

CHAPTER NINE

Real Estate

Real Estate in the Economy

Valuation

Tax in Real Estate

Investment Trust

Replacement Rate

Real Estate in the
Economy

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Investment Trust

Replacement Rate

Real Estate in the Economy

Real Estate

Property consisting of land and buildings.

Real estate represents 20% of the value of all assets in the U.S.

Real estate is the largest asset in value that most people own.

Real Estate in the
Economy

Valuation

Tax in Real Estate

Investment Trust

Replacement Rate

Valuing Real Estate Investments

Investors should always consider the following when exploring interest in a property acquisition:

- **Net Operating Income (primary)**
The total income generated from owning a property minus its associated operating expenses
 - Defines cash flow after payment of all annual operating expenses
- **Interest Rate (secondary)**
Determines the overall return on the investment

Real Estate in the
Economy

Valuation

Tax in Real Estate

Investment Trust

Replacement Rate

Valuing Real Estate Investments

$$\text{CAP RATE} = \frac{\text{Annual Operating Income (NOI)}}{\text{Value of Property (Cost)}}$$

$$\text{CAP RATE} = \frac{\$40,000 \text{ (NOI)}}{\$500,000 \text{ (Price of Building)}} = 8\%$$

Real Estate in the
Economy

Valuation

Tax in Real Estate

Investment Trust

Replacement Rate

Valuing Real Estate Investments

Methods to value real estate:

- The Income Capitalization Approach
 - Capitalization of Income – a type of real estate appraisal method that estimates the value of a property based on the current operating income the property generates
 - Determines the value based upon how much rent will be produced
 - Extrapolates a future market value from the current net operating income
 - Uses the capitalization rate to develop a market sale price for the property

Capitalization Rate = Annual operating income (NOI) / value of property (cost)

Real Estate in the
Economy

Valuation

Tax in Real Estate

Investment Trust

Replacement Rate

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Methods to value real estate:

- The Discounted Cash Flow Approach
 - Discounted Cash Flows - an appraisal method that determines the value of real estate today based on projections of how much income it will generate in the future
 - Calculated by developing projected cash flow data followed by discounting the future expected operating income back to the present to determine the current value

Real Estate in the
Economy

Valuation

Tax in Real Estate

Investment Trust

Replacement Rate

Tax in Real Estate

Taxes do not determine market value for a particular property.

Taxes do impact net profit.

Depreciation

The reduction in value of real estate over time due to wear and tear.

- A tax deduction applied to allocate the cost of wear and tear over a property's useful life

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Economy

Valuation

Tax in Real Estate

Investment Trust

Replacement Rate

Tax in Real Estate

Two types of rental property tax:

- *Net Taxable Income*
Tax from operating income property is generally subject to income tax at ordinary tax rates
- *Capital Gains Tax*
Tax applicable to any gain realized on properties when they are sold

Investors pay professionals to handle the taxes of real estate properties.

Real Estate in the
Economy

Valuation

Tax in Real Estate

Investment Trust

Replacement Rate

Real Estate Investment Trust

Real Estate Investment Trust

A company that owns, operates, or finances income-generating real estate.

A real estate investment trust influences the growth of the real estate industry.

Real Estate in the
Economy

Valuation

Tax in Real Estate

Investment Trust

Replacement Rate

The Replacement Rate

Replacement Rate

Number of people that must be born to replace the number of people that died.

Current replacement rate = 2.1 (estimated)

Replacement rate is a key economic indicator.