

Overview of Types of Real Estate Investments

2. INTRODUCTION AND BASIC FORMS OF REAL ESTATE INVESTMENT

- **Real estate characteristics:**
 - Stable income
 - Inflation protection
 - Low correlation with bonds & stocks
 - Offer diversification benefits
- **Private Real-estate Investments** are suitable for investors with long-term investment horizons and who have the ability to accept relatively lower liquidity.
- **Securitized real estate ownership** - investment in
 - Real estate investment trust (REIT)
 - Real estate operating company (REOC)
 - Mortgage-backed security (MBS)

1.1 REAL ESTATE MARKET SIZE

- Total market size of real estate is higher compared to debt and equity.
- Within real estate residential real estate is the largest segment

1.2 REAL ESTATE INVESTMENT BASIC FORMS

- Real estate can be classified based on:
- Property type (residential or non-residential – owner occupied or for rent):
 - Capital position (debt or equity):
 - Investment vehicle (private investment or public investment).

1.3 Characteristics

- i. Unique asset and fixed location:
- ii. High unit value:
- iii. Management intensive:
- iv. High transaction costs:
- v. Depreciation:
- vi. Need for debt capital: (require large amounts to invest)
- vii. Illiquidity:
- viii. Price determination: (based on estimates or appraisals)

1.4 Risk Factors

Property Demand & Supply

- Business conditions
- Demographics
- Excess supply

Valuation

- Cost and availability of capital
- Availability of information
- Lack of liquidity
- Rising interest rates

Property Operations

- Management
- Lease provisions
- Leverage
- Environmental conditions
- Obsolescence
- Recent (COVID-19) & ongoing market disruptions
- Natural disasters

3. ECONOMIC VALUE DRIVERS, ROLE IN PORTFOLIO, AND RISK/RETURN OF REAL ESTATE INVESTMENTS RELATIVE TO STOCKS AND BONDS

2.1 Economic Drivers

- Economic growth
- Employment growth rate and job creation:
- Retail sales growth rate
- Demographic Trends and Population growth
- New space & construction time period:
- Supply and demand imbalance
- Real estate quality characteristics

2.2 Role of Real Estate in an Investment Portfolio

- Benefits:**
- Current income
 - Price appreciation
 - Retail sales growth rate
 - Inflation hedge
 - Diversification
 - Tax benefits

2.3 Real Estate Risk & Return Relative to Stocks & Bonds

- Real estate as an asset class has exhibited:
- have features of both bonds & stocks.
 - ↑ return and ↑ risk compared to Investment-grade bonds.
 - ↓ return and ↓ risk compared to a diversified portfolio of stocks.

2.4 Classifications

- Two property types are:
- A. Residential properties**
- single family
 - multi-family
- B. Non-residential properties**
- Commercial
 - Multi-family
 - Office
 - Industrial & warehouse
 - Retail
 - Hospitality
 - Other specialty types
 - Farmland
 - timberland

2.5 Investment Characteristics by Property Type

2.5.1 Common types of leases

- 1) Net lease:** Tenant pays operating expenses
- 2) Gross lease:** Owner pays operating expenses
- 3) Triple-net lease (or NNN lease):** Tenants pay their share of the following operating expenses:
 - Common area maintenance (CAM) & repair expenses
 - Property taxes
 - Building Insurance costs
- 4) Sale-leaseback:** Owner sells the property to an investor & signs a long-term lease contract to buy back the same property from the investor.

2.5.2 Office

- They include single and multi-tenant office buildings that serve the needs of a specific tenant.
- Demand depends on the economy.

2.5.3 Industrial & warehouse

Special purpose properties used for light or heavy manufacturing and the associated warehouse space.

2.5.4 Retail

- Retail properties include small stores, large shopping centers with several stores, large department stores etc.
- Demand depends on the economy.

2.5.5 Multi-Family

- The demand for multi-family space largely depends on population growth, population demographics.
- They are differentiated based on location & shape of structure

4. CONSIDERATIONS IN ANALYSIS AND DUE DILIGENCE

Due diligence process includes:

- Market review:
- Lease and Rent Review:
- Costs of re-leasing space:
- Reviewing ownership history
- Reviewing agreements
- Verifying compliance with regulations.

5. INDEXES

4.1 Appraisal-Based Indexes

- Appraisal based indices combine valuation information from individual properties & provide a measure of market movement.
- The return for all the properties is calculated as:

$$Return = \frac{NOI - Capex + (ending\ MV - Beg.MV)}{Beg.MV}$$
- These individual property returns are then value weighted to get the return for all properties in the index.
- Such index allows us to compare the performance of RE with other asset classes.

4.2 Transaction-Based Indexes

- Such index is possible by companies that collect information on enough transactions to create an index based only on transactions.
- Problem \Rightarrow same property may not sell very frequently.
- To develop an index, some econometric technique is applied on different properties selling every quarter.
- More sales, the more reliable is the index.
- Hedonic index \Rightarrow control for differences in the characteristics of the property.
- Such indices require sufficient amount of data.

4.3 Advantages & Disadvantages of Appraisal-Based & Transaction-Based Indexes

- Disadvantage of *appraisal-based index*.**
- Appraisals lag in case of sudden shifts in the market.
 - Index with appraisal lag is more of an issue when compared with other publicly traded asset classes.
 - Appraisal lag tends to smooth the index.
 - Two general ways of adjusting the appraisal lag.
 - Unsmooth the appraisal-based index.
 - Use a transaction-based index.
- Disadvantage of *transaction-based index*.**
- Can be noisy.
 - Statistical techniques are used to control the noise, can be challenging.

4.4 Real Estate Security Indexes

Numerous index providers, exchanges and organizations produce real estate equity and debt indexes.