lack of communication among real estate building contractors, coupled with the time lag between the start-up and the completion of buildings, is a major factor in this problem. Another problem arises when contractors base a decision to build on gut feelings instead of market research. Real estate tends to have a longer contraction phase than other types of industry. A manufacturer of appliances may lay off workers and cut back production to ride out a contraction in the market. The owner of an office building still has the same amount of space to lease, and therefore, may stay in contraction longer.

Entering the market at the peak of a cycle involves planning, possible rezoning, and financing, as well as labor and material acquisitions in anticipation of construction. When building continues at a feverish pace to capture the profits of backlogged demand, little thought is given to overbuilding until the inevitable occurs and supply exceeds demand.

Now the situation is reversed, with few buyers and many alternative properties from which to choose. An associated lowering of prices results until little, if any, profits are left. Building ceases and market conditions continue at a low point until the excess supply is absorbed, at which time, the market begins to move toward the peak again.

Bubbles are a frequent phenomenon in the real estate cycle. A bubble is a sharp rise in real estate prices, fueled by speculation among those who operate under the greater fool theory of real estate investing. The *greater fool theory* supposes that whatever price is paid in a rapidly rising market, some fool will pay more to purchase it from the current investor. Fortunes are made during such times, until the fools are sated, prices decline, values crash, money becomes tight again, and there are long lines at bankruptcy courts and foreclosure auctions. The Federal Housing Finance Agency maintains statistics of home prices in markets around the country. There are various rules of thumb for signs of a bubble, but most can be summed up by answering this question: "Are local price increases significantly greater than national averages, and is there any identifiable economic factor, other than speculation, that would explain the increase?"

Despite the cyclical short-run fluctuations in any real estate market, property values, in general, rise over the long term. However, this trend is based on a summarization of activities involving many properties. Any individual property may react cyclically or counter-cyclically to the general activities of the marketplace, much as individual stocks gain or lose value within the stock exchange. Real estate investors are cautioned to consider each purchase carefully from both its micro and macro positions in the realty market. Investors must be aware of the long-term aspect of real estate investments.

Value theory of real estate

Although all the forgoing economic principles are important for potential real estate investors to keep in mind, in the final analysis, investors will be primarily concerned with the value of one particular property. Real estate has value only as one in a series of alternative investment opportunities. Value is, in reality, in the eye of the beholder, the occupier, or the user.

A seller's value is, more often than not, a reflection of personal and slightly sentimental feelings. Undoubtedly, the buyer or agent will have an entirely different opinion of the value of that particular property. Likewise, an insurable value, a condemnation value, and a taxable value, among others, may all indicate a different dollar amount for the same property.

In theory, the value of a parcel of real estate is interpreted to be market value or its value as established in an exchange. As such, **market value** is defined as that price which a knowledgeable buyer will pay and a knowledgeable seller will accept for a property that has been exposed for sale to the market for a reasonable length of time and with neither buyer nor seller acting under duress or enjoying any advantage, financial or otherwise. Most real estate transactions will require an estimate of the market value of the property involved.

However, market value, as estimated by the seller, appraiser, or perhaps a real estate broker, may differ substantially from market price, which clearly is established by what the buyer will actually pay for the property. To illustrate the difference, the market value of a three-bedroom, two-bath brick home in a good school zone might be $X. The product is fairly fungible and similar to many other nearby homes with recent sales records. If that same home has a famous former owner, or trendy new finishes, or supernatural phenomena, then emotional decision-making can drive the price up or down, varying from the value. *Price* is more in the realm of behavioral economics, while *value* is more in the realm of traditional economics.

When determining the value of a particular property at a specific point in time, an evaluator has several basic principles of value to use as guides. The *principle of substitution* contends that no rational, economical person would pay more for one property than for another of like design, quality, and utility. This principle is the basis for the comparable sales approach to estimating the market value of real property.

The *principle of balance* identifies the problems that result from an oversupply or undersupply of a particular type of real estate. For example, too many condominiums of the same size, design, and price in one area would act to depress the values of all of these properties within the market.

The *principle of contribution* states that the value of an addition to a property is a function of its contribution to the overall profitability of the property, not just its construction cost.

The *principle of conformity* states that homogeneity in design and quality creates the most reasonable value for a property, while a property that is dramatically different from or nonconforming to its surroundings is invariably lowered in value.

The *principle of anticipation* stipulates that most investors make their investment decisions based on the measurement of the present value of an anticipated net income stream. This principle is the basis of the income capitalization approach to realty evaluation.

The *principle of highest and best use* is fundamental to estimating the value in use of a real estate investment. This principle is defined as the legal and possible use that is most likely to produce the greatest net return from a property over a given period.

In addition to its market value, real estate also has a **value in use**. This is the value on which a number of real estate investors rely and a value that could differ from the property's market value. For example, compare the market value of a property currently used as a parking lot with its potential value as the site for a high-rise office building. Thus, *value in use* is that use of the property that may or may not be its **highest and best use**.

As discussed earlier, value is primarily a function of the interactions of supply and demand. A relatively scarce but desirable item's value may increase specifically because of its scarcity and desirability. It must also be remembered that change is ever-present, thus affecting attitudes concerning desirability and value.

Real estate is considered to be a relatively scarce and desirable item. Its value is in a constant state of change because of a myriad of continuously operating social and economic forces.

Estimators of real estate value must be acutely alert to three stages of change in property values:

1. **Integration**—a condition of developing value when building new
2. **Equilibrium**—a condition of stable value during the holding period
3. **Disintegration**—a condition of declining value during the aging process

A property's value is affected by the prevailing stage of change in its city or neighborhood. Because property cannot be moved, it may go through this evolutionary cycle many times during its economic life.

SUMMARY

In economic terms, land is considered a relatively scarce commodity, although from a practical point of view, land is infinite in supply because it can be developed into the air and underground and split into temporal units, such as time-sharing. Still, most of the earth's population gathers tightly in the great cities of the world, congregating where there are jobs. Thus, there is an ever-increasing demand for a limited supply of desirable real estate. This pressure of demand acts to force the prices of available real estate to new heights.

Real estate market activities fluctuate as a function of supply and effective demand. When the top of the cycle has been reached, with high prices reflecting high profits, the entry of new builders acts to add to the supply and reduce the prices and profits accordingly, resulting in a reversal of the cycle. The microcycle is local in character, while the long-term cycle shows an ever-increasing value for real estate over time.

In addition to the demands of a growing population, artificial limitations on the supply of real property add to the increasing costs of real estate. Concerns with pollution have led to environmental controls that limit new construction. Political attitudes regarding controlled growth have also inhibited construction in many areas of the country. Natural gas and water shortages, sewer inadequacies, central city decline, and resultant suburban expansions have all placed substantial burdens on current property owners to support their local governments on an ever-shrinking tax base.

Despite all these obstacles, real estate investors continue to seek profitable projects. Attempting to anticipate demand and, in some areas of this country, creating demand by the very design of their projects, real estate developers are adjusting the sizes of homes, rethinking the frills in office buildings, providing the magnetism necessary to attract customers to shopping centers, and creating new concepts in planned unit developments, manufactured-home parks, office parks, and industrial parks. All of this is in an effort to bring a usable product to a receptive market.

The measurement of a property's value is a function of its utility, its ability to generate income in the future, and its position in a spectrum of alternative investment opportunities.

Price often is based on subjective intuitive interpretations, although a body of principles has been developed to describe property value in terms that are more objective. These principles include those of substitution, highest and best use, balance, contribution, conformity, and anticipation, and they describe the function of value in conjunction with the activities of a rational, economic investor.

DISCUSSION TOPICS

1. Investigate the economic conditions of your community and identify the point in the real estate cycle at which you believe it to be.
2. Identify a specific neighborhood in your community and estimate where it is on the development spectrum: integration, equilibrium, or disintegration.

UNIT 1 EXAM

1. Real estate investments should be considered first and foremost from the viewpoint of
   A. the economic soundness of the project.
   B. the unique financing techniques available.
   C. the tax shelter opportunities.
   D. the unlimited growth potential.

2. Which of the following is *TRUE* regarding the characteristics of real estate?
   A. It has a central and controlled market.
   B. It is a short-term asset.
   C. Each parcel is similar to other parcels.
   D. Its market condition is seldom in balance with supply and demand.

3. Supply and demand theory indicates that if they both increase at the same rate, prices will
   A. go up.
   B. go down.
   C. first go up and then go down.
   D. remain constant.

4. A buyer's market indicates all of the following *EXCEPT*
   A. excess supply.
   B. lower prices.
   C. high demand.
   D. flexible terms.

5. Which of the following approaches to value reflects the actual price that a knowledgeable buyer will pay?
   A. Value in use
   B. Highest and best value
   C. Appraised value
   D. Market value

6. When properties in blighted areas begin attracting investors, they are entering a period of
   A. integration.
   B. equilibrium.
   C. disintegration.
   D. urban renewal.

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