**Unit 5 Outline**

**Learning Objectives**

Study of this unit should enable the student to

* discuss the characteristics of real estate markets;
* explain why the market for real estate is not like other markets;
* identify the types of market analysis that help define the market for real estate;
* discuss the ways in which real estate is financed;
* name the elements that create value;
* define market value and explain other types of value;
* identify influences on real estate value;
* list and explain the basic value principles that must be considered in determining market value.

**Unit Outline**

I. Overview

II. The Market for Real Estate—place for buying and selling

A. Characteristics of Real Estate Markets

1. An efficient market includes

a. Readily exchangeable products

b. Ample supply of knowledgeable buyers and sellers

c. Little or no government regulation influencing value

d. Relatively stable prices

e. Easy product supply and transfer of title

2. Characteristics of land—because land is immobile, location is most important single factor in determining real estate value

B. Market Analysis

1. Market analysis begins with a study of area demographics

2. Market is then segmented into areas of preference and the activities of the people comprising the segments are forecast

3. Feasibility study of the likely success of a proposed development includes:

a. Absorption analysis

b. Cost analysis

c. Up-to-date information on the political climate and governmental forces that may result in regulations affecting property ownership and use

C. The Cost of Credit—depends on the availability of funds in relation to the number of potential borrowers

1. Sources of capital—for real estate development include

a. Short-term money market funds

b. Longer-term capital markets

2. Competing investments

a. Debt investors require a security interest in the property financed

b. Equity investors are willing to take a riskier unsecured role—provide venture capital

D. How Real Estate is Financed

1. Mortgage terms and concepts

a. Lien on real estate may take the form of either a mortgage or a deed of trust

i. With a mortgage, the property owner is the mortgagor and the lender is the mortgagee

ii. With a deed of trust (or trust deed), the property owner is the trustor, the lender is the beneficiary, and a neutral third party is the trustee who holds title to the secured property

b. Security instrument is the document that hypothecates the real property that serves as the lender's assurance that the debt will be paid

c. When real estate is used as security, the debtor retains possession

2. Mortgage payment plans

a. Repayment of a mortgage debt requires payment of both principal and interest

b. Interest rate—fixed (the same for the life of the loan) or adjustable (varies according to an established index)

3. Types of mortgages

a. Fully amortized fixed-rate mortgage—requires regular payments of both principal and interest

b. Adjustable-rate mortgage—payments can rise or fall as the interest rate rises or falls in line with the index used

c. Graduated payment mortgage—provides lower monthly payments in the early years of the loan term, with gradual increases over five to ten years that then level off for the rest of the loan term

d. Growing equity mortgage—provides a fixed interest rate but an increasing payment amount, allowing for a more rapid payoff

e. Reverse annuity mortgage—provides a monthly payment to a homeowner using a previously mortgage-free home as collateral, with the entire loan amount plus interest due at the end of the loan term—attractive to older homeowners with substantial home equities

f. Shared appreciation mortgage—offers a below-market interest rate and lower payments in exchange for the transfer of some equity from borrower to lender

E. Elements That Create Value

1. The four elements that create value must be present for real estate to have value and they can be remembered by the word DUST

a. Demand—present when someone wants the property and has the financial ability to buy it—called “effective purchasing power”

b. Utility—the property can serve a useful purpose

c. Scarcity—present when the property is in short supply relative to demand

d. Transferability—refers to the fact that title to the property can be moved readily from one person or entity to another

F. Types of Value

1. Value in exchange—the ability of a good or service to command another good or service

2. Definition of market value

a. *USPAP* defines market value as a type of value, stated as an opinion, that presumes the transfer of a property, as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal.

b. Fannie Mae definition of market value states that it is the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.

c. Arm's-length transaction always assumed

i. Buyer and seller are typically motivated

ii. Both parties are well informed or well advised, and acting in their best interests

iii. A reasonable time is allowed for exposure in the open market

1. Payment is made in terms of U.S. dollars or its equivalency

v. The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions

3. Sales price—what property actually sells for—its transaction price

4. Cost—amount paid for a good or service

5. Investment value—value of a property to a particular investor, considering the investor's cash flow requirements

6. Other values—real estate may have many different values at the same time, such as use value, insurable value, assessed value, depreciate value, and so on

G. Influences on Real Estate Value—forces affecting value, which can be remembered by the word PEGS, include

1. Physical and environmental

2. Economic

3. Government and legal

4. Social

# Exercise 5-1

III. Basic Value Principles

A. The factors that influence value include

1. Anticipation—the expectation of appreciation of real estate; its increase in value over time

2. Balance—land tends to be at its highest value when the four factors of production (land, labor, capital, management) are in balance—also refers to a mix of land uses that maximizes land values

3. Change—both physical and economic, affecting all property

4. Competition—may decrease value, as competing businesses share the same customer pool, but may increase value if more customers overall are drawn to the area

5. Conformity, Progression, and Regression—comparison of improvements to others in the neighborhood

a. Generally, buildings should conform to neighborhood standards in design, construction and age

b. A building that is not up to neighborhood standards will benefit by progression

c. A building that is above neighborhood standards will suffer by regression

6. Contribution—the value of an improvement is only what it contributes to the overall value of the property

7. Externalities—influences outside a property may have a positive or negative effect on its value

8. Four Factors of Production—considers the four factors of production (capital, labor, land and management) and the return required by each in a specific enterprise

9. Life Cycle of Property—GEDR—stages of the life cycle through which improved property will pass

a. Growth—improvements are new and demand grows

b. Equilibrium or stability—period of little change

c. Decline—property deteriorates over time, requiring more upkeep, which may lessen demand

d. Revitalization or rehabilitation—demand may increase, providing the impetus for major property renovation

10. Highest and Best Use—the most profitable legally and physically permitted use of property

a. Most important consideration

b. Results from analysis of community, neighborhood, site, and improvements

c. Measured as of date of appraisal report

11. Law of Increasing Returns—property improvements increase property value

12. Law of Decreasing Returns—point at which additional property improvements bring no corresponding increase in the property’s income or value

13. Opportunity Cost—value differential between alternative investments with differing rates of return

14. Substitution—value is influenced by the cost of acquiring a substitute or comparable property

15. Supply and Demand—property values rise as demand increases and/or supply decreases

16. Surplus Productivity—net income that remains after the costs of capital, labor, and management have been paid—the surplus is attributable to land rent

B. Conclusion—value principles are the keys to understanding why, when, and how certain factors act to influence the value of real property

# Exercise 5-2

# Summary

# Review Questions