

LM02 Overview of Types of Real Estate Investment

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1. Introduction

Real estate derives its value from existing and expected future economic uses. Financial investors in this asset class seek periodic income and potential capital appreciation from a future sale.

This learning module focuses on commercial or residential real estate properties that are relatively well developed, stable, and generate reliable periodic income. The learning module covers:

- Key features of real estate relevant to valuation
- Economic drivers affecting property cash flows and prices
- The distinctive investment characteristics of commercial properties
- Unique information challenges that investors face when assessing and valuing real estate
- Valuation process for real estate properties – income, cost, and sales comparison approaches
- Real estate investment indexes, their construction and potential biases

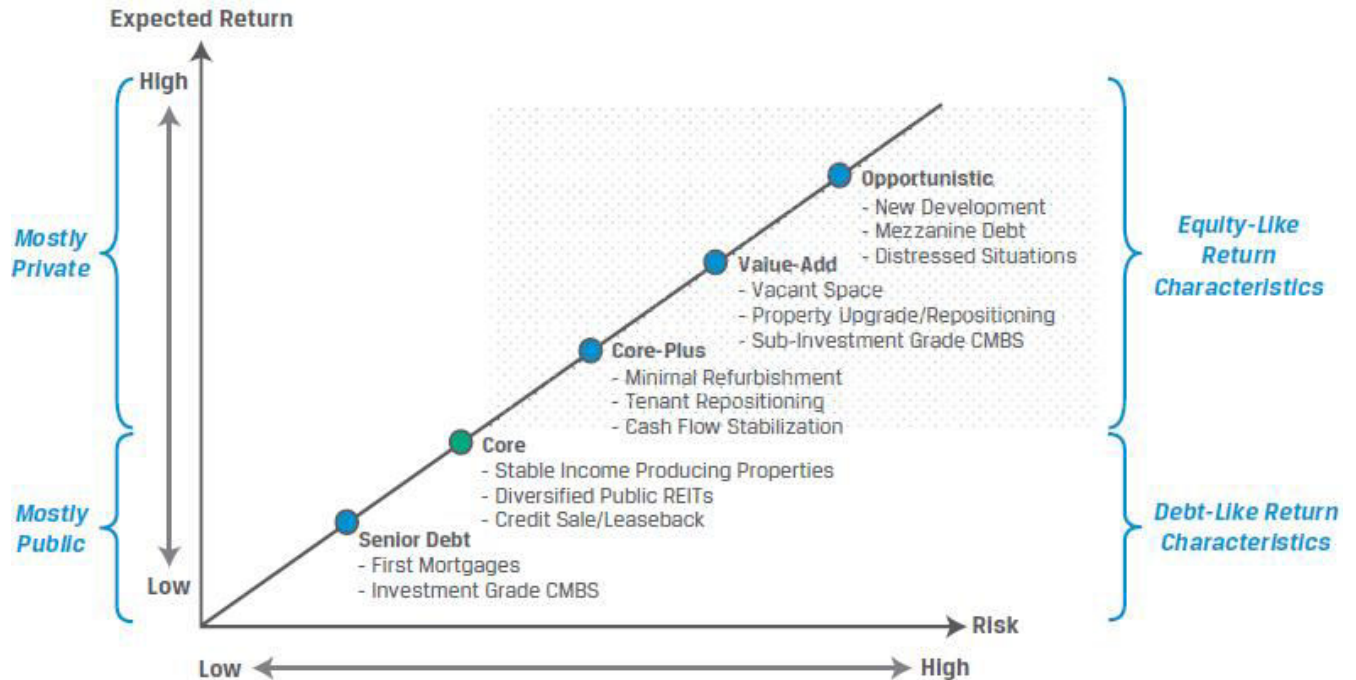
2. Real Estate Investment Features

Key features of real estate investments include:

- Long-term stable income
- Expected capital appreciation
- Inflation protection
- Low correlation with stocks and bonds
- Tax benefits

General Characteristics

As shown in Exhibit 1, real estate investment characteristics range from relatively stable, income-producing properties (referred to as *core real estate*), to more speculative *opportunistic real estate* investments, typically funded on a private basis.



Core real estate which consists of stable income producing properties is more bond-like in nature, while opportunistic real estate which consists of new property developments or projects that require substantial improvement is more equity-like in nature.

Key determinants of pricing and demand for real estate are:

- Current and potential economic use
- Expected net cash flows
- Unique features including location, size, age, features and amenities offered
- Price and availability of comparable properties
- Economic environment faced by existing and potential users
- General business conditions
- Industry-specific dynamics
- Technological, environmental and social changes

The following example from the curriculum shows the impact of Covid-19 on commercial real estate.

COMMERCIAL REAL ESTATE TRENDS IN THE WAKE OF COVID-19

The economic lockdowns in many countries due to the COVID-19 pandemic had both immediate and more permanent effects on commercial real estate markets. For example, the shift to fully remote work for many companies during the pandemic led to a sharp drop in office leases, while delays in returning to work combined with more flexible work arrangements had a more permanent effect on office space demand. According to the global commercial real estate service firm Jones Lang LaSalle, global office leasing volume fell

from a pre-pandemic high of over 11 million m² per quarter to just 5 million m² in the second quarter of 2020 and remained well below pre-pandemic levels through 2022.

Online shopping expanded while retail outlets suffered under lockdowns, driving an estimated increase in e-commerce as a percentage of total global retail sales from 15% in 2019 to a record 21% in 2021. As web-based sales remained strong following reopening and companies sought to regionalize supply chains following border closings and lockdowns elsewhere, rents in the logistics and warehouse space rose at double to triple the pace on an annual basis compared to their pre-pandemic growth rates.

Net Operating Income (NOI)

Income producing real estate is evaluated using a metric – ‘net operating income (NOI)’. NOI is calculated as:

$$\text{NOI} = \text{Effective gross income} - \text{Operating expenses} - \text{Property maintenance allowance.}$$

The periodic lease or rental payments are usually fixed for a period defined by the contract between the property owner and the tenant. Contracts can be renewed on expiry and they provide owners an opportunity to renegotiate rates based on inflation, changes in demand, competition, market conditions, property upgrades etc. In some cases, owners may offer lower rents as an incentive for tenants to accept longer lease terms, while in others, periodic rent increases may be included in the contracts.

A property’s ‘gross rent’ and ‘effective gross income’ are calculated as:

$$\text{Gross rent} = \text{Average rent per square foot} \times \text{Total rentable space}$$

$$\text{Effective gross income} = \text{Gross rent} + \text{Other sources of revenue} - \text{Deductions for vacancies or concessions}$$

‘Operating expenses’ include fixed costs such as taxes, insurance, service, repairs, and variable costs that vary with occupancy levels, e.g. utilities. Operating expenses may be borne by the owner or partially/fully passed to tenants based on the lease agreement terms.

Property owners are required to separately allow for expenses to maintain a property’s current level of income generation. This ‘property maintenance allowance’ varies by jurisdiction and type of property. It includes capital expenditures needed to maintain a property’s current economic use, but it does not include capital expenditures that significantly upgrade or change a property’s economic use.

The following example from the curriculum demonstrates the calculation of NOI.

EXAMPLE 1

Wallonia Transit Warehouse Facility

Wallonia Transit is a single-tenant warehouse facility in southern Belgium with 10,000