



## Real Estate

# INSIGHTS

### U.S. Real Estate Outlook

There is little doubt that since the debt crisis of 2007 to 2009, the most serious since the Great Depression, U.S. real estate has experienced a significant recovery despite continuing uncertainty in domestic and international financial markets. Of note, the CMBS market, which marked the beginning of the recession with a series of significant failures, appears to have finally stabilized to the point where several new CMBS pools have recently been oversubscribed.

The recovery in the U.S. property markets has been a tale of two cities (apologies to Mr. Dickens) where assets in primary and gateway cities, especially Class A and “trophy” assets, have multiple bidders driving up prices and compressing cap rates while assets in secondary cities and tertiary markets have a difficult time finding investors. Assets in secondary cities and tertiary markets may offer greater yields, but continue to be outside the risk/reward threshold of a majority of the investment community. This bifurcation is compounded when property types are considered, with a similar dynamic occurring among the various property types.

#### Driving Factors

There are a number of factors driving the real estate recovery, including:

- Funds that have raised, or have committed capital, that needs to be deployed
- REITs and companies considering conversion or formation as a REIT have access to capital that will also need to be deployed

- Expanded private equity fund activity (an example is the purchase by real estate firms of thousands of foreclosed homes with the intention of renting the homes and subsequently selling them as values rise or to convert these homes into a REIT to benefit as a long term investment)
- Historically (albeit artificially) low interest rates
- The return of foreign investment in U.S. real estate

#### Constricting Factors

There are also a number of factors or concerns constricting the real estate recovery, including:

- Unwillingness to accept risk beyond core properties
- Employment uncertainty
- The ongoing debt crisis that still does not allow the same loan-to-value ratios as previously available

One lasting, and continuing, remnant of the financial crisis is a decline in U.S. homeownership rates from the highs reached in 2006. The continuing downward pressure on homeownership, combined with the limited amount of supply brought to market over the past five years has been a boon to multi-family property owners and investors. This sector is considered to be stable and likely to continue to show increases in revenue and returns to investors while also providing protection against inflation. However, as with the overall real estate

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recovery, primary and gateway cities are seeing the most activity. The price points for some deals in these markets have reached levels at which some large national investors have indicated dynamic could be a good sign for secondary cities and tertiary markets as investors seek to deploy capital in search of returns. Of how will the multi-family sector fare over the longer-term horizon as more units are developed and homeownership rates stabilize and begin their inevitable ascent?

### Retail Sector

A similar scenario is playing out, although to a lesser extent, in the retail real estate sector. Key assets in primary and gateway cities have been commanding a premium as large national (and international) real estate investment trusts and other funds deploy capital. Leverage rates on these recent deals have remained fairly low as private placements is put to work. The story is the same here with properties in cities like New York, Washington, D.C., Chicago, San Francisco and Boston, to name a few, which are receiving an overallotment of attention while smaller markets are struggling to attract risk-averse investors.

### Other Sectors

Other property types, such as office and industrial, continue to struggle, with vacancies across all markets with few bright spots. Most large real estate owners in these sectors are focusing on improving their portfolios, especially their core assets, as they deal with the various property issues. The recovery of these property types will trail the overall economic recovery as they are more

dependent on improvements in the overall economy and employment specifically.

### Outlook

As the U.S. slowly emerges from the recession and the overall economy gains momentum, real estate markets will follow suit. Although the fundamentals play an important role, location (especially densely populated urban areas) has become the dominant consideration as risk-averse investors seek adequate risk adjusted yields. With improvements in the economy, secondary cities and tertiary markets will attract investors and offer return opportunities no longer available in the primary cities.

*Stuart Eisenberg is a Partner and National Real Estate Industry Practice Leader at BDO USA, LLP.*



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## Investments: Raw Land

A recent report by the national association of realtors says investors have a new target in real estate: undeveloped land.

Buyers are snatching up land heavily discounted in bankruptcy proceedings from developers and banks that foreclosed on builders once money ran out for their projects. Investors then resell the land at a price that returns as much as 20 percent on their investment or, in some cases, hold the land planning to partnership with homebuilders. Said one portfolio manager, "We are coming out of the mother of all housing cycles and residential land is the best way to play the ultimate recovery." Investors say the most attractive land to buy is a parcel that already has all planning permissions in place ready to start construction. Otherwise, the approval process for building approval can be costly and time consuming.

The attractiveness of raw land is its low cost when compared to that of developed property. The price paid for raw land may bear little or no relationship to its ultimate use, and can be significantly influenced by the landowner's reason for selling. Types of landowners are varied, including working farmers, gentlemen farmers, estates, lenders that have closed on mortgages, government agencies and municipalities, builders and developers, and land speculators. Reasons for selling may include a need for ready cash or the bailing out of a defaulted loan.

### Diversified Locations

The (relative) low cost of raw land also permits an investor to obtain property in several different locations so that the risk of a major loss is reduced. On the other hand, raw land generates no income until it is sold or until the land is ground-leased to a buyer. In addition, until the landowner waits to sell or ground-lease the property, all carrying charges (taxes and perhaps maintenance of the land) must be paid.

### Institutional Financing

The fact that raw land generates no income does not make it attractive to institutional lenders. In addition, future value may be difficult to appraise because a lender will not evaluate land on the same basis as a speculator-purchaser. A purchaser may be able to obtain a loan on the strength of his or her own credit, but this requires the risk of personal recourse. In some cases, mortgage financing may be available if the land is being used for some income-producing activity, something not easy to arrange.

### Land Defects

An obvious concern for a buyer is to be sure the land has no defects that make it undesirable for development. Such features include the following: steep grades, poor soil conditions, subsurface rock formations or flat land that might have drainage problems and that has a high water table. Raw land may be subject to utility drainage easements. Finally, boundaries may be imprecise.



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### Zoning Regulations

Finally, even if land satisfies all other requirements, local zoning laws, building codes and related land-use regulations may prevent future development. A prospective land purchaser – usually an experienced attorney or broker – should check local laws and regulations.

*Wing Leung is a senior manager in the Real Estate and Hospitality Service practice in BDO USA's New York office.*



# Real Estate

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## Valuing Real Estate: 10 Key Concepts

At a time such as now when real estate markets are in ferment, appraising real estate for purchase, sale or financing can be a highly uncertain process.

Each of the three traditional approaches for determining value has its limitations. First, establishing the value of comparable property by recent sales (market data approach) can mislead because of limited market activity. Second, capitalizing net operating income (NOI) from a property (income approach) can be misleading because of the uncertain outlook for NOI. Finally, determining replacement or reproduction cost of a property and accrued depreciation (cost approach) is difficult because future costs may vary widely. Instead, an investor, developer or lender should consider the underlying economic concepts that affect value for any parcel of property. Understanding these economic concepts offers insight into the rationale underlying the various appraisal methods. To the extent these concepts are better understood, they will become more valuable tools for investment analysis.

### Substitution

When two parcels of property have the same utility (usefulness), the property available at the lower price will sell first. This commonsense statement has important implications. For example, in the cost approach, the concept of substitution explains why a buyer will not pay more for improved real estate than the cost to the buyer to acquire a site and construct an improvement of equal utility.

### Anticipation

This concept again embodies a self-evident point of view - an estimate of value always should be based upon future anticipation rather than past performance. Past financial history may be important evidence of future trends, but can never be a substitute for a judgment about the future. This concept is especially applicable with the income approach to value, since here value is estimated by capitalizing future income.

### Change

In one sense, change is merely a specific application of the concept of anticipation. The emphasis here is on the inevitability of change and the need to identify trends that will affect the property in question. For example, the concept of regression says that the value of a superior property in a neighborhood will be adversely affected by surrounding inferior properties. The concept of progression states the reverse, i.e., an inferior property will benefit by its location in the superior neighborhood. An investor who can identify an early trend toward neighborhood improvement, and so make bargain purchases of property, is successfully using the concept of change.

### Competition and Excess Profit

This concept expresses the idea that in a relatively unregulated market, abnormal profits cannot be expected to continue indefinitely. Put another way, unless monopoly profit is protected by unique location, government regulation or some other factor, competition will be generated that, in time, will reduce the abnormal profit

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## Valuing Real Estate: 10 Key Concepts

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to a normal range. When the purchaser of a shopping center capitalizes coverage rentals at a rate lower than that for fixed rentals because of anticipation that competition from another center will reduce the percentage rents, he is applying the concept of competition.

### Increasing and Diminishing Returns

This concept says that in any given case, a certain optimum combination exists of land, labor, capital and entrepreneurship. If any one of the four factors of production is increasingly applied, diminishing returns eventually will be experienced. For example, an outlying site may be capable of returning some positive cash flow if improved with a retail store. If the owner were to invest additional capital and construct a 10-story office building, the result likely would be negative cash flow. In other words, diminishing returns would result from increased capital investment. The determination of just the right combination of factors to produce maximum income from a parcel of property is one of the most difficult jobs of the real estate appraiser or analyst.

### Contribution

Contribution is an application of the concept just discussed. Contribution says that changes in an existing improvement can only be justified in a financial sense if the increase in cash flow represents a fair return on the additional investment. For example, an office-building investor must decide whether to replace manned elevators with automatic ones. Offsetting the initial capital investment will be lower operating expenses

due to a smaller payroll. The question is whether the additional cash flow represents a satisfactory return on the new investment. If higher rents can be charged because the Automatic elevators are quicker and more efficient, this factor also must be considered.

### Surplus Productivity

Of the four factors of production, land is the last to be paid. It plays a passive role and a return must first be paid to the other three factors (capital, labor and entrepreneurship) in order to bring about utilization of the land. Consequently, the return to land is surplus productivity in the sense that it is the residual return. This concept is often important in analyzing many small business operations. Consider the case of a couple who operate a fast-food restaurant. They purchase the land, construct the improvement, and work seven days a week. At the end of the year, they realize a good profit. But what is earning a return? First, they must pay themselves salaries for their labor, as well as some return for the entrepreneurial risk assumed. Second, a portion of the profit represents a return of investment (equivalent to depreciation of improvements) and an additional portion represents a return on the investment in improvements. The balance, if anything is left, represents a return on the capital invested in the land. It may turn out that there is no surplus productivity so that the land is earning no return at all.

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### Conformity

Experience has shown that maximum value accrues to a parcel of land when a reasonable degree of physical and economic homogeneity is present in the location. The concept of conformity reflects the fact that economic and psychological benefits arise from the grouping of similar activities. Zoning laws are a partial recognition of this concept.

best use (from the point of view of return on investment) is the present use.

*David Tevlin is managing director of the Corporate Real Estate Services practice in BDO's New York Office.*

### Supply and Demand

Supply and demand is the basic economic logic that lies behind pricing. In a wholly free economy, the interaction of supply and demand would be the sole determinant of price and, hence, of value. In our partially free and partially regulated economy, the law of supply and demand is only one factor, although a crucial one, in setting prices.

### Highest and Best Use

This most quoted concept in real estate valuation is that vacant land is to be valued based on the use likely to produce the highest return in the foreseeable future, bearing in mind that such use is likely to change over time. An outlying site suitable for a one-story retail store today may be able to support increasingly larger structures as urban expansion takes place. The highest-and-best use concept also applies to developed land, but here an additional factor applies, i.e., the cost of demolishing the existing improvement. The highest and best use of vacant land might be a 20-story office-building, but if the land already is improved with a 10-story structure, the cost of demolishing it must be added to the investment equation. The result may be that the highest and



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## Review of a Residential Appraisal

The crucial role of the appraisal process in mortgage lending has been highlighted by the real estate collapse of recent years. Apart from cases of actual fraud, two more significant causes of poor appraisals were pressure on appraisers to produce a figure supporting the requested loan and appraisal work that was carelessly performed. The following constitute an excellent set of guidelines for any mortgage lender or other investor reviewing an appraisal report:

- **Faraway comparable.** The soundness of an appraisal based on comparable sales (the usual method for valuing residential properties) depends on a good choice of other properties. If the properties are too far away (in some cases, as much as 100 miles) or are in a rural area when the subject property is in a city, or are in a different state, the comparison may have little validity.
- **Noncomparable comparables.** Frequently, comparable data are inadequate because the location, style, amenities and size of the comparable property are not remotely similar to the subject property. The appraiser then is forced to make numerous large adjustments in order to compare values and the end result is meaningless. This problem is not always easy to spot in a written appraisal report but a warning flag should be raised whenever the appraiser's adjustments seem excessive.
- **Old comparables.** In a period of rapid economic and financial change, as the present, the time factor is vital when comparing property sales. Generally, comparable sales should have occurred within a year of the appraisal report. When values have been declining, even this period of time may be excessive.
- **Overappraised properties.** In an effort to make the numbers work, appraisers sometimes seek to "pump value" by large upward adjustments in the comparison process. Any indication of such adjustments is a clue that the appraisal report is questionable.
- **Missing or inaccurate information.** Often, appraisers omit information that is vital to the loan underwriting process. For example, an appraisal report that omits incompatible uses near the subject property or relevant zoning information, prevents the lending institution from making an informed judgment about risk.
- **Failure to bracket sales data.** An ideal set of comparables includes properties that are a little better than the subject property and some that are not as good. By thus bracketing the subject property, adjustments can be made with much greater assurance.



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## Review of a Residential Appraisal

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- **Sales price as market value.** Sales price and market value are two different concepts. The two may be the same but usually are not. When appraisers adjust comparables to come up with an appraisal equal to the sales price, they have failed to do their job.
- **Excessive time adjustments.** Indications in the appraisal report of large time adjustments are a warning signal. Time adjustments are those that reflect the length of time between the date of appraisal and the sale of the property used for comparison.
- **Construction cost as market value.** Appraisal reports sometimes seek to justify the loan amount based on the construction cost of the improvement. Construction cost usually is not the equivalent of market value, particularly in the case of custom homes.
- **Final market value adjustments.** Sometimes, an appraisal will end up with several estimates of value that are nowhere near each other. This obviously is of little help to the loan underwriter and should itself raise serious doubts about the validity of the appraisal process that was followed.

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*Mark J. Puttick, is a senior associate with BDO's Real Estate practice in New York, on secondment from BDO Real Estate in London.*