

Real Estate Principles

A Value Approach

Sixth Edition



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Real Estate Principles

A Value Approach

Sixth Edition

David C. Ling

University of Florida

Wayne R. Archer

University of Florida









REAL ESTATE PRINCIPLES: A VALUE APPROACH, SIXTH EDITION

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Dedications

To my wife, Lucy, for her continued patience and understanding during this latest revision of the book and to our (now grown) children, Alex, Sarah, and Rebecca, who continue to try to understand what Dad actually does for a living.

-DCL

To my wife, Penny, who has always matched our efforts in this book with an equal measure of her devotion, support, and assistance; to our children Stephen, John, and Jennifer, who generously supported me with enthusiasm for the task; and to my mother and Penny's mother, who always kept the faith that I would do something useful with my "typewriter."

-WRA









About the Authors

DAVID C. LING

David C. Ling is the McGurn Professor of Real Estate at the University of Florida. Professor Ling received an MBA (1977) in finance and a Ph.D. (1984) in real estate and economics from The Ohio State University. His academic and professional publications have included articles on housing policy and economics, mortgage markets and pricing, private commercial real estate investments, publicly traded real estate companies, and performance evaluation. Professor Ling's research has been published in general interest finance journals (*Journal of Financial Economics*), leading field journals in finance and economics (e.g., *Journal of Urban Economics, Journal of Money, Credit and Banking, Journal of Banking and Finance, National Tax Journal*), as well as the leading real estate focused journals (*Real Estate Economics, Journal of Real Estate Finance and Economics, Journal of Real Estate Finance*

During 2000, Professor Ling served as President of the American Real Estate and Urban Economics Association (AREUEA). From 2000 to 2005, he also served as editor of *Real Estate Economics*. Professor Ling serves on numerous journal editorial boards including *Real Estate Economics*, the *Journal of Real Estate Finance and Economics*, the *Journal of European Real Estate Research*, and *The Journal of Real Estate Research*. In 2011, Professor Ling was the recipient of the George Bloom Award, which is presented annually by the Directors of the American Real Estate and Urban Economics Association for "outstanding contributions to the field of real estate academics." In 2010, he was awarded the David Ricardo Medal by the American Real Estate Society, which is ARES's highest honor "in recognition of research productivity and influence over a twenty year period."

Additional information on Professor Ling is available at http://warrington.ufl.edu/directory/person/5291.

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Wayne R. Archer is the William D. Hussey Professor at the Warrington College of Business, University of Florida. He is Executive Director of the Bergstrom Center for Real Estate Studies. He received a Masters in economics from Wichita State University (1968) and a Ph.D. in economics from Indiana University (1974). He has been a faculty member at the University of Florida since 1971. From 1979 through 1981, he served as a visiting researcher at the Federal Home Loan Bank Board and Federal Savings and Loan Insurance Corporation. His research publications include articles on office markets, house price indices, mortgage prepayment, mortgage pricing, and mortgage default risk.

Professor Archer is a member of the American Real Estate and Urban Economics Association, where he has served on the board of directors, and also is a member of the American Real Estate Society. He served on the editorial board of *Real Estate Economics*. He is a Fellow of the Homer Hoyt Institute.

Professor Archer teaches in the University of Florida's distance MBA program, and has worked in industry education throughout his academic career, including service as the educational consultant to the Florida Real Estate Commission from 1985 to 1999. Among additional roles, he served as a regular faculty member in programs of the Mortgage Bankers Association of America, in the Institute of Financial Education affiliated with the U.S. League of Savings and Loan Associations, and, more recently, with Freddie Mac. In addition, he has provided consulting services to industry and government from time to time throughout his career, and also serves from time to time as a consultant and advisor for real estate graduate programs in other universities.

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Preface

he study and practice of real estate draws on a multitude of disciplines including architecture, urban and regional planning, building construction, urban economics, law, and finance. This diversity of perspectives presents a challenge to the instructor of a real estate principles course. Depending on their backgrounds and training and on the interests of the students, some instructors may choose to emphasize the legal concepts that define and limit the potential value of real estate. Other instructors may focus more on licensing and brokerage issues (popular topics with many students) or on the investment decision-making process. Still others may feel that real estate market and feasibility analysis should be the core topics in a principles class. In short, one of the difficulties in teaching an introductory real estate course is that there appear to be too many "principles." The critical question thus becomes: What framework should be used to teach these principles?

Although the subject of real estate can be studied from many perspectives, we have adopted the value perspective as our unifying theme. Why? Because value is central to virtually all real estate decision making including whether and how to lease, buy, or mortgage a property acquisition; whether to renovate, refinance, demolish, or expand a property; and when and how to divest (sell, trade, or abandon) a property. Thus, whether a person enters the business of real estate in a direct way (e.g., development and ownership), becomes involved in a real estate service business (e.g., brokerage, property management, consulting, appraisal), or simply owns a home, he or she must continually make investment valuation decisions or advise others on their decisions. The key to making sound investment decisions is to understand how property values are created, maintained, increased, or destroyed.

Once value is established as the central theme, all other concepts and principles of real estate analysis can be built around it. Legal considerations, financing requirements and alternatives, income and property tax considerations, and local market conditions all are important primarily in the context of how they affect the value of the property. For example, in Part 2 students will study growth management and land use regulations. Although these concepts have great interest from a political and public policy perspective, they are important from a real estate view primarily because of their potential effects on property rents and values. Similarly, the "imperfections" in real estate markets discussed in Part 3—such as the lack of adequate data, the large dollar value of properties, and the immobility of land and structures—are of interest primarily because of their effects on market values. Our objective is to provide the reader with a framework and a set of valuation and decision-making tools that can be used in a variety of situations.

The Sixth Edition

Since the publication of *Real Estate Principles: A Value Approach*, Fifth Edition, continued changes have come upon the world of real estate. This is true in transactions and brokerage with continued advancement of electronic marketing and the arrival of completely new forms and procedures for most real estate transactions, it is true in valuation with the expansion of automated valuation systems, a new version of the Uniform Residential Appraisal Report, and of new residential and commercial property data sources, and it is true in development and construction with the shift to "green" building. But it is still more true in real estate finance and capital sources where the dramatic advancement of internet lending and the implementation of the "Dodd-Frank" Act have displaced traditional practices,

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Preface

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procedures and players, in mortgage finance. In addition, there continues to be change with profound and far-reaching implications in a world where we now understand that both residential and commercial property values can go down as well as up. This realization colors the demand for home ownership as well as every aspect of real estate investment, finance, and transactions for the foreseeable future.

Changes in This Edition

- The Test Bank has been expanded by 5 to 10 questions per chapter.
- *Industry Issues* are updated throughout the text to reflect current issues and concerns in the real estate industry.
- All web links and web search exercises are revised and updated.
- Data, charts, and graphs have been updated wherever possible throughout the text.
- Chapter 1: The discussion of land use in the United States is updated.
- Chapter 2: Numerous clarifications and updates have been made throughout the chapter.
- Chapter 3: Updated information on implied easements, and a new Industry Issues.
- Chapter 4: New sections added on traditional and new methods of land use control. Reorganized to better reflect the evolution of land use controls.
- Chapter 5: Industry Issues examples are extensively updated.
- Chapter 6: All content is updated. Additional clarification added around Real Estate application example, and Industry Issues boxes are extensively updated.
- Chapter 7: The chapter is updated to reflect recent changes in Uniform Standards for Professional Appraisal Practice (USPAP) that governs the appraisal process. The latest version of the Uniform Residential Appraisal Report (URAR) is included.
- Chapter 8: All content is updated. Industry Issues boxes have been completely rewritten.
- Chapter 9: All charts are updated.
- Chapter 10: All the data and examples are updated. Chapter has been extensively reorganized, rewritten, and updated. New section on home mortgage "adventurism."
- Chapter 11: Numerous topics have been clarified and all tables, charts, and examples
 have been updated. The terminology is updated to reflect current industry usage. Discussion of mortgage banking has been updated to reflect changes in the nature of that
 industry. Finally, discussion is added on the new public policy focus in home mortgage
 lending: ability to pay.
- Chapter 12: The example listing agreement form has been replaced with an updated version. All information and examples are updated and discussions are expanded or clarified.
- Chapter 13: All forms have been replaced and updated. Also, a new section has been added on the increasingly common use of electronic documents in closings.
- Chapter 15: There is a new emphasis on using Excel to make calculations. A new exhibit shows the difference in interest rates between adjustable-rate and level-payment mortgages.
- Chapter 16: Revisions reflect ongoing changes in the typical permanent loan origination process, recourse versus nonrecourse loans, the level of available commercial mortgage rates, and other typical loan terms. The discussions of preferred equity and of maximum loan size have been expanded. A discussion of bridge loans has been added.
- Chapter 17: There is expanded discussion of private equity funds, including debt funds, to reflect their surge in importance in recent years. The section on real estate investment trusts (REITs), including their recent return performance, has been completely updated. Updated data support the revised discussion of the sources of commercial real estate debt and equity.
- Chapters 18 and 19: The discussion of financial risk ratios, including the increased use
 of debt yield ratios by lenders to size loans, has been updated, as are the data on capitalization rates.











Preface

- Chapter 20: All tax rates and data are updated. The Tax Cuts and Jobs Act of 2017
 has been integrated into the text narrative and Exhibits. There is a new section on tax
 deferral strategies, and another on opportunity zones.
- Chapter 21: There is a new Industry Issues about green buildings.
- Chapter 22: The discussion of lease terms and conditions is updated to reflect recent changes and industry standards. There is a new discussion of ground leases.
- Chapter 23: All data and examples have been updated.

Intended Audience

Real Estate Principles is designed for use in an introductory real estate course at both the undergraduate and graduate levels, though some chapters may be used by instructors teaching courses focused on real estate market analysis, finance, and investment. In terms of background or prerequisites, some familiarity with basic economics and business finance principles is helpful and will allow the instructor to move more quickly through some of the material (especially Parts 1, 3, 6, and 7). However, the book is designed to be largely self-contained. As a result, students with different backgrounds will find the text accessible. In particular, the direct use of discounting and other time-value-of-money techniques is limited to Parts 6 to 8, allowing the text to be used by students with little or no background in time-value-of-money techniques.

Organization

Part 1 of the book provides an overview of real estate and real estate markets. In Part 2, we provide an overview of the legal foundations of value and discuss the significant influence that federal, state, and local governments and agencies have on real estate decision-making and property values. In Part 3, we discuss the market determinants of value, how the benefits and costs of ownership can be forecasted, and how real estate appraisers convert these estimates of future cash flows and expenses into estimates of current market value.

Part 4 discusses the financing of home ownership, including the law that underlies residential mortgage contracts, the most common types of mortgages used to finance home ownership, and the lenders and other capital market investors that provide funds for residential mortgage loans. In addition to financing their real estate acquisitions, owners must navigate the often time-consuming and complex waters associated with acquiring and disposing of real property. The brokering and closing of real property transactions is presented in Part 5.

Parts 1 to 5 (Chapters 1 to 13) do not require knowledge of discounting and time-value-of-money techniques; thus, these chapters are accessible to students with limited or no background in finance and economics. Although basic time-value concepts are at the heart of this book, not every student studies them before encountering a real estate course. We have separated the formal application (though not the underlying ideas) of time-value into one section (Part 6). This enables the instructor to choose when and how these concepts will be put before the student—whether before, parallel with, or after the student is introduced to the real estate content. Indeed, one option is for the student to complete Chapters 1 to 13 without interjection of formal time-value instruction. Further, this nontechnical approach can be extended to Chapters 16 to 18, as noted below.

In Part 6, we introduce the formal applications of compound interest and present value that are often key to a deeper understanding of mortgage calculations and the valuation of income-producing properties, such as office buildings and shopping centers. For students who have had basic economics and business finance courses, Chapters 14 and 15 of Part 6 may contain substantial review. For others, these chapters contain new concepts that will require study and practice to master. Instructors wishing to bypass Part 6 can move directly from Part 5 to Chapters 16 to 18. However, instructors wishing to dig more deeply into commercial real estate financing and investing should review or cover in detail Chapters 14 and







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Preface

15 before proceeding with coverage of Part 7. We note that the three chapters contained in Part 8 also do not assume knowledge of time-value-of-money techniques.

Although we recommend the material be covered in the order presented in the text, Parts 2 through 8 can generally be covered in any order, depending on the preferences of the instructor and the primary focus of the course. For example, instructors who prefer to cover the investment material first may elect to move directly to Parts 6 and 7 immediately after Part 1.

Regardless of the emphasis placed on the various chapters and materials, we believe strongly that an introductory course in real estate should be as substantive and challenging as beginning courses in fields such as accounting, economics, and finance. The course should go beyond definitions and the discussion of current professional practice. Moreover, its focus should be on real estate principles and decision tools, not simply the current rules and practice for transactions that are so important to real estate sales licensing and brokerage.

David C. Ling

Wayne R. Archer









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Main Features

We have included many pedagogical features in this book that will be valuable learning tools for your students. This overview walks through some of the most important elements.

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- Explain the role of transportation modes and natural resources in the location and evolution of cities
- Define economic base activities, distinguish them from secondary activities, and explain the role of both in the growth or decline of a

Learning Objectives

Each chapter begins with a summary of the objectives of the chapter and describes the material to be covered, providing students with an overview of the concepts they should understand after reading the chapter.

OUTLINE

Introduction

Market Misjudgments in Real Estate

Minimizing Market Errors

The Creation, Growth, and Decline of Cities Where Cities Occur

The Economic Base of a City Resources of a City: The Supply Side of Urban

Growth

The Shape of a City

Demand for Proximity and Bid-Rent Curves

Bid-Rent Curves, Urban Land Uses, and Land Value

Changing Transportation, Changing Technology, and

Chapter Outlines

A chapter outline is featured among each chapter opener. Each outline lists the chapter headings and subheadings for a quick reference for both professors and students.

Introduction

In an ideal economic world market competition would compel the most desirable uses of land for society. If real estate markets worked well, unregulated competitive bidding would bring about the most productive use of each parcel, and the price paid for the parcel would exactly reflect its usefulness, much as described in Chapter 5. But this does not completely happen for several reasons. One of the reasons is because of externalities: The unintended and unaccounted for consequences of one land user upon others. For example, the creation of a shopping center on a site may cause harm to neighbors through increased traffic delays, noise, increased storm runoff across neighboring land, "light pollution," or other visual or environmental deterioration. Another problem that arises is that buyers of property suffer from incomplete information. Once a structure is built it is difficult, and sometimes impos

Chapter Introductions

The first section of each chapter describes the purpose of reading each chapter, and provides links between the different concepts.

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Main Features

Key Terms

Key terms are indicated in bold within the text for easy reference. A list of key terms from each chapter plus page references can be found in the end-of-chapter material. The glossary contains the definitions of all key terms.

Market Value, Investment Value, and Transaction Prices

Before discussing the framework for estimating the market value of real estate, it is important to distinguish among the concepts of market value, investment value, and transaction price. Real estate appraisers generally define the market value of a property as its most probable selling price, assuming "normal" sale conditions. Alternatively, it can be viewed as the value the typical (imaginary) participant would place on a property. The concept of market value rests upon the presence of willing buyers and sellers freely bidding in competition with one another. It is the result of the interacting forces of supply and demand. If real estate markets were perfectly competitive, market value would equal the property's most recent transaction

Industry Issues

These boxes, located in almost all chapters, feature current and interesting real-world applications of the concepts discussed in the chapters.

INDUSTRY ISSUES virtually all long-term carrying costs, passing the savings directly to the purchaser in the form of a reduced price. The result is often a win-win situation: sellers obtain immediate cash and buyers purchase properties at fair market value, the price determined by open, competitive hidrlinn. states. The National Association of Realtors

Real Estate Applications

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These boxes, located in select chapters, offer case applications of key topics.

In response to lines secret. | Clinitial) The Broker | so or | so not authorized to display the listed Property on the Internet, then (B), (C), and (D) do not apply. | | Clinitial) The Broker | so or | so to authorized to have the address of the

Career Focus

These boxed readings provide students with valuable information on the many different career options available to them, and what those positions entail.



CAREER FOCUS

provide for growth and revitaliza-tion of communities, while helping local officials make decisions ranging from broad urban problems to new community infrastructure. They may participate in deci-sions on alternative public transportation

system plans, resource development, and protection of sitive regions.
Planners also
may be involved
with drafting legislation con-cerning local com

Urban and regional planners often confer with land developers, civic leaders, and public officials. They may function as mediators in community disputes and present alternatives acceptable to opposing parties. Planners may prepare metarget and civic meetings, and appear before legislative committees and elected officials to explain and defend their proposals. Planners rely heavily on sophisticated computer-based databases and analytical tools, including geographical information systems (GSS).

Most entry-level jobs in federal, state, and local government agencies require a master's degree in urban or regional planning, urban design, geography, or a

similar course of study. Planners must be able to think in terms of spatial relation ships and visualize the effects of their plans and designs. They should be flexible and able to reconcile different viewpoints and to make constructive policy recom-mendations. The ability to communicate mendations. The ability to communicate effectively, both orally and in writing, is necessary for anyone interested in this field.

In 2015, 80 percent of planners earned between about \$45, 180 and \$114, 170, with a median of \$73,050.



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Main Features

www.houstontx.gov/ legal/deed.html

An unusually descriptive local government explanation of deed restrictions, their use and enforcement in Texas, where deed restrictions can replace zoning.

Concept Check

7.2 Assume a house is listed for sale for which you would be willing to pay up to \$200,000. The seller has put the property on the market with an asking price of \$180,000. List some possible reasons why your investment value exceeds that of the seller. Is the price you pay likely to be closer to \$200,000 or \$180,000? Explain.

due is \$5,801.91, or \$276.28 greater than the \$5,525.63 accumulated value assuming yearend deposits. What is the relationship between the standard future value result and the annuity due result? Note that the \$5,801.91 annuity due solution can be obtained by multiplying the solution to the regular annuity problem by 1 plus the periodic interest rate [i.e., $$5,801.91 = $5,525.63 \times (1 + 0.05)$].

Exhibit 3-2 Creating Evidence of Titl



Exhibit 6-10 Where People Work in Orland



Website Annotations

Websites are called out in the margins in every chapter and include a notation of what can be found by visiting them.

Concept Check

Every major section contains one or more questions for review. This feature helps students test their understanding of the material before moving on to the next section. Solutions to each Concept Check are provided at the end of each chapter so students can check their answers.

Calculator Keystrokes

Found in applicable chapters, calculator keys are shown with values to help guide students through numerical calculations.

Figures & Tables

This text makes extensive use of real data and presents them in various exhibits. Explanations in the narrative, examples, and end-of-chapter problems will refer to many of these exhibits.

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End-of-Chapter Features

Chapter Summary

Each chapter ends with a short section that highlights the important points of the chapter. This provides a handy study tool for students when they review the chapter.

Test Problems

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Because solving problems is so critical to a student's learning, approximately 10 multiple-choice problems are provided per chapter to help students master important chapter concepts.

Study Questions

Each chapter contains 10–20 study questions that ask students to apply the concepts they have learned to real situations and problems to reinforce chapter concepts.



This chapter surveys three basic powers of government: its right to regulate land use, its right to take private property for public use, and its right to tax property. The power of federal, state, and local governments to regulate land use through planning, zoning, building codes, and other means is vested in their police power. Communities use these tools to limit the negative effects of market failures such as monopolies, externalities, and incomplete structure information, thus attempting to increase market efficiency and equity.

Planning is the process of developing guidelines for controlling growth and development. Zoning assigns specific permitted uses to individual parcels of land to carry out the comprehensive plan. Other conventional tools of land use control include building codes and subdivision regulations. Newer land use control tools include PUDs, performance standards, impact fees and form-based zoning. States and local jurisdictions experiencing rapid growth have adopted a wide variety of measures to manage such growth. Some states pass laws requiring cities and counties to develop comprehensive plans, require economic and environmental impact statements in large development proposals, prohibit new development unless concurrency provisions are met, and require an allocation of affordable housing in new residential developments. Additionally, some states give local communities the right to establish urban service areas, or to plan and control urban development outside their boundaries. Though lawsuits have challenged zoning and growth management from a variety of standpoints, courts generally have upheld its validity when it is reasonable, nonexclusionary, and comprehensive.

Environmental hazards have become an important consideration in land use regulation in recent years. Asbestos, fiberglass, LUSTs, lead paint, radon gas, and mold are some of the most common threats. Real estate investors must protect themselves from these hazards by having environmental inspections and by requiring written statements of indemnification from developers and previous owners.

Eminent domain is the power of government to acquire private property for public use in exchange for just compensation. Courts have interpreted the term public use broadly to include property taken for a public purpose. Just compensation is the market value of the property. Courts have generally ruled that regulations imposing limits on property rights do not need to be compensated; however, if regulation goes "too far" it will be recognized as a taking and subject to compensation.

Test Problems

- Answer the following multiple-choice problems:

 1. The final price for each comparable property reached after all adjustments have been made is termed the:

 a. Final estimate of value.

 b. Final adjusted sale price.

 c. Market value.
- d. Weighted price.2. Which of the following is not included in accrued deprecia-

- 2. Which of the following is not included in accrued depreciation when applying the cost approach to valuation?

 a. Physical obsolescence.

 b. Functional obsolescence.

 c. External obsolescence.

 d. Tax depreciation.

 3. In the sales comparison approach, the value obtained after reconciliation of the final adjusted sale prices from the comparable sales is termed the:

 a. Adjusted price.

 b. Final adjusted sale price.

- a. Physical deterioration.
 b. Functional obsolescence.
 c. External obsolescence.
 d. Replacement cost obsolescence.
 To reflect a change in market conditions between the date on which a comparable property sold and the date of appraisal of a subject property, an adjustment must be made for which of the following?
 a. Conditions of sale.
 b. Market conditions.
 c. Location.

Study Questions

- List five major economic base activities for your city of residence.
- 2. Find the historical population figures for your community Find the historical population figures for your community for the 20th century. Create a chart with 10-year intervals. Determine the most rapid periods of growth, and try to discover what caused them. (For most cities, you can go to the Wikipedia page for the city and scroll to a table of populations by Census year. Another way is to "google" your city. Usually you get a chart for multiple decades.)

 On the U.S. Census website, use the approach shown the Explore the Web (next page) to access the American Community Survey. For your county and for your state find the distributions using percentage for each income interval. Which is higher, county or state?
- Identify at least five locational attributes that you believe are important in the location of a fast-food restaurant. Compare notes with someone in the industry such as a local restaurant.
- notes with someone in the industry such as a local restaurant manager or owner.

 5. Perfect Population Projections Inc. (PPP) has entered into a contract with the city of Popular, Pennsylvania, to project the future population of the city. In recent years, Popular has become a desirable place to live and work, as indicated by the table on the next page.

 The contract states that PPP must project Popular's population for the year 2020 using both a simple linear method and an economic base analysis. The ratio of population to total samplescent is 2083 in

total employment is 2.0833. Your help is needed!

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End-of-Chapter Features

EXPLORE THE WEB

Choose two states of interest to you. Using your favorite search engine enter "your state statutes." The statutes of virtually all states are online and searchable, although all have different search formats. For the two states you have chosen, compare and contrast the statutes on issues such as:

- 1. Himeshade laws.
 2. Laws pertaining to property obtained during marriage.
 3. Laws regarding tenant-landlord relationships.
 4. When mechanics' liens become effective (at contract signing? start of construction?).

Explore the Web

These boxes contain Internet activities that weave the Web, real data, and practical applications with concepts found in the

Solutions to Concept Checks

- Solutions to Concept Checks

 1. Three features of real property that introduce special challenges for the orderly transfer of ownership are:

 a. Real property interests can be very complex.

 b. Ownership has a very long history.

 c. All real property is bounded by other properties, so description errors always matter.

 2. In a normal contract, all parties must be legally competent, whereas in a deed only the grantor must be legally competent.

 3. The three covenants that distinguish the "quality" of deeds are:
- a. Seizin, which promises that the grantor actually holds

- title.

 b. No encumbrances, which promises that there are no undisclosed encumbrances.
 c. Quiet enjoyment, which promises that no superior claim to title will appear.
 4. Any property interest not being conveyed to the grantee is stated in the exceptions and reservations clause.
 5. The highest-quality deed is the general warranty deed. A deed that businesses often use to convey real estate is the

- bargain and sale deed. A deed used to relinquish ambiguous or conflicting claims is the quitclaim deed.

 6. When property is conveyed to heirs in accordance with a will, it is said to be conveyed testate or by devise, whereas when property is conveyed to heirs without a will, it is said to be conveyed instast or by descent.

 7. Four events that can cause an owner to convey real property involuntarily through some type of deed are condemnation, bankruptey, foreclosure, and divorce.

 8. Two types of easements that are created without a deed, but with the knowledge of the grantor, are an implied easement and an easement by estoppel.

 9. Real property can convey to a new owner without a deed, and without the consent or knowledge of the original owner. A fee simple interest being conveyed in this manner is said to convey by adverse possession, while an easement is said to convey by prescription.

 10. All persons are presumed to be informed of legal documents placed in public records according to the doctrine of constructive notice.

Solutions to Concept Checks

Located at the end of each chapter, answers to each Concept Check question are provided to help the student understand the concepts and the reasoning behind them.

Additional Readings

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Ihe following books contain expanded examples and discussions of real estate valuation and appraisal:

Appraisal Institute. The Appraisal of Real Estate, 14th ed. Chicago: American Institute of Real Estate Appraisers, 2013.

Appraisal Institute. 2020-2021 Uniform Standards of Professional Practice. Chicago: Appraisal Institute, 2019.

Betts, R. M. Basic Real Estate Appraisal, 6th ed. Florence, Ky: Cengage Learning, Inc., 2013.

The following books contain expanded examples and discussions

Carr, D. H., J. A. Lawson, and J. C. Schultz, Jr. Mastering Real

of real estate valuation and appraisal:

Estate Appraisal. Chicago: Dearborn Financial Publishing,

Fanning, S. F. Market Analysis for Real Estate. Chicago: Appraisal

Institute, 2014.

Lusht, Kenneth L. Real Estate Valuation: Principles and Applications. New York: McGraw-Hill, 1997.

Additional Readings & Websites

Each chapter is followed by a list of books and articles to which interested students can refer for additional information and research.











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Supplements

Supplements

Instructor supplement files for this edition are available in *Connect*.

Instructor's Manual, prepared by Benjamin Scheick, Villanova University

Developed to clearly outline the chapter material as well as provide extra teaching support, the instructor's manual contains a number of valuable resources. Sections include: a chapter overview, a listing of chapter concepts, presentation strategies, and presentation outlines that reference the accompanying PowerPoint slides for easy classroom integration.

Solutions Manual, *prepared by Wayne R. Archer and David C. Ling, University of Florida* This manual provides detailed answers to the end-of-chapter problems.

Test Bank, prepared by Benjamin Scheick, Villanova University

With hundreds of multiple-choice questions in Microsoft Word format, this Test Bank provides a variety of questions to meet any instructor's testing needs.

PowerPoint Presentation, prepared by Wayne R. Archer and David C. Ling, University of Florida

Prepared by the authors, more than 500 full-color slides of images and tables from the text, lecture outlines, and additional examples are available with this product.

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Chapter 1

PART ONE

The Nature of Real Estate and Real Estate Markets

Wealth is not without its advantages and the case to the contrary, although it has often been made, has never proved widely persuasive.

- Galbraith, John Kenneth, "The Affluent Society"

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- Provide three alternative definitions for the term real estate.
- Discuss the distribution of U.S. land among the various uses to which it is put (e.g., developed land, federal land, forest land).
- Discuss the value and importance of U.S. real estate compared with the values of other asset classes such as stocks and bonds.
- Describe the role real estate plays in the portfolios of U.S. households.
- Discuss the primary ways that real estate markets are different from the markets for assets that trade in well-developed public markets.

OUTLINE

Introduction

Real Estate: Some Basic Definitions

Real Estate: A Tangible Asset Real Estate: A Bundle of Rights Real Estate: An Industry and Profession

Real Estate and the Economy

Land Use in the United States Real Estate and U.S. Wealth

Real Estate Markets and Participants

User, Capital, and Property Markets The Role of Government The Interaction of Three Value-Determining Sectors The Production of Real Estate Assets

Characteristics of Real Estate Markets

Heterogeneous Products Immobile Products Localized Markets Segmented Markets Privately Negotiated Transactions with High **Transaction Costs**

Introduction

Real estate is the single largest component of wealth in our society. Because of its magnitude, it plays a key role in shaping the economic condition of individuals, families, and firms. It can substantially influence a family's ability to finance its education, health care, and other important needs. Changes in the value of real estate can dramatically affect the wealth of businesses and their capacity to grow.

Similarly, real estate resources can greatly affect a community's ability to attract and support profitable business activities, as well as to provide secure, convenient, and affordable





2

Part 1 Setting the Stage

living environments for its citizens. The adequacy of the housing stock, as well as the public infrastructure, including roads, bridges, dams, airports, schools, and parks, all affect the quality of life in a region.

Real estate, excluding primary residences, has been estimated to represent approximately 25 percent of the world's total economic wealth. In addition, it is often viewed as an important symbol of strength, stability, and independence. Consider, for example, the symbolic importance of structures such as Saint Peter's Basilica in Rome to the Roman Catholic Church, the buildings of the Forbidden City in Beijing to the Chinese people, or the Burj Khalifa Tower, the tallest building in the world, to the citizens of the United Arab Emirates (see also Industry Issues 1-1). It is not surprising that real estate has been at the center of many regional disputes. It has been, and continues to be, a vital resource.

The prominence of real estate means that decisions about it also are important. For the individual, the firm, and the region, better decisions about the creation and use of real estate assets will bring greater productivity, greater wealth, and a better set of choices for life.

This book is about making informed decisions concerning real estate. We will show that virtually all decisions about the acquisition, disposition, or improvement of real estate depend on some assessment of the real estate's value. These decisions, which we refer to as investment decisions, involve comparing the resulting value of an action with its immediate cost. If the value exceeds the cost, the action should be pursued. The breadth and importance of these investment decisions in real estate are hard to overstate.

As a beginning, we first look at the different uses of the term *real estate*. This is followed by a discussion of land use in the United States and real estate's contribution to U.S. and household wealth. The chapter finishes with a discussion of the real estate market, its participants, and the characteristics that make real estate assets unique.

Real Estate: Some Basic Definitions

It is important at the outset that we define the term *real estate*, as well as some closely related terms used throughout this book. When people think of real estate, they often think of the homes in their community or the business of buying and selling houses. This is probably because the personal investment that most households make in their home represents their primary involvement in the real estate market. Of course, real estate includes not only our homes, but also our places of work, commerce, worship, government, education, recreation, and entertainment—our physical environments, natural and built. In addition, it includes a wide range of business and institutional activities associated with the development, purchase, use, and sale of land and buildings.

Real estate is property. The term **property** refers to anything that can be owned or possessed. Property can be a tangible asset or an intangible asset. **Tangible assets** are *physical* things, such as automobiles, clothing, land, or buildings. **Intangible assets** are *nonphysical* and include contractual rights (e.g., mortgage and lease agreements), financial claims (e.g., stocks and bonds), interests, patents, or trademarks.

The term *real estate* is used in three fundamental ways. First, its most common use is to identify the tangible assets of land and buildings. Second, it is used to denote the "bundle" of rights associated with the ownership and use of the physical assets. Finally, the term real estate may be used when referring to the industry or business activities related to the acquisition, operation, and disposition of the physical assets.

Real Estate: A Tangible Asset

When viewed purely as a tangible asset, **real estate** can be defined as the land and its permanent improvements. **Improvements** *on* **the land** include any fixed structures such as buildings, fences, walls, and decks. **Improvements** *to* **the land** include the components necessary to make the land suitable for building construction or other uses. These improvements are

1. World Wealth Report 2014, Capgemini Consulting, p. 19 (www.worldwealthrerport.com).









INDUSTRY ISSUES

1-1

umerous super-tall buildings have been completed in the last decade (see listing below). They are in cities such as Hong Kong and Shanghai in China and Dubai on the Arabian Peninsula. Currently, the world's tallest building—Burj Khalifa at 2,717 feet—is in Dubai, UAE. Tall structures are as old as civilization, from

the Pyramids in Egypt to the cathedrals of medieval Europe. Historians attribute this phenomenon in part to religious and spiritual motives—the desire to build to the sky. In modern times, however, the motive has been largely economic. The skyscraper era began in the United States in the late 19th century when the technology of

steel-framed construction and safe elevators made it possible. It started in Chicago, although New York evolved into the leading skyscraper city during the 20th century. However, only four of the world's 40 tallest buildings are now located in the United States.

World's Tallest Buildings: 2014

1 Burj Khalifa Dubai, UAE 2,717 2 2 Shanghai Tower Shanghai, China 2,074 2 3 Makkah Clock Royal Tower Makkah, Saudi Arabia 1,972 2 4 Ping An International Finance Center Shenzhen, China 1,965 2 5 Goldin Finance 117 Tianjin, China 1,957 2 6 Lotte World Tower Seoul, South Korea 1,824 2 7 One World Trade Center New York City, US 1,776 2 8 CTF Finance Centre Guangzhou, China 1,739 2 9 CTF Tianjin Tower Tianjin, China 1,739 2 10 Zhongguo Zun Beijing 1,732 2 11 Taipei 101 Taipei, Taiwan 1,671 2 12 Shanghai World Financial Center Shanghai, China 1,518 2 13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Peter	2015 Rank	Building	City, Country	Height (feet)	Year Completed
3 Makkah Clock Royal Tower Makkah, Saudi Arabia 1,972 2 4 Ping An International Finance Center Shenzhen, China 1,965 2 5 Goldin Finance 117 Tianjin, China 1,957 2 6 Lotte World Tower Seoul, South Korea 1,824 2 7 One World Trade Center New York City, US 1,776 2 8 CTF Finance Centre Guangzhou, China 1,739 2 9 CTF Tianjin Tower Tianjin, China 1,739 2 10 Zhongguo Zun Beijing 1,732 2 11 Taipei 101 Taipei, Taiwan 1,671 2 12 Shanghai World Financial Center Shanghai, China 1,614 2 13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower	1				2010
4 Ping An International Finance Center Shenzhen, China 1,965 2 5 Goldin Finance 117 Tianjin, China 1,957 2 6 Lotte World Tower Seoul, South Korea 1,824 2 7 One World Trade Center New York City, US 1,776 2 8 CTF Finance Centre Guangzhou, China 1,739 2 9 CTF Tianjin Tower Tianjin, China 1,739 2 10 Zhongguo Zun Beijing 1,732 2 11 Taipei 101 Taipei, Taiwan 1,671 2 12 Shanghai World Financial Center Shanghai, China 1,614 2 13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS <td< td=""><td>2</td><td>Shanghai Tower</td><td>Shanghai, China</td><td>2,074</td><td>2014</td></td<>	2	Shanghai Tower	Shanghai, China	2,074	2014
5 Goldin Finance 117 Tianjin, China 1,957 2 6 Lotte World Tower Seoul, South Korea 1,824 2 7 One World Trade Center New York City, US 1,776 2 8 CTF Finance Centre Guangzhou, China 1,739 2 9 CTF Tianjin Tower Tianjin, China 1,739 2 10 Zhongguo Zun Beijing 1,732 2 11 Taipei 101 Taipei, Taiwan 1,671 2 12 Shanghai World Financial Center Shanghai, China 1,614 2 13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS Suzhou, China </td <td>3</td> <td>Makkah Clock Royal Tower</td> <td>Makkah, Saudi Arabia</td> <td>1,972</td> <td>2012</td>	3	Makkah Clock Royal Tower	Makkah, Saudi Arabia	1,972	2012
6 Lotte World Tower Seoul, South Korea 1,824 2 7 One World Trade Center New York City, US 1,776 2 8 CTF Finance Centre Guangzhou, China 1,739 2 9 CTF Tianjin Tower Tianjin, China 1,739 2 10 Zhongguo Zun Beijing 1,732 2 11 Taipei 101 Taipei, Taiwan 1,671 2 12 Shanghai World Financial Center Shanghai, China 1,614 2 13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS Suzhou, China 1,483 1 18 Petronas Tower I Kuala Lumpur, Malaysia 1,483 1 20 Zifeng Tower Nanjing, China <td>4</td> <td>Ping An International Finance Center</td> <td>Shenzhen, China</td> <td>1,965</td> <td>2016</td>	4	Ping An International Finance Center	Shenzhen, China	1,965	2016
7 One World Trade Center New York City, US 1,776 2 8 CTF Finance Centre Guangzhou, China 1,739 2 9 CTF Tianjin Tower Tianjin, China 1,739 2 10 Zhongguo Zun Beijing 1,732 2 11 Taipei 101 Taipei, Taiwan 1,671 2 12 Shanghai World Financial Center Shanghai, China 1,614 2 13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS Suzhou, China 1,483 2 18 Petronas Tower I Kuala Lumpur, Malaysia 1,483 1 19 Petronas Tower II Kuala Lumpur, Malaysia 1,483 1 20 Zifeng Tower Nanjing, Chi	5	Goldin Finance 117	Tianjin, China	1,957	2016
8 CTF Finance Centre Guangzhou, China 1,739 2 9 CTF Tianjin Tower Tianjin, China 1,739 2 10 Zhongguo Zun Beijing 1,732 2 11 Taipei 101 Taipei, Taiwan 1,671 2 12 Shanghai World Financial Center Shanghai, China 1,614 2 13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS Suzhou, China 1,483 2 18 Petronas Tower I Kuala Lumpur, Malaysia 1,483 1 19 Petronas Tower II Kuala Lumpur, Malaysia 1,483 1 20 Zifeng Tower Nanjing, China 1,462 2 21 The Exchange 106 Kuala Lumpur, Malays	6	Lotte World Tower	Seoul, South Korea	1,824	2016
9 CTF Tianjin Tower Tianjin, China 1,739 2 10 Zhongguo Zun Beijing 1,732 2 11 Taipei 101 Taipei, Taiwan 1,671 20 12 Shanghai World Financial Center Shanghai, China 1,614 20 13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS Suzhou, China 1,483 2 18 Petronas Tower I Kuala Lumpur, Malaysia 1,483 1 19 Petronas Tower II Kuala Lumpur, Malaysia 1,483 1 20 Zifeng Tower Nanjing, China 1,462 2 21 The Exchange 106 Kuala Lumpur, Malaysia 1,462 2 22 Willis Tower Chicago, US	7	One World Trade Center	New York City, US	1,776	2014
10 Zhongguo Zun Beijing 1,732 2 11 Taipei 101 Taipei, Taiwan 1,671 2 12 Shanghai World Financial Center Shanghai, China 1,614 2 13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS Suzhou, China 1,483 2 18 Petronas Tower I Kuala Lumpur, Malaysia 1,483 1 19 Petronas Tower II Kuala Lumpur, Malaysia 1,483 1 20 Zifeng Tower Nanjing, China 1,476 2 21 The Exchange 106 Kuala Lumpur, Malaysia 1,462 2 22 Willis Tower Chicago, US 1,450 1 23 KK100 Shenzhen, China	8	CTF Finance Centre	Guangzhou, China	1,739	2016
11 Taipei 101 Taipei, Taiwan 1,671 20 12 Shanghai World Financial Center Shanghai, China 1,614 20 13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS Suzhou, China 1,483 2 18 Petronas Tower I Kuala Lumpur, Malaysia 1,483 1 19 Petronas Tower II Kuala Lumpur, Malaysia 1,483 1 20 Zifeng Tower Nanjing, China 1,476 20 21 The Exchange 106 Kuala Lumpur, Malaysia 1,462 2 22 Willis Tower Chicago, US 1,450 1 23 KK100 Shenzhen, China 1,449 2 24 Wuhan Center Wuhan, China 1,437 2 25 Guangzhou International Finance Center	9	CTF Tianjin Tower	Tianjin, China	1,739	2019
12 Shanghai World Financial Center Shanghai, China 1,614 20 13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS Suzhou, China 1,483 2 18 Petronas Tower I Kuala Lumpur, Malaysia 1,483 1 19 Petronas Tower II Kuala Lumpur, Malaysia 1,483 1 20 Zifeng Tower Nanjing, China 1,476 2 21 The Exchange 106 Kuala Lumpur, Malaysia 1,462 2 22 Willis Tower Chicago, US 1,450 1 23 KK100 Shenzhen, China 1,449 2 24 Wuhan Center Wuhan, China 1,437 2 25 Guangzhou International Finance Center Guangzhou, China 1,435 2 26 432 Park Avenue </td <td>10</td> <td>Zhongguo Zun</td> <td>Beijing</td> <td>1,732</td> <td>2018</td>	10	Zhongguo Zun	Beijing	1,732	2018
13 International Commerce Centre Hong Kong, China 1,588 2 14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS Suzhou, China 1,483 2 18 Petronas Tower I Kuala Lumpur, Malaysia 1,483 19 19 Petronas Tower II Kuala Lumpur, Malaysia 1,483 19 20 Zifeng Tower Nanjing, China 1,476 20 21 The Exchange 106 Kuala Lumpur, Malaysia 1,462 2 22 Willis Tower Chicago, US 1,450 1 23 KK100 Shenzhen, China 1,449 2 24 Wuhan Center Wuhan, China 1,437 2 25 Guangzhou International Finance Center Guangzhou, China 1,435 2 26 432 Park Avenue New York Ci	11	Taipei 101	Taipei, Taiwan	1,671	2004
14 Lakhta Center St. Petersburg, Russia 1,516 2 15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS Suzhou, China 1,483 2 18 Petronas Tower I Kuala Lumpur, Malaysia 1,483 19 19 Petronas Tower II Kuala Lumpur, Malaysia 1,483 19 20 Zifeng Tower Nanjing, China 1,476 20 21 The Exchange 106 Kuala Lumpur, Malaysia 1,462 2 22 Willis Tower Chicago, US 1,450 1 23 KK100 Shenzhen, China 1,449 2 24 Wuhan Center Wuhan, China 1,437 2 25 Guangzhou International Finance Center Guangzhou, China 1,435 2 26 432 Park Avenue New York City, US 1,398 2	12	Shanghai World Financial Center	Shanghai, China	1,614	2008
15 Vincom Landmark 81 Ho Chi Minh City 1,513 2 16 The Wharf IFS Tower 1 Changsha, China 1,483 2 17 Suzhou IFS Suzhou, China 1,483 2 18 Petronas Tower I Kuala Lumpur, Malaysia 1,483 19 19 Petronas Tower II Kuala Lumpur, Malaysia 1,483 19 20 Zifeng Tower Nanjing, China 1,476 20 21 The Exchange 106 Kuala Lumpur, Malaysia 1,462 2 22 Willis Tower Chicago, US 1,450 1 23 KK 100 Shenzhen, China 1,449 2 24 Wuhan Center Wuhan, China 1,437 2 25 Guangzhou International Finance Center Guangzhou, China 1,435 2 26 432 Park Avenue New York City, US 1,398 2	13	International Commerce Centre	Hong Kong, China	1,588	2010
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17 Suzhou IFS Suzhou, China 1,483 2 18 Petronas Tower I Kuala Lumpur, Malaysia 1,483 19 19 Petronas Tower II Kuala Lumpur, Malaysia 1,483 19 20 Zifeng Tower Nanjing, China 1,476 20 21 The Exchange 106 Kuala Lumpur, Malaysia 1,462 2 22 Willis Tower Chicago, US 1,450 1 23 KK 100 Shenzhen, China 1,449 2 24 Wuhan Center Wuhan, China 1,437 2 25 Guangzhou International Finance Center Guangzhou, China 1,435 2 26 432 Park Avenue New York City, US 1,398 2	15	Vincom Landmark 81	Ho Chi Minh City	1,513	2018
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19 Petronas Tower II Kuala Lumpur, Malaysia 1,483 19 20 Zifeng Tower Nanjing, China 1,476 29 21 The Exchange 106 Kuala Lumpur, Malaysia 1,462 29 22 Willis Tower Chicago, US 1,450 19 23 KK 100 Shenzhen, China 1,449 29 24 Wuhan Center Wuhan, China 1,437 29 25 Guangzhou International Finance Center Guangzhou, China 1,435 29 26 432 Park Avenue New York City, US 1,398 29	17	Suzhou IFS	Suzhou, China	1,483	2018
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21 The Exchange 106 Kuala Lumpur, Malaysia 1,462 2 22 Willis Tower Chicago, US 1,450 1 23 KK 100 Shenzhen, China 1,449 2 24 Wuhan Center Wuhan, China 1,437 2 25 Guangzhou International Finance Center Guangzhou, China 1,435 2 26 432 Park Avenue New York City, US 1,398 2	19	Petronas Tower II	Kuala Lumpur, Malaysia	1,483	1998
22Willis TowerChicago, US1,450123KK 100Shenzhen, China1,449224Wuhan CenterWuhan, China1,437225Guangzhou International Finance CenterGuangzhou, China1,435226432 Park AvenueNew York City, US1,3982	20	Zifeng Tower	Nanjing, China	1,476	2009
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25 Guangzhou International Finance Center Guangzhou, China 1,435 2 26 432 Park Avenue New York City, US 1,398 2	23	KK100	Shenzhen, China	1,449	2011
26 432 Park Avenue New York City, US 1,398 2	24	Wuhan Center	Wuhan, China	1,437	2017
	25	Guangzhou International Finance Center	Guangzhou, China	1,435	2010
44 Empire State Bldg. New York City, US 1,250 1	26	432 Park Avenue	New York City, US	1,398	2015
	44	Empire State Bldg.	New York City, US	1,250	1931

Skyscrapers: A Shift Toward Asia

Note: The Twin Towers of the World Trade Center in New York were 1,368 feet high when they were destroyed in 2001.

The rising value of land in densely settled cities has been the economic incentive to build up rather than out. The shift of skyscraper development to the Far East, however, has been a reflection of other trends, especially that region's emergence onto the global economic scene. The region's spectacular buildings are symbols of pride among nations that see themselves with new roles in the 21st century. A return

on investment is less of an impediment in nations not wedded to market economics, such as China.

Source data: Emporis.com

3







Part 1 Setting the Stage

often referred to as infrastructure and consist of the streets, walkways, storm water drainage systems, and other systems such as water, sewer, electric, and telephone utilities that may be required for land use. Subject to legal and practical limits, it should be noted that real estate includes not only the surface of the earth but also the area above and below the surface.

In practice, the term **land** may include more than simply the earth; it may also include the improvements to the land. For example, the term *land* is often used to refer to a building site, or lot, and includes the infrastructure but not any structures. In contrast, land is also commonly used to refer to a larger area that does not include *any* improvements. These areas are sometimes identified as **raw land**. These distinctions become especially important when the value of land is considered.

Tangible assets include both real property and personal property. In professional practice and throughout this book, the terms **real property** and real estate are treated as interchangeable. **Personal property** refers to things that are movable and not permanently affixed to the land or structure. For example, a motor home is personal property, while a custom "site-built" house is real property. A mobile home may be real or personal property, depending on how it is secured to the land and legally recognized by the jurisdiction (e.g., city, county, or state) in which it is located.

Concept Check

1.1 What distinguishes real property from personal property?

Real Estate: A Bundle of Rights

Although real estate is a tangible asset, it can also be viewed as a "bundle" of intangible rights associated with the ownership and use of the site and improvements. These rights are to the *services*, or benefits, that real estate provides its users. For example, real property provides owners with the rights to shelter, security, and privacy, as well as a location that facilitates business or residential activities. This concept of real property as a bundle of rights is extremely important to understanding real estate, and it is the subject of Chapter 2.

The bundle of property rights may be limited in numerous ways. It typically is reduced by state and local land use restrictions (see Chapter 4). Also, the rights can be divided and distributed among multiple owners and nonowners. For example, an apartment owner divides his or her full interest in the property when he or she leases an apartment unit and grants to a tenant the right to occupy and control access to the unit. Similarly, the tenant may be able to divide his or her interests by subleasing the apartment to another. As another example, an owner may purchase a property that has a utility access granted through a portion of the property. Thus, real estate can also be viewed as a bundle of rights inherent in the ownership of real property.

The value of a bundle of rights is a function of the property's physical, locational, and legal characteristics. The physical characteristics include the age, size, design, and construction quality of the structure, as well as the size, shape, and other natural features of the land. For residential property, the locational characteristics include convenience and access to places of employment, schools, shopping, health care facilities, and other places important to households. The location characteristics of commercial properties may involve visibility and access to customers, suppliers, and employees. The bundle of rights that determines the legal characteristics of a property can range from complete ownership to nonpossessory rights such as easements and liens. The physical and location characteristics required to provide valuable real estate services vary significantly by property type.

Concept Check

1.2 What is the difference between tangible and intangible assets? Does the ownership of "real estate" involve tangible assets, intangible assets, or both?









CAREER FOCUS

ne of the exciting things about pursuing a career in real estate is that many options are available. Career paths can accommodate individuals working for corporations, banks, advisory firms, or in the mortgage industry; analytical personality types working in real estate appraisal or consulting jobs; salespeople working in brokerage, leasing, or property management; or entrepreneurs interested in developing new properties or renovating historical buildings. Career opportunities also exist in the public sector with employers like the Department of Housing and Urban Development (HUD), the General Service Administration (GSA), the Bureau of

Reclamation, and numerous county property tax assessors, to name just a few.

As you familiarize yourself with the material presented in this book, the type of work associated with the job opportunities listed above will become increasingly clear. However, it is important that you begin to read some of the real estate articles that appear in newspapers, magazines, and journals. You should also begin searching for and bookmarking interesting real estate websites. To get started, we suggest you examine the career information available on the website of the University of Cincinnati's Real Estate Program (https://business.uc.edu/faculty-and-research/research-centers/real-estate/

career-paths.html). The National Association of Realtors also maintains an informative site on real estate careers (https://www.nar.realtor/careers-in-real-estate). The Real Estate Express website contains information on 30 real estate jobs and their salaries (https://www.realestateexpress.com/career-

hub/real-estate-salary/ 30-real-estate-jobsand-theirsalaries/).

Career Opportunities in Real Estate

nr

www.realtor.org

Website of the National Association of Realtors; provides information about brokerage as well as other real estate professions.

Real Estate: An Industry and Profession

The term *real estate* frequently is also used to refer to the industry activities associated with evaluating, producing, acquiring, managing, and selling real property assets. Real estate professions vary widely and include (1) real estate brokerage, leasing, and property management services; (2) appraisal and consulting services; (3) site selection, acquisition, and property development; (4) construction; (5) mortgage finance and securitization; (6) corporate and institutional real estate investment; and (7) government activities such as planning, land use regulation, environmental protection, and property taxation.

Real estate business opportunities in areas such as brokerage, leasing, appraisal, construction, and consulting often offer entrepreneurial-minded individuals the ability to observe and understand local real estate markets in addition to receiving above average compensation. These types of positions allow individuals the opportunity to have their fingers on the "pulse" of the market, often enabling them to directly participate in real estate investment activities.

Real estate professionals involved in a wide range of activities can be found in consulting firms, insurance companies, financial institutions, real estate investment firms, pension fund advisory firms, and non-real estate firms that use real estate in their business. Companies such as restaurant groups and retailers seeking to expand often require the services of "in-house" site acquisition analysts, construction managers, and facility managers.

Finally, the activities of state and federal government units, such as departments of transportation, commerce, planning, housing, and environmental protection, and local government agencies such as planning and property tax offices necessitate the employment of real estate research analysts and professionals.

www.census.gov

Numerous construction statistics.

www.nahb.org

Website of the National Association of Home Builders; contains extensive information on the housing industry.

Real Estate and the Economy

Real estate typically generates over 25 percent of U.S. gross domestic product (GDP), creates jobs for nearly 9 million Americans, and is the source of nearly 20 percent of local government revenues.² The total contribution of the housing sector alone averages 17 to 18 percent

2. Statistics about the real estate industry, Real Estate Roundtable, www.rer.org, and the Urban Institute, https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-and-local-backgrounders/property-taxes.

5









Part 1 Setting the Stage

of GDP.³ Because of the significant influence of real estate on the nation's economy, investors on Wall Street closely monitor real estate construction, construction permit activity, and real estate sales figures. Housing starts and sales are widely viewed as leading economic indicators.

Land Use in the United States

The United States represents about 6 percent of the Earth's land area, or approximately 2.3 billion acres (3.5 million square miles). To give a sense of scale to an acre, a football field, not including the end zone areas, is slightly more than one acre (1.1 acres). More precisely, an acre is defined as 43,560 square feet; there are 640 acres in one square mile. The size of a single-family residential lot is typically between one-fifth and four-fifths of an acre.

It is estimated that the contiguous 48 states comprise 1.9 billion acres and that 70 percent of this acreage is in nonfederal, rural land uses. According to the 2015 National Resources Inventory Summary Report, produced by the Department of Agriculture, developed land represents approximately 6 percent of the land in the continental United States (see Exhibit 1-1). Developed land consists of residential, industrial, commercial, and institutional land uses, including roads, railways, rights-of-ways, construction sites, utility sites, sanitary landfills, and other land uses of similar purpose. Much of the undeveloped land in the United States is divided in approximately equal shares among water areas and federal lands (24 percent), crop land and Conservation Reserve Program (CRP) land (20 percent), range land (21 percent), and forest land (21 percent).⁴ Pastureland and other rural land comprise 6 percent and 2 percent, respectively, of the 1.9 billion acres.

Overall, land use changes from 1982 to 2015 have been relatively minor. Most notable, however, is the increase of developed land from 73 million acres in 1982 to 115 million acres in 2015. Although only a small portion of the total land area in the United States, the amount of developed land has increased by 58 percent since 1982.

Real Estate and U.S. Wealth

It is hard to overstate the size and variety of capital commitments to real estate. We estimate that the total market value of real estate was approximately \$38.5 trillion in the fourth quarter of 2018. This estimate includes owner-occupied housing, investible commercial real estate, and land, but excludes real estate held by non-real estate corporations (such as

Exhibit 1-1 Land Use and Land Use Changes in the United States

Land Use	1982 Land use (mil. of acres)	% of Total	2015 Land use (mil. of acres)	% of Total
Developed land	73	4	115	6
Water areas and federal land	448	23	457	24
Crop land	420	22	367	19
CRP land			18	1
Pasture land	131	7	122	6
Range land	416	21	404	21
Forest land	403	21	416	21
Other rural land	48	2	45	2
Totals	1,938	100	1,944	100

Source of data: 2015 U.S. Department of Agriculture.

www.nrcs.usda.gov

U.S. Department of Agriculture resources include comprehensive information on trends for land use and development.





^{3.} Robert Dietz, "Housing's Share of GDP: 15.5% for the Second Quarter," Eve on Housing, National Association of Homebuilders, September 26, 2014.

^{4.} CRP land is a federal program established under the Food Security Act of 1985 to assist private landowners in converting highly erodible crop land to vegetative cover.



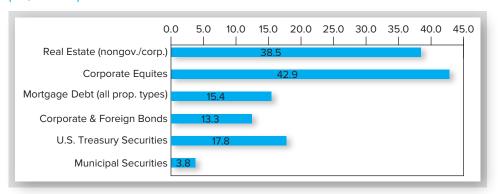
Chapter 1 The Nature of Real Estate and Real Estate Markets



www.bea.gov

U.S. Department of Commerce site contains vast amounts of national and international economic data.

Exhibit 1-2 Aggregate Market Values of Selected Asset Categories (in \$Trillions)—2018Q4



Note: Real estate (nongov/corp) includes developed land. It does not include farmland, water areas, and other rural lands. It also does not include real estate owned by non-real estate corporations.

Source of data: 2019 U.S. Federal Reserve Flow of Funds Accounts of the United States, Federal Reserve (March 7, 2019 various tables). The value of nongovernment and noncorporate real estate is equal to the value of owner-occupied housing from the Fed Flow of Funds Accounts, plus the value of investible commercial real estate from NAREIT, "Estimating the Size of the Commercial Real Estate Market," REIT.com, National Association of Real Estate Investment Trusts, May 2018.

McDonald's and Ford) and real estate owned by various federal, state, and local governmental entities. Real estate constitutes the second largest asset class in the United States, as shown in Exhibit 1-2. In comparison, the total value of publicly traded (listed) corporate equities (i.e., stocks) in late 2018 was approximately \$42.9 trillion; the value of outstanding real estate mortgage debt was approximately \$15.4 trillion. This is larger than the value of corporate and foreign bonds but less than the outstanding value of U.S. Treasury securities.

As reported by the U.S. Federal Reserve Board, housing represents one of the largest asset categories in the net worth portfolios of households (see Exhibit 1-3). On average, it represents approximately 21 percent of U.S. household wealth. This is similar to household holdings of corporate stock and mutual fund shares. Housing's 21 percent share in the typical household's portfolio dominates deposits and money market funds (11 percent) and equity invested in non-corporate businesses (11 percent). Moreover, the 21 percent housing share understates the importance of real estate for some households, because direct investments in private commercial real estate assets (e.g., apartments, office buildings) are not included as household assets in Exhibit 1-3. Finally, note that 64 percent of household liabilities are home mortgages.

By the fourth quarter of 2018, U.S. households had approximately \$15.5 trillion in housing equity (market value of the home minus mortgage debt). This represents, on average, about 60 percent of the value of their real estate and about 15 percent of their net worth. As a percentage of total household wealth, housing increased slightly during the early 2000s as house prices rose and corporate stock values declined. Although the stock market performed better during the 2003 to 2005 period, the housing sector continued to outperform stocks and bonds. This trend can be seen in Exhibit 1-4. However, in 2006, U.S. housing prices began a precipitous decline, which reduced the value of housing assets as a percentage of total household assets. Since 2010 housing has represented about 21 percent of total household assets.

www.federalreserve.gov

U.S. Federal Reserve System site contains extensive information on the U.S. banking system and economy.

Real Estate Markets and Participants

In the United States and many other countries, market competition serves to distribute most resources (i.e., goods, services, and capital) among the various users. The market's forces of demand and supply interact within the economy to determine the price at which goods, capital, and services are exchanged and to whom they are allocated. Real estate resources are







Part 1 Setting the Stage

Exhibit 1-3 U.S. Household Wealth*

	2018Q4	
Asset/Liability category	(\$ in billions)	% of Tota
Tangible assets		
Housing	\$25,877	21
Consumer durables	5,531	5
Other tangible assets	3,966	3
Financial assets		
Deposits & money market funds	12,869	11
Government & corporate bonds	5,435	5
Stocks & mutual fund shares	23,939	20
Pension assets (excluding stocks)	25,640	21
Other securities & assets	4,078	3
Noncorporate business equity	13,055	11
Total assets	120,390	100
Home mortgages (including lines of credit)	10,337	64
Other debt	5,724	36
Total liabilities	16,061	100
Net worth	\$104,329	
Owner's equity in real estate	\$15,540	
Owner's equity as a percent of housing/net worth	60%	15%

^{*}This sector consists of individual households and nonprofit organizations. Nonprofits account for about 6 percent of the sector's financial assets.

Source of data: 2019 U.S. Federal Reserve, Financial Accounts of the United States, Fourth Quarter of 2018, Federal Reserve (March 7, 2019, Table B.101), www.federalreserve.gov.

Exhibit 1-4 Selected Household Assets as a Percentage of Total Assets



Source of data: U.S. Federal Reserve, Financial Accounts of the United States, Table B.101, Balance Sheet of Households and Nonprofit Organization, various quarters, www.federalreserve.gov.







Chapter 1 The Nature of Real Estate and Real Estate Markets



Concept Check

1.3 According to Exhibit 1-3, U.S. households own \$25.9 trillion in housing assets. Assume this amount does not include rental real estate. On average, what percent of the value of the U.S. housing stock is financed with home mortgage debt?

allocated among its various users—individuals, households, businesses, and institutions—in the real estate market. Real estate values derive from the interaction of three different sectors, or markets, in the economy: local user markets (the "real world"), capital markets (the "financial world"), and property markets. A brief discussion of each of these sectors is presented below.

User, Capital, and Property Markets

Real estate **user markets** are characterized by competition among users for physical locations and space. As we will explain in Chapter 5, this competition determines who gains the use of each parcel of land and how much they must bid for its use. The primary participants in user markets are the potential occupants, both owner occupants and tenants, or renters. Ultimately, the demand for real estate derives from the need that these individuals, firms, and institutions have for convenient access to other locations, as well as for shelter to accommodate their activities. Based on the financial positions of households and firms and their wants and needs, they decide either to own and occupy property or to lease property from others. About two-thirds of U.S. households own their home, and many businesses own their real estate, while most commercial real estate located in the central business districts of U.S. cities is leased.

The **capital markets** serve to allocate financial resources among households and firms requiring funds. Participants in the capital markets invest in stocks, bonds, mutual funds, private business enterprises, mortgage contracts, real estate, and other opportunities with the expectation of receiving a financial return on their investment. Funds flow from investors to the investment opportunities yielding the highest expected return (i.e., the greatest benefit), considering risk. Thus, real estate competes for scarce investment capital with a diverse menu of other investment opportunities available in the capital market.

The capital markets can be divided into two broad categories: equity interests and debt interests. We commonly view the equity participants as the "owners of the real estate." Equity investors in real estate expect to receive a return on their investment through the collection of rent and through price appreciation. The debt participants, the "lenders," hold claims to the interest on borrowed funds that are secured by individuals, businesses, and property. The equity and debt interests can each be divided further into private and public market components. The primary participants in each of the four capital market categories—private equity, public equity, private debt, and public debt—are outlined in Exhibit 1-5. (The capital sources of real estate finance are discussed further in Chapters 11 and 17.)

Finally, **property markets** determine the required property-specific investment returns, property values, capitalization rates, and construction feasibility. The **capitalization rate**, or the ratio of a property's annual net income from rental operations to its value, is a fundamental pricing metric in commercial real estate markets.

Concept Check

1.4 Investible assets based on real estate are traded in each of the four capital market quadrants. List the four quadrants and at least one real estate asset that trades in each.

5. Investors who occupy their own properties "receive" the rent they would have paid to others had the property been leased from another investor. This is termed "implicit" rent.



Private firm that provides data on interest rates and bond yields.







1-2 INDUSTRY ISSUES

eal estate auctions often experience unfounded negative images in the marketplace. The majority of auctions today don't result from foreclosure of distress situations, but rather are the result of a Real Estate seller choosing **Auctions** a cost-effective method to sell a property. **Auctions allow** sellers to eliminate

virtually all long-term carrying costs, passing the savings directly to the purchaser in the form of a reduced price. The result is often a win–win situation: sellers obtain immediate cash and buyers purchase properties at fair market value, the price determined by open, competitive bidding.

Auction.com (www.auction.com) markets its auction platform as the nations' largest online auction marketplace. As of early 2019, Auction.com's transaction platform had resulted in \$39 billion in sales, 4.4 million registered buyers on Auction.com, 329,000 properties sold to date, and more than 15,000 auctions per year in all 50 states.

The National Association of Realtors (NAR) can help you understand the basics and benefits of a real estate auction. Learn about different auction types, how you can get involved, find online training, locate an auctioneer and more at www.nar.realtor/auctions.

Source: Authors, Auction.com (www.auction.com), and the National Association of Realtors (www.nar. realtor/auctions).

Exhibit 1-5 The Four Quadrants of Real Estate Capital Market Participants for Income Property

	Private Markets	Public Markets
Equity/owners	Individuals, partnerships, limited	Public real estate investment trusts
	liability corporations, private	(REITs) and real estate operating
	equity funds	companies
Debt/lenders	Banks, insurance companies,	Commercial mortgage-backed secu-
	finance companies, private	rities (CMBS) and mortgage
	lenders	REITs

The Role of Government

Government affects real estate markets, and therefore values, in a host of ways. Local government has perhaps the largest influence on real estate. It affects the supply and cost of real estate through zoning codes and other land use regulations, fees on new land development, and building codes that restrict methods of construction. Further, local government affects rental rates in user markets through property taxes. Finally, it profoundly affects the supply and quality of real estate by its provision of roads, bridges, mass transit, utilities, flood control, schools, social services, and other infrastructure of the community. (The influence of local government on real estate values through land use controls, property tax policy, and services is expanded upon in Chapter 4.)

State governments also affect real estate values. Through the licensing of professionals and agents, states constrain entry into real estate-related occupations (see Chapter 12). Through statewide building codes, they can affect building design and cost. Through disclosure laws and fair housing laws, states affect the operation of housing markets. In addition, states typically set the basic framework of requirements for local government land use controls, and even intervene in the realm of land use controls for special purposes such as protection of environmentally sensitive lands. Finally, states affect the provision of public services important to a community, including schools, transportation systems, social services, law enforcement, and others.

The national government influences real estate in many ways. Income tax policy can greatly affect the value of real estate and therefore the incentive to invest in it. (The extensive effect of income taxes on real estate value is detailed in Chapter 20.) Federal housing subsidy programs can have enormous effects on the level and type of housing construction.

www.uli.org

The Urban Land Institute is an influential U.S. organization for those engaged in development and land use planning.







Chapter 1 The Nature of Real Estate and Real Estate Markets

11

Federal flood insurance programs can influence development in coastal and wetlands regions. Federal financial reporting and disclosure requirements, and government-related financial agencies such as the Federal Reserve System and the Federal Deposit Insurance Corporation (FDIC) all have profound effects on the operation of the real estate capital markets (see Chapter 11 for details of the government's role in mortgage markets). Further, consumer protection laws affect few aspects of household activity more than they impact housing purchases and financing (see Chapters 9 and 13). In addition, laws protecting the environment and endangered species have significantly affected the use of real estate. Finally, national fair housing laws and other civil rights legislation are very important influences on housing markets.

The Interaction of Three Value-Determining Sectors

The interaction of the three value-determining sectors is illustrated in Exhibit 1-6. In local user markets, households and firms compete for the currently available supply of locations and space (left-hand side of Exhibit 1-6). This competition for space, coupled with the existing supply of leasable space, determines current rental rates (let's call this a space market equilibrium) and current cash flows (net operating incomes) of a property. The riskiness of the future cash flows depends on the degree of uncertainty about future space demand, future space supply, and the resulting future space market equilibriums.

Capital markets provide the financial resources (debt and equity) necessary for the development and acquisition of real estate assets (right-hand side of Exhibit 1-6). Within the capital markets, the returns investors require for a broad range of available investment opportunities, including real estate, are determined. Required investment returns equal the risk-free rate in the economy (i.e., the return available on a Treasury security), plus a risk premium that reflects how reliable or uncertain the forecasted net operating incomes are from the rental of the properties. Finally, in the interaction between user and capital markets, the expected stream of rental operating income for a particular property is capitalized into value through "discounting," which is the process of converting expected future cash flows into present value. Discounting incorporates the opportunity cost of waiting for the uncertain cash flows (center panel of Exhibit 1-6). (Discounting is the subject of Chapter 14.) Each market participant bids for properties based on his or her individual assessment of value. The prices current owners are willing to accept reflect each seller's assessment of value. This continuous bidding process determines market values and transaction prices in local property markets. As noted above, government influences on this value-determining process are numerous, ranging from local government land use controls and property taxes to federal income tax policy.

Our view is that sound decision making requires an understanding of how real estate values in local property markets are determined. Thus, value is the unifying theme of this book. This allows for an integrated framework for the study of real estate because all of the concepts and principles discussed in this text—such as legal considerations, local market conditions, interest rates, and local land use controls and regulations—are important primarily in the context of how they affect real estate values.

The Production of Real Estate Assets

If rental rates and their riskiness are determined in the space market, and required risk premiums are largely determined in the general capital markets, what role do local property (asset) markets play? First, local property markets allocate available property investments among competing investors. Second, local property markets determine the pace of new construction. A primary determinant of the feasibility of new construction is the relationship between the current level of property prices and the cost of new construction. If current property values are greater than the cost of new construction—including land costs and a fair developer profit—developers and investors have an incentive to add new space to the existing stock in an attempt to capture excess profits. Ultimately, however, the expansion of supply





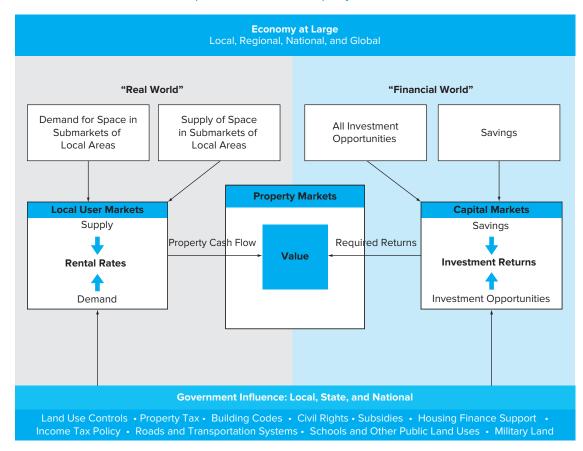






Part 1 Setting the Stage

Exhibit 1-6 User Markets, Capital Markets, and Property Markets



(holding the demand for space constant) causes rents in the space market (and therefore values in the property market) to decrease toward the level of current construction costs.

If current property values are below construction costs, as in an overbuilt market, a combination of reduced construction, normal growth in demand for space, and the steady obsolescence of the existing stock is required to push market rents and property values to their required levels. Only then will most developers find new construction projects profitable once more.

Real estate construction historically has been a volatile process because real estate prices and costs tend to be volatile. Thus, building booms and slumps often characterize real estate production, as discussed in Chapter 6. To compound the volatility further, real estate values also can be affected by shocks to the capital markets. For example, if interest rates rise, property values will generally fall, again rendering construction less profitable. Finally, construction costs can be very volatile. Organized labor disputes in cities such as New York or Boston, or unexpected events causing shortages in lumber, steel, or other building materials, can damage the financial viability of both small and large real estate development. (Real estate development is treated further in Chapter 23.)

Concept Check

In what market are rental rates for commercial real estate assets determined? In what market are property values determined?









Chapter 1 The Nature of Real Estate and Real Estate Markets

Characteristics of Real Estate Markets

Real estate assets and markets are unique when compared to other goods. The two primary characteristics of real estate assets are their heterogeneity and immobility. Because of these two factors, the market for buying, selling, and leasing real estate tends to be illiquid, localized, and highly segmented, with privately negotiated transactions and high transaction costs.

www.marshallswift.com

Private firm that tracks construction costs.

Heterogeneous Products

Real estate tends to be heterogeneous, meaning that each property has unique features. An example of a relatively homogeneous product is gasoline. Although it is possible to purchase different grades of gasoline (e.g., octane levels), a gallon of gasoline received from a particular pump cannot be distinguished from the next gallon.

For real estate, however, age, building design, and especially location combine to give each property distinctive characteristics. Even in residential neighborhoods with very similar houses, the locations differ. Corner lots have different locational features than interior lots; their access to parks and transportation routes may differ, and the traffic patterns within the neighborhood create differences. The most influential site and structural attributes of a home are typically observable and amenable to valuation (e.g., pools, bedrooms, and garages). However, information about a property's location attributes is much more difficult to observe and value because numerous external effects (positive and negative) act upon a land parcel at a given location, and these effects are reflected in the parcel's value. Said differently, each parcel of land has a unique location-value signature (LVS) and differences in LVSs create variation in property values.

Locational differences are particularly critical for retail properties. Significant value differences may result between retail properties on different sides of the same street, depending on whether the property is on the "going-home" or the "going-to-work" side. Most food outlets, drugstores, clothing stores, and service centers prefer to be on the going-home side of the street. Even within a single shopping center, there are important differences in location for a retail establishment depending on the need of the establishment for exposure to shoppers.

Immobile Products

Real estate is immobile. Although it is sometimes physically possible to move a building from one location to another, this is generally not financially feasible. The vast majority of structures removed from the land are demolished rather than moved.

Another term for location is access. For households, it is access to schools, shopping, entertainment, places of employment, and more. For commercial properties, it may be access to customers, the labor force, or suppliers. The nuances of access are fundamental to real estate value, as we discuss in Chapter 5.

Localized Markets

Real estate markets tend to be localized. By this we mean that the potential users of a property, and competing sites, generally lie within a short distance of each other. For example, competing apartment properties may lie within 15 minutes, or less, in driving time from each other, while competing properties of single-family residences may tend to be within a single elementary school district or even within a small number of similar subdivisions. Clearly, the market for a neighborhood shopping center is very localized. Such centers usually draw







^{6.} The term *location-value signature* is attributable to "Modeling Spatial Variation in House Prices: A Variable Interaction Approach." Timothy J. Fik, David C. Ling, and Gordon F. Mulligan, *Real Estate Economics*, vol. 31, no. 4, 2004.





Part 1 Setting the Stage

the majority of their customers from within a five-mile radius, or less. For a parent looking for a gallon of milk, a convenience store 15 minutes away is not a good substitute for the convenience store up the street. Users of other commercial property types may be more "footloose"—that is, they do not depend so heavily on access to a particular location. Thus, some commercial property users may search a wide range of alternative markets within a single metropolitan area or even among different metropolitan areas.

www.prea.org

Pension Real Estate Association.

Segmented Markets

Real estate markets tend to be highly segmented due to the heterogeneous nature of the products. Households that search for single-family detached units in the market will generally not consider other residential product types such as an attached townhouse unit or condominium. In addition, real estate is segmented by product price. The same holds true, although to a lesser extent, in the commercial property market. Commercial property markets are segmented by both users and investors. Larger, more valuable commercial properties, generally well over \$10 million in value, are often referred to as **investment-grade properties** or **institutional-grade real estate**. This is the segment of the property market targeted by institutional investors such as pension funds, publicly traded real estate companies, and real estate private equity funds. Individual private investors typically do not compete directly with institutional investors for properties.

The localized nature of real estate markets also contributes to segmentation and explains why rents and prices for otherwise similar property can vary significantly across metropolitan markets and even submarkets within a given metropolitan area.

www.costar.com www.loopnet.com

Private firms with information on a large number of commercial properties for sale.

Privately Negotiated Transactions with High Transaction Costs

A final distinctive feature of real estate is the complexity of property and transactions. As we discuss in Chapter 2, real estate is a uniquely complex "bundle of rights." The property interest to be conveyed cannot be standardized and therefore must be carefully assessed to determine what rights it actually contains. Further, because real estate has a history of ownership, the current claims of ownership must be confirmed by examining the past history of the property. Finally, property parcels are contiguous, so the problem of accurate description requires unique and elaborate systems of delineation. All these special issues in real estate are sufficient to compel unique laws, institutions, and procedures for the conveyance of real estate. Moreover, real estate agents, mortgage lenders, attorneys, appraisers, property inspectors, and others are usually involved in the transaction. The negotiation process between buyers and sellers can be lengthy, and the final transaction price and other important details such as lease terms are not usually observable. Thus, in almost every transaction involving real estate, there are time requirements and costs not present in most non-real estate transactions. These special challenges in virtually any transaction involving real estate can affect real estate values and risks and must be recognized by investors. It is important to note that the use of auctions to sell real estate has increased in recent years (see Industry Issues 1-2). The growing popularity and use of auctions are a response by some market participants to the costs and delays associated with privately negotiated transactions.

One final note on the uniqueness of real estate: Investors and lenders seem to get into trouble most commonly when they lose sight of these unique characteristics of real estate. The latest, graphic example of this is the subprime mortgage meltdown that occurred in the late 2000s. Such mortgages were used mostly by borrowers with weak credit or by borrowers who wanted to use more debt to purchase their homes than could be obtained with a "prime" mortgage. The creation and dissemination of subprime mortgage investments became detached from any thoughtful assessment of the underlying borrowers, housing values, or market depth. When average housing prices declined dramatically from 2006 to 2010, the cost of this short-sightedness was felt in every corner of the United States.

www.auction.com

Founded in 2007, this is one of the nation's leading online real estate marketplace.







Chapter 1 The Nature of Real Estate and Real Estate Markets

Concept Check

1.6 Identify four ways in which real estate markets differ from the market for publicly traded stocks.

Summary

We began this chapter by looking at the different uses of the term *real estate*. This was followed by a discussion of land use in the United States and the contribution of real estate to U.S. and household wealth, and then a discussion of the real estate market.

The term *real estate* is used in three fundamental ways: (1) to identify the tangible assets of land and buildings; (2) to denote the "bundle" of rights associated with the ownership and use of the physical assets; and (3) to refer to the industry, or business activities, related to the acquisition, operation, and disposition of the physical assets. Viewed as a tangible asset, real estate constitutes the physical components of location and space. In this context, real estate is defined as the land and any improvements permanently affixed on, or to, the land. The bundle of intangible rights, or interests, associated with the ownership and use of the physical characteristics of space and location constitutes the services that real estate provides to its users. It is the services/benefits that result from the use of the property that create value. Said differently, tracts of dirt do not have any intrinsic value. It is the uses to which the dirt can be put that create value.

Real estate typically generates over 25 percent of U.S. gross domestic product (GDP), creates jobs for nearly 9 million Americans, and is an important source of local government revenues. The total contribution of the housing sector alone approaches 20 percent of GDP. Real estate construction, construction permit activity, and real estate sales figures are closely watched by investors on Wall Street and across the world because of the effect real estate has on the nation's economy. Real estate also represents a significant share of our accumulated national wealth. The total value of owner-occupied housing and investible commercial real estate in the United States is estimated to be \$38.5 trillion. Approximately \$25.9 trillion of this represents the value of owner-occupied housing. Housing alone represents approximately 21 percent of U.S. household wealth.

Real estate market activity is influenced by the activities and conditions that take place in three sectors of a market economy: (1) the user market, (2) the financial or capital market, and (3) the property market. Real estate users compete in the market for location and space. Among the users of space are both renters and owners. The financial resources to acquire real estate assets are allocated in the capital market; hence, equity investors and investors in mortgage debt (lenders) are capital market participants. Local and state governments, as well as the federal government, influence the activities of each of the participant groups through regulations, provisions of services and infrastructure, taxes, and various subsidies.

Two primary characteristics of real estate assets distinguish them from others: heterogeneity and immobility. Because of these two factors, the market for evaluating, producing, buying, selling, leasing, and managing real estate tends to be illiquid, localized, and highly segmented, and it usually involves privately negotiated transactions with relatively high transaction costs.

Key Terms

Acre 6 Intangible assets 2 Raw land 4 Capital markets 9 Real estate 2 Investment-grade properties Real property 4 Capitalization rate 9 Land 4 Improvements on the land 2 Personal property 4 Tangible assets 2 User markets 9 Improvements to the land 2 Property 2 Institutional-grade real estate 14 Property markets 9











Part 1 Setting the Stage

Test Problems

Answer the following multiple-choice problems:

- 1. A market where tenants negotiate rent and other terms with property owners or their managers is referred to as a:
 - a. Property market.
 - b. User market.
 - c. Housing market.
 - **d.** Capital market.
- The market in which required rates of return on available investment opportunities are determined is referred to as the:
 - a. Property market.
 - b. User market.
 - c. Housing market.
 - d. Capital market.
- 3. The actions of local, state, and federal governments affect real estate values:
 - a. Primarily through user markets.
 - **b.** Primarily through the capital market.
 - c. Primarily through their taxation policies.
 - d. Through all of the above.
- 4. What portion of households owns their house?
 - a. Approximately one-third.
 - b. Approximately two-thirds.
 - c. Approximately one-half.
 - d. Approximately one-quarter.
- **5.** Of the following asset categories, which has the greatest aggregate market value?
 - a. Corporate equities.
 - b. Mortgage debt.
 - c. Government debt.
 - d. Nongovernment real estate.

- 6. Storm water drainage systems are best described as:
 - a. Tangible assets.
 - **b.** Improvements to the land.
 - c. Intangible assets.
 - d. Improvements on the land.
- 7. Among the following four categories, which is the largest asset category in the portfolio of the average U.S. household?
 - a. Housing.
 - b. Stocks.
 - c. Deposits and money market funds.
 - d. Government and corporate bonds.
- 8. Real estate markets differ from other asset classes by having all of the following characteristics except:
 - a. Local market.
 - **b.** High transaction costs.
 - c. Segmented market.
 - **d.** Homogeneous product.
- **9.** Which of the following is *not* important to the location of most commercial properties?
 - a. Access to customers.
 - b. Visibility.
 - c. Access to schools.
 - d. Availability of communications infrastructure.
- **10.** Which of the following attributes of a home are the most difficult to observe and value?
 - a. Land/site attributes.
 - **b.** Structural attributes.
 - c. Location attributes.
 - d. Financing attributes.

Study Questions

- 1. The term *real estate* can be used in three fundamental ways. List these three alternative uses or definitions.
- 2. The United States represents about 6 percent of the Earth's land surface, or approximately 2.3 billion acres. Who owns this land? What is the distribution of this land among the various uses (e.g., developed land, federal land, forest land)?
- **3.** Describe the value of U.S. real estate by comparing it to the values of other asset classes (e.g., stocks, bonds).
- **4.** How much of the wealth of a typical U.S. household is tied up in housing? How does this compare to the role that assets and investments play in the portfolios of U.S. households?
- Real estate assets and markets are unique when compared with other assets or markets. Discuss the primary ways that

- real estate markets are different from the markets for other assets that trade in well-developed public markets.
- 6. Explain the role of government in real estate at the federal, state, and local levels. Which has the most significant impact on real estate markets?
- Identify and describe the interaction of the three economic sectors that affect real estate value.
- 8. Real estate construction is a volatile process determined by the interaction of the user, capital, and property markets. What signals do real estate producers (i.e., developers) use to manage this process? What other factors affect the volatility of real estate production?

Solutions to Concept Checks

- 1. A major difference between real and personal property is whether or not the property is movable or permanently affixed to the land or structure.
- 2. Tangible assets are physical assets such as land, automobiles, and buildings. Intangible assets are nonphysical, including patents, financial claims, or contractual agreements. Real estate is a tangible asset, but a bundle of intangible rights is also associated with the ownership and use of the property.
- **3.** About 40 percent of the U.S. housing stock is financed with home mortgage debt. (\$10.3 trillion in mortgage debt divided by \$25.9 trillion in housing value.)
- 4. The four capital market quadrants include private equity, private debt, public equity, and public debt. The private equity market includes transactions of real property between individuals, firms, and institutions. Private debt includes the trading of home mortgages. Investors trade real estate companies such







Chapter 1 The Nature of Real Estate and Real Estate Markets



- as equity REITs in the public equity market. Mortgage-backed securities are traded in the public debt markets.
- 5. Commercial real estate rental rates are determined in local user (space) markets, while property values are determined largely in the local property market.
- First, real estate is a heterogeneous product distinguished by its age, building design, and location. Second, real estate

is immobile, and therefore location and its accessibility are important. Third, real estate is a localized, segmented market due to local competition and the heterogeneous nature of the product. Finally, real estate transactions have high transfer costs, and most deals are privately negotiated.

EXPLORE THE WEB

The government affects real estate in many ways. At the federal level, many housing programs exist. Go to the Department of Housing and Urban Development's website, www.hud.gov, click on the "Resources" tab at the top of the page, and explore the resources available to households looking to find an apartment, locate a lender, avoid foreclosure, buy a home, make home improvements, and obtain rental assistance, to name a few.

Additional Readings

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Chapter 2

PART TWO

Legal Foundations to Value

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- 1 List three characteristics of rights that distinguish them from permission and power, list three components of property rights, distinguish between real and personal property, and define a fixture.
- 2 State the distinguishing characteristic of an estate, list three types of freehold estates, and distinguish a freehold estate from a leasehold.
- **3** Define an easement, distinguish it from a license, distinguish two basic types of easements, and identify four examples of each.
- 4 Define a restrictive covenant, state who can enforce it and how, and list five ways that restrictive covenants can become unenforceable.
- **5** List one type of general lien and three types of specific liens, list two factors that determine priority among liens, and state the significance of priority.
- **6** List the features that distinguish these forms of ownership: tenancy in common, joint tenancy, tenancy by the entireties, condominium, and cooperative.
- **7** Distinguish among the provisions of dower, elective share, and community property for the distribution of property between husband and wife.
- **8** List three common levels of timeshare claims, and identify what is most important to evaluate in a timeshare plan.

OUTLINE

Introduction

The Nature of Property

The Nature of Rights
Real Property and Personal Property: The Problem of
Fixtures

The Real Property Bundle of Rights

Possessory Interests (Estates)
Nonpossessory Interests

Forms of Co-Ownership

Indirect Co-Ownership Through a Single Entity Direct Co-Ownership Timeshare

Rights Related to Water

Rights to Oil, Gas, and Minerals

Appendix: Property Rights Relating to Water



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Chapter 2 Legal Foundations to Value

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Introduction

When we purchase real estate, it is not so much the ground and bricks that we acquire but rights to do certain things with them. This understanding opens the window to a wealth of questions and possibilities. The diversity of the possible claims (rights) to land is rich, with important implications for value. In fact, no estimate of value is meaningful until we know what rights are involved. This chapter provides a tour of these possible claims on real estate, to some of their uses, and to some of the resulting effects on value.

Several concepts are necessary to understand the nature of real property. The very concept of rights is the beginning point. Next, the difference between personal rights and property rights is important. Finally, we must distinguish between personal property and real property.

The bundle of property rights can range from complete ownership down to little more than the "squatter's rights" of an unintended tenant. A variety of nonpossessory rights also can affect the value of real property, including restrictive covenants, easements, and liens. Ownership of the bundle can be by multiple persons. These co-ownership claims can arise both from traditional law and from laws enacted by states, and they can occur in a variety of forms. A special source of co-ownership claims is marriage, and it is important to understand the variations in joint property rights that automatically arise from that union. Real property also can be divided in time through a variety of "interval ownership" arrangements. Real property often involves bodies of water and the use of groundwater. It is important to understand the issues involved with water rights. Finally, an important part of land is rights to minerals, including oil and gas.

The Nature of Property

The notion of property is anything but simple, having more to do with society's rules or patterns of behavior than with actual physical objects. Three fundamental distinctions are important in understanding property:

- What do we mean by rights?
- What is the difference between personal rights and property rights?
- What is the difference between personal property and real property?

The Nature of Rights

A principal definition of real estate is "rights to land and its permanent structures." But what do we mean by rights? First, rights are claims or demands that our government is obligated to enforce. For example, ownership of a car gives us the right to possess it. If someone steals it, we can expect law enforcement to try to reclaim it for us and punish the offender. This is in contrast to claims that are enforced only by force or threat. For example, a street gang may claim part of a street by intimidation, but government will not honor and support its claim.

A second characteristic of rights is that they are nonrevocable. We can contrast this, for example, with the typical office space usage: Employees may have an office in which they have considerable privacy; have liberty to arrange, equip, and decorate with discretion; and can come and go freely. But the employees understand that this is not ownership. They have this access by permission of the employer and it is revocable. Property rights are not revocable. The ownership claims to a residence or other real estate cannot be canceled, ignored, or otherwise lessened by any other private citizen. While they may be diminished significantly by action of government in the interest of public health, safety, and welfare, there is a limit to the restriction. At some point, it becomes excessive, and is regarded as a "taking." The government must then acquire the property through due process of law, and with just compensation.







^{1.} The power of government to take private property is called eminent domain. It, and the related legal procedure, condemnation, are discussed in Chapter 4.

Part 2 Legal and Regulatory Determinants of Value

The nonrevocable nature of rights suggests a third aspect of property rights: They are enduring. They do not fade away with time. The government is obligated to defend them in subsequent generations just as now, and it does not have the power to abandon that obligation.

Concept Check

2.1 How do rights to an object differ from attaining it by force or intimidation? What distinguishes rights from permission?

Society is concerned with two kinds of rights: personal rights and property rights (see Exhibit 2-1). In the United States, **personal rights** (personal freedoms) derive primarily from the Bill of Rights and other amendments and clauses of the U.S. Constitution. **Property rights**, rights to things both tangible and intangible, derive from ancient times, and are as old as the notion of law itself. The principal rights in property include (exclusive) possession, use (enjoyment), and disposition. If we own a computer, for example, we have the right to:

- 1. Prevent others from using it.
- 2. Enjoy the use or benefit of it for ourselves.
- 3. Get rid of it as we see fit (but without harm to others).

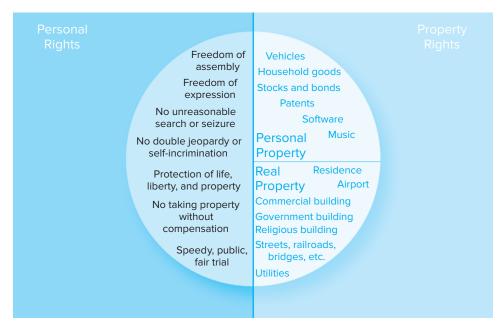
√ Concept Check

2.2 List three components of property rights.

As suggested by Exhibit 2-1, the two kinds of rights abut each other, and can conflict in important ways (see Industry Issues 2-1). For example, the right of a shopping mall owner to require behavior and attire that enhances the shopping environment—and thus the value of the property—can conflict with what patrons regard as their personal rights of expression and assembly in a "public" place.

Property is divided into two classes, real and personal. **Real property** is defined as rights in land and its permanent structures. **Personal property** is the rest; that is, it is simply rights in any other kind of object, including intellectual matters.

Exhibit 2-1 Rights in Our Society





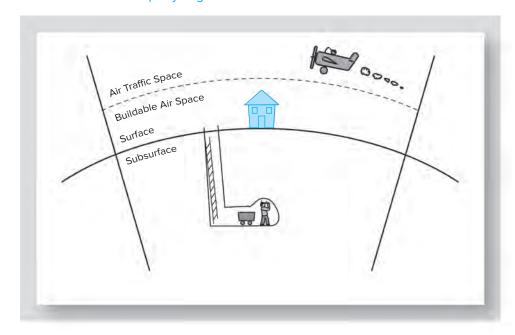




Chapter 2 Legal Foundations to Value

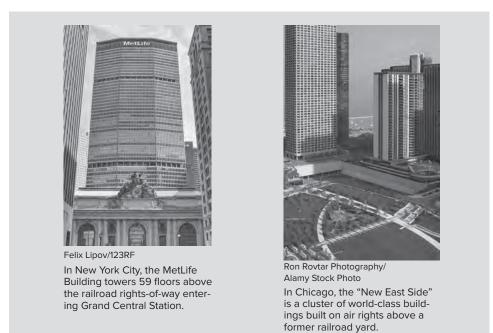


Exhibit 2-2 Real Property: Rights in Three Dimensions



Real property is rights in land, but what is land? It is the surface of the earth, of course, but, as shown in Exhibit 2-2, it also includes rights to air space above the land either up to the height it is technologically feasible to erect structures or to the level where airspace becomes reserved for air traffic. Also, it includes rights to the subsurface down to the center of the earth, and to the minerals, including oil and gas, contained therein. Rights to the subsurface and to airspace can be an extremely valuable part of real estate. In large cities, many prominent structures are built on air rights alone, as exemplified in Exhibit 2-3.

Exhibit 2-3 "Groundless" Building Stories: The Use of Air Rights



2. Oil, gas, and mineral rights are discussed briefly at the end of this chapter.





2-1

INDUSTRY ISSUES

Tree protester sued for trespassing

SANTA CLARITA, California (AP)—A developer trying to get a 400-year-old oak tree out of the way of a road-widening project turned up the heat on tree-sitter, John Quigley, trying to protect it, charging him with trespass-

ing and shooing away his supporters. . . . Sup-

Which of these poses
a greater challenge to
property rights?

porters sleeping
below the tree
were ordered to
clear the area,
and a chain-link
fence and "No
Trespassing"
signs went up
around the oak.
Bill Rattazzi, pres-

ident of the Los Angeles division of John Laing Homes, said no attempt was made to



Soqui/Corbis/Getty Images

remove or arrest Quigley. "These actions were taken to stabilize the situation and allow the issue to be decided in the courts in an orderly manner," he said.

Laing, which owns the property on which the tree grows, wants it out of the way to widen a road that would serve the proposed 21,600-home Newhall Ranch development north of Los Angeles. Quigley's response: "You have this irreplaceable natural resource... for our lifetimes and the lifetimes of may be 10 generations. We can't replace that."...

Update: The resolution was that "Old Glory" was moved to a nearby park, certified by Guinness's as the most ambitious tree relocation ever. Eighteen years later, it is reported to be surviving quite well.

Endangered species act restricts use of vast areas in the United States

The Endangered Species Act (1973), intended to conserve ecosystems vital to troubled plants and animals, has encountered troubles of its own through controversy about protected critical habitats. Early warning of the problem came in 1977 when threat to the habitat of the snail darter, a three-inch fish, held up construction of the Tennessee Valley Authority's Tellico Dam. Protection of spawning grounds for salmon in the Pacific Northwest is a recent issue, pitting protection of salmon against irrigation demands. Yet another skirmish involves a tiny bird, the southwest willow flycatcher. In seven southwestern states, protecting its habitat along streams has threatened to end centuries-old cattle grazing. But

the premier controversy stirred by the law concerns the northern spotted owl. In the Pacific Northwest, millions of acres of mature forest were restricted from logging to protect the owl's habitat. Loggers bitterly opposed this as a threat to their industry. To date, the habitat protection has been less effective than advocates hoped, while the economic damage may be less than its critics feared.

In 2010, a new chapter in the ESA was opened. The law prompted the Sage Grouse Initiative, a voluntary private and public effort to preserve the Sage Grouse habitat in 11 western states through such tools as conservation easements. By 2015, 1,129 ranches and 4.4 million acres had been enrolled in the program, and the bird is no longer endangered.



Source: Erie Foraman/Courtesy USGS

The distinction between personal rights and property rights is far from simple (see Industry Issues 2-1). However, this issue is beyond the scope of this chapter. (It is discussed at length in Chapter 4.) We instead focus our attention on the distinction between personal property and real property.

Real Property and Personal Property: The Problem of Fixtures

A **fixture** is an object that formerly was personal property but has become real property. This special class of real property is an enduring problem in real estate. Consider these examples: On a construction site, when do building materials cease to be the personal property of the contractor and become part of the "land and its permanent structures" (real property)? If a valuable antique chandelier is hung in a new home, is it then part of the real







Chapter 2 Legal Foundations to Value

property? Are custom draperies real property? What about removable shutters or storm windows? What about a kitchen range or refrigerator? This ambiguity between personal property and real property has long been recognized, and rules have evolved in the common law tradition to help sort it out.³

Specifically, these four rules help to determine whether an object has become a fixture:

- 1. The manner of attachment: The question in this rule is whether removal of the object results in damage to the property. Clearly, for example, removal of vinyl floor covering would damage a building. But a court may regard removal of wire connecting a dwelling to cable service as being damage as well.⁴
- 2. The character of the article and manner of adaptation: Under this rule, items that have been custom designed or custom fitted tend to be regarded as fixtures. Examples might include window screens, storm windows, church pews, custom bookshelves, custom draperies, or custom security systems.
- 3. The intention of the parties: This rule refers not to the private intention of the parties but to the facts of the situation and the intention that an observer familiar with custom-ary practice would conclude from them. A major example would be kitchen appliances: If a kitchen range or refrigerator is in a single-family residence being sold, it normally is expected to remain with the seller. On the other hand, if the appliances are furnishings in a rental apartment building, they normally would be expected to remain with the building. Thus, the rule of intention would treat the appliances as personal property in the single-family residence, but as fixtures in the apartment.
- **4.** Relation of the parties: For landlord and tenant relationships, special versions of the rule of intention have evolved in determining fixtures:
 - a. Trade fixtures, which are items installed by a commercial tenant to conduct its business, are always considered personal property of the tenant unless they are abandoned at termination of the lease. Thus, despite the fact that wall treatments, wall display cases, floor display cases, and so forth are usually custom fitted, and usually "injure" the facility when removed, they still are regarded as property of the tenant.
 - **b.** Agriculture fixtures, such as fences, also are considered property of the tenant. Anything that is installed by the tenant remains personal property.
 - c. Residential tenants also tend to be given the same protection. Any item installed in the residence by the tenant is regarded as the tenant's personal property, at least until it is abandoned.

The rule of intention is the most recent, and dominant, rule. That is, if there is conflict among the rules, the rule of intention generally will prevail.

There is a very practical importance to the fixture issue for property value. A contract for the sale of real estate applies only to real property unless personal property involved is explicitly included. Frequently when property is purchased, including personal residences, there are items on the property that may or may not be fixtures. Thus, who owns them after sale of the property may not be clear. In any real estate transaction, it is important for both parties involved to carefully review the property with this issue in mind, and to draw up the contract so that there is no ambiguity regarding disposition of these items.

The Real Property Bundle of Rights

The owner of real property holds a bundle of rights that is complex. As noted above, this bundle is some combination of the right of exclusive possession, use (enjoyment), and disposition. But this bundle can be dismantled in many ways, creating lesser bundles, held by different individuals. These bundles of rights are referred to as **interests**. The value of the







^{3.} Common law is the body of traditional law derived from the ancient courts of England, constantly evolving through new court rulings or case law.

^{4.} T-V Transmission, Inc. v. County Board of Equalization, 338 N.W. 2nd 752 (Neb. 1983).

Part 2 Legal and Regulatory Determinants of Value

property will tend to vary with the completeness of the interest. Below, we examine the possible variation in the bundle.

Concept Check

2.3 Is a fixture real or personal property? What is the dominant rule for determining whether something is a fixture? Under the "rule of intention," identify two possible results for the example of kitchen appliances.

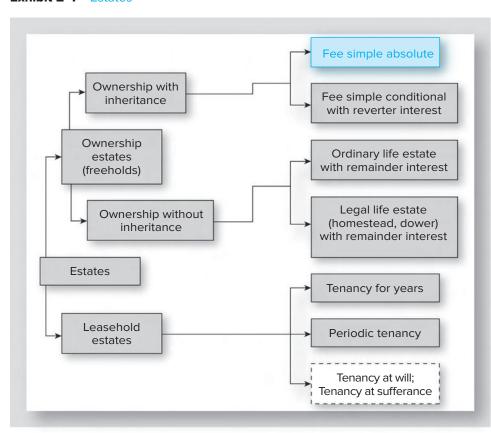
Possessory Interests (Estates)

Interests in real property that include exclusive possession are called **estates**. These can range from the complete bundle of rights (fee simple absolute) to a claim that is little more than "squatter's rights" (tenancy at sufferance). In between are a variety of bundles, differing by the combination of other rights included. The range of estates is displayed in Exhibit 2-4. The most complete estate, the fee simple absolute, is singled out, as are the weakest, tenancy at will and tenancy at sufferance. Each possible estate is discussed below.

Concept Check

2.4 When is a real property interest an estate?

Exhibit 2-4 Estates











Chapter 2 Legal Foundations to Value

Ownership Estates (Freeholds or Titled Interests). The more substantial or complete estates are those that are indefinite in length. These are the titled interests we commonly think of as ownership. In the common law term, they are freeholds. They can differ by variations in the right of disposition.

Fee Simple Absolute. **Fee simple absolute** is the most complete bundle of rights possible, and has the greatest value. Subject to the limitations imposed by government or by prior owners, all possible rights of exclusive possession, use and enjoyment, and disposition are possessed by the owner. This is the traditional concept of landownership. It is this interest that is intended when persons of the real estate world refer to owning or holding the "fee."

Fee Simple Conditional. In a fee simple conditional, ownership is subject to a condition or trigger event. In this case, the owner's bundle of rights is complete unless the trigger event occurs, which may cause ownership to revert to a previous owner (or his or her heirs). This uncertain interest held by the previous owner (or heirs) is called a reverter interest. For example, an owner could convey a small apartment building to a university but require that the property be used for a scholarship dormitory for women students. As long as the university uses the property for this purpose, it may enjoy all the rights of a fee simple owner. However, if it ever allows men students to occupy the house, the previous owner or the owner's heirs can bring suit to recover the property. The resulting uncertainty that this kind of condition creates can, of course, greatly reduce the value of ownership.

Ordinary Life Estate and Remainder. In an ordinary life estate, the rights of disposition of the fee simple absolute are unbundled and separated completely. For example, suppose an older homeowner lives adjacent to an expanding university, and the university would like to acquire her residence for future university use. Suppose also that she is willing to sell, but is not interested in moving. A possible solution is for the university to purchase a remainder estate while the owner retains a life estate. In this arrangement, the homeowner retains all rights of exclusive possession, use, and enjoyment for her lifetime while the university gains the right of disposition. The owner is compensated either through cash payment or a tax deduction (if the remainder is donated) and simplifies the eventual settlement of her estate, while assuring the continued right to occupy her home. At the time of her death, the life estate and remainder estate are rejoined, becoming a complete fee simple absolute owned by the university.⁵

Legal Life Estate. Legal life estates are created by the action of law. In Florida, for example, a family residence that is declared a homestead carries the possibility of becoming subject to a life estate. If a family having minor children occupies a homestead residence, and if one spouse dies, Florida's homestead law gives the surviving spouse a life estate and gives the children "vested remainder" interests in the residence. While intended to protect the surviving family, this law can create as many problems as it solves. If the surviving spouse needs to sell the residence to relocate, a trustee must be created to act on behalf of the minor children to convey their interests in the sale. Thus, additional legal costs and delays are likely to result.⁶

Other Life Estates. Life estates also can arise out of a marriage. In the English common law tradition, a right known as dower automatically gave a widow a life estate in one-third of the real property of her decedent husband. Today, however, dower generally has been displaced, as discussed later in this chapter.







While rare, and normally inadvisable, the life estate could be tied to the life of someone other than the owner.

^{6.} For this reason, families in Florida are advised to acquire their primary personal residence by the special joint ownership known as tenancy by the entirety (discussed later in this chapter).