**Topic 1: Introduction to Real Estate Decision Making**
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*Preface*: It is an especially interesting time in modern human history to observe the real estate markets. Covid was a game-changer; employers sent people home to work remotely, and many workers liked the accompanying flexibility. It has not been unusual for those who have anticipated continuing to "WFH" (work from home) to move to less congested areas, and buy larger houses since prices were lower there and they would be spending so much time at home. Large cities' populations have declined as a result, hurting their residential real estate markets. Downtown office building values have been negatively affected as office space sits empty, and values may fall farther as long-term leases come up for renewal and the current business tenants use less space going forward. A tug-of-war continues between firms that want employees to "RTW" (return to work) for the greater productivity /cohesion/mentoring, and the employees who prefer to work remotely – though home buyers' reduced desire for "cloffice" space by 2023[1] may indicate an expectation of returning to on-site work, at least part-time. Late 2023 figures showed that 62% of U.S. firms allowed working from home for at least part of each week.[2] As office occupancy has fallen by about half relative to 2019's pre-Covid standard, businesses that had served office workers, like downtown restaurants, have suffered. Some such businesses have moved to the exurbs, following the workers who now go out to lunch near the homes they now work from – gutting the revenues of downtown landlords (= real estate investors) who rented to those support businesses. Retail property has also been adversely affected, as on-line shopping displaces many trips to the mall. However, neighborhood "strip mall" centers have benefited as people shop more, you guessed it, near their homes. And luxury chains like Chanel and Gucci have signed leases for more space than they have used in the past, sometimes moving into markets where they previously did not have stores.[3]

The big bump up in interest rates starting in late 2021, after more than a decade of rates at all-time lows, has affected real estate in multiple ways. People who got home mortgage loans when rates were super low have been reluctant to sell, even if they have some motivation to move, because they do not want to have to get new loans at higher rates – and, as a result, the number of houses on the market has been unexpectedly low. So home prices, at least in some areas, have fallen as borrowers can not afford to pay high prices plus high interest costs, but likely not by as much as they would have if supply were not constrained. (We might note, though, that people reluctant to move also reduce pressure on the market's demand side. And could there be an issue with technology helping older people, who used to sell their houses without competing on the demand side, stay in place longer?) Homes available to purchase also have been fewer in number because large investor groups, historically apartment property buyers, now snap up individual houses and rent them out. This post-2000s financial crisis phenomenon reflects, in part, the desire of people other than just "renters by necessity" to rent, rather than own, detached houses. Owners of (= investors in) income-producing real estate often have loans with interest rates that periodically are re-set to market levels, and many will be facing the double-whammy of having their loan payments rise at the same time their revenues drop, as long-term leases expire and tenants that have been contractually obligated to keep paying rent for half-empty offices commit to less space going forward (and those owners already must compete with their tenants, who try to sub-lease unneeded space they are paying for). Such owners may lose their properties. Even income-producing properties that are not forfeited may be worth less money than they would be if they could be fully rented, so their owners will pay less in property taxes to support local government going forward.

With those quick observations behind us, let's complete a more systematic introduction to real estate.

I. Real Estate as a Field of Academic Study

A. What is real estate?
Real estate consists of land (best defined as a *permanent position in space*, a wedge-shape running from the center of the earth outward to the skies), and items seen *legally* as having a *permanent* connection to the land. (Real estate is contrasted with *personal property*, which is movable and not permanently connected to land.)

B. *Why do we have one or more separate courses in real estate within a university finance program? Because every parcel of real estate has a unique location, and improvements to real estate (think buildings) generally have long expected useful lives*. These features cause real estate to have special (and often interacting) economic, physical, legal, and financial characteristics that we do not observe (at least to the same extent) with other assets:

- Economic: the fixed location means that each unique parcel's use affects the value of, and its value is affected by the use of, what surrounds it, or at least is nearby (positive and negative externalities).

- Physical: because of their unique locations, even two parcels of real estate with seemingly similar physical features can have substantially different values; think of two condominium units in the same complex that have identical floor plans, but one has a view of the parking lot and the other overlooks a golf course.
- The unique, unchanging physical location means that a parcel of real estate is there for the whole world to see and verify; it can not be stolen, hidden, or lost.
- Legal: government entities, especially at the municipal level, want to raise revenue by taxing the value of real estate (which can not be hidden), so they impose regulations to prevent any parcel's use from harming the value of real estate around it, and then more tax can be collected on the jurisdiction's overall higher measured values (private parties regulate the use of real estate, too; home owner associations are an example). There are many other instances of laws and government administrative practices (like the recording of documents) that apply to real estate, but not to other types of assets.
- Financial: it will stay where it is for the whole world to see, so if, *e.g.*, a building is well constructed, and if what is around it helps its value/at least does not hurt it too badly (maybe because of well-chosen public sector or private regulations), it can serve as strong security on a high-dollar, long-term "mortgage" loan.

C. A few interesting tidbits:
Real estate can not be physically possessed like gold coins or a diamond ring, so we think in terms of:

- Real estate "services" (roof over your head, place to conduct business – some parts of which wear out over time and eventually will likely have to be replaced, at then-current replacement prices).
- A "bundle" of real property rights. Sometimes those rights are discussed in the context of *use* (subject to restrictions imposed by government entities or private parties), *exclusion* (telling others to get off of your land), *disposition* (sell/give away rights, most closely tied to what we might correctly think of as ownership), and the *right to do none of those* – but when a party with rights in real estate does not use/protect them, then other parties might gain rights – all relating to real estate's fixed location.
- Different parties holding different sticks in the bundle, to a greater extent than we usually see with other types of assets. Think of an apartment building whose tenants have the right to use the units and exclude others; local government that has the right to tax the value of the property and can acquire possession if the taxes are not paid; a lender with the right to be repaid, and to acquire possession if it is not; a repair provider with the right to be paid, and to acquire possession if it is not; and an owner with the residual claim – the value that remains after all other parties' claims have been satisfied.
- The long lead time for new construction requires creativity when the demand for housing/other real estate services rises quickly (and the inability to move surplus space to other areas requires creativity when the demand for housing/other real estate services falls quickly). Other assets, like vehicles, can be moved to locations where they are needed as demand in local markets changes. But real estate owners sometimes are creative in repurposing property; news accounts in August of 2020 told that Amazon had considered acquiring vacant Sears and J.C. Penney stores at shopping malls for distribution warehouse purposes.

  Then again, by fall of 2022 news reports were saying that warehouse capacity was in oversupply, and Amazon was closing some existing distribution centers and cancelling plans to open some others amid announced layoffs, and financing for building new warehouses had become expensive. Yet also by that time we were seeing, after the one-two punch of Covid on top of on-line buying, a return to in-person shopping that reduced concerns about the need to repurpose retail properties, especially high-end shopping malls. A late 2022 new account indicated that other retail may be coming back, with the Ross, Burlington, Marshalls, and T.J. Max discount clothing chains all looking to add from dozens to hundreds of new store locations in coming years, and Barnes & Noble adding many new, but smaller sized, bookstore locations.[4] (The retail chain with the most outlets nationwide seems to be Dollar General.)

  Also by fall of 2022, as many firms continued to let employees work from home post-Covid, developers were working with local governments in Chicago and other large cities to convert some of the considerable resulting vacant, and therefore cheap-to-buy, office buildings to affordable housing (designing apartments around an office building's window configuration is a challenge – as is getting people to want to live in locations not served well in the past by grocers and other retailers). Several sources were reporting in 2022 and 2023 that only about half as much office space was being used, nationwide, as had been observed pre-pandemic. The situation was exacerbated by substantial layoffs at Meta and fears that other tech companies would be cutting back on their historically intensive use of office space, with problems thus persisting even as many firms were bringing workers back to the office to enhance productivity. A 20-story New York City office building on prestigious Fifth Avenue sold in 2023 for $66 million less than the prominent developer who owned it had borrowed against its value in a 2020 refinancing.[5] A group of NYC buildings valued at $207 million late in 2023 had been appraised at $640 million in 2018.[6]

- We have a system of laws and traditions for real estate that do not always apply to other types of assets. Examples: Contracts for the sale of real estate generally must be in writing to be enforceable, homesteads get special protection (divorce, bankruptcy), courts are more likely to use *specific performance* as remedy for the breach of a contract because there are no perfect substitutes for a particular parcel of real estate.

II. Aspects of Real Estate that are of interest to us in a finance course:

A. Physical aspects

1. Land is located everywhere ("Under all is the land," from preamble to National Association of Realtors® code of ethics)
2. Long-term life of land, even improvements
   Long-term commitments allow for long-term financing opportunities
   Long period that passes between the idea and completion phases affects risk, planning
   Developers may try to anticipate the market by building in areas expected to thrive later
3. Each parcel is unique
   Lack of standardization affects market efficiency
   Even seemingly similar improvements can have different values because of features like views, distance to schools or employment opportunities
4. Fixed location/immobile – so it is easy to regulate and to tax, but also can serve as dependable collateral/security for borrowing money

B. Economic aspects

1. Real estate is an essential input in the production of goods and services, and important component of the nation's wealth (one estimate showed land and buildings as constituting ⅔ of US wealth, with residential land and accompanying improvements by themselves worth more than $20 trillion).
   Even the sale/purchase of one individual parcel typically is a large dollar transaction
   The real estate sector (including construction and lending) is a major part of our economy in terms of asset values, consumption and investment spending, employment, and tax bases
   Slowed home sales in 2022-23 also adversely affected sales of furniture, appliances, and electronics
2. Typically a real estate purchase is a substantial investment for an individual buyer
   Individuals who buy brick-and-mortar income-producing properties typically combine returns on investment with returns on their labor
3. Fixed location causes real estate to be subject to:
   External influences (interdependence of uses: a bad neighbor can hurt your property value; being near transportation or other positive influences can enhance value)
   Regulation by government bodies and private parties (can exercise some control, and need to)
   Taxation by local government
   But also is strong collateral for loans (U.S. residential mortgage debt is in excess of $14 trillion)

Borrowed money plays such a huge role in real estate purchasing that the Federal Reserve's repeated increasing of interest rates during 2022-23 changed the housing market in many U.S. areas from one of multiple bids for each listed property and selling prices often well above asking prices, to one of falling prices and potential sellers reluctant to move and have to buy a new house with a high interest rate loan.

4. Scarcity of land suitable for specific uses
   Quantity of land is fixed
   Quantity of sites available can change as bidders raise prices, also with changes in infrastructure and construction technology. A September 26, 2022 *Wall Street Journal* article noted the difficulty of obtaining land for residential development in many U.S. sunbelt cities. Among reasons for shortages are insufficient roads and other infrastructure, zoning laws that require large lots, and some owners' reluctance to sell land that they feel will continue to rise in value (such owners sometimes benefit from local laws that tax undeveloped land at favorable low rates).

5. Land can be altered with improvements:
   Improvements *on* land – buildings, fences are examples
   Improvements *to* land – streets, sidewalks, sewers are examples

[Improvements *to* land are said to make the land more suited for improvements *on* land.]

III. Types of Improved Property

[Each type is usually restricted to areas "zoned" by local governments for such use]

A. Detached residential – up to 4 units. Single-family, duplex, triplex, fourplex. Called "residential" because the owner typically lives there. Owner usually buys as a residence even if part of the property is rented out (favorable financing usually is available on residential properties of up to four units if one of the units is owner-occupied). Single-family home sizes have steadily grown over recent decades; an October 9, 2022 *Chicago Tribune* article reported that the proportion of newly-built "starter" houses that were 1,400 square feet or smaller fell from 70% in the 1940s to 8% now. At the higher end of the housing spectrum, luxury basement upgrades or additions have become a popular selling point.

[U.S. federal government agencies such as the Department of Veterans Affairs, which promote home ownership opportunities and make or guarantee home mortgage loans, generally deal with properties of up to 4 units.]

B. Multi-family residential – Structures with 5 or more units
1. Tenant-occupied – Apartments and hotels ("destination" or "transient") (an "apartment" structure has been defined as one in which five or more dwelling units share a foundation and/or roof.) At the low end are "single room occupancy" (SRO) units, where residents have private sleeping rooms but share kitchen and bath facilities with fellow tenants – like college dorm life in the real world.
2. Owner-occupied – Condominiums and cooperatives

[Interesting feature of hotels is short-term nature of leases (or do "guests" hold "licenses"?). Condo: individual household gets its own mortgage loan, and all owners together own the common areas. Co-op: a corporation owns the property and gets a mortgage loan in the corporation's name; all occupants are shareholders in the corporation, each shareholder has a special lease on the unit occupied.] But note that condo & co-op are not types of buildings, but rather *forms of ownership*. In a big city you might see a condominium office building or even parking garage; person owns that one parking space she parks in each day individually and owns common areas with other owners.

C. Commercial – Retail and office

Used to be mostly in downtowns, or "CBDs" (central business districts). Now we see suburban shopping centers, secondary urban centers; there have always been neighborhood commercial areas, as well. Sometimes residential and commercial are combined into "mixed use" developments. Grocery and gas station/convenience stores are seen as good investments because their sales tend not to be reduced much by economic downturns or on-line shopping.[7]

D. Industrial – Manufacturing and warehouse

Used to be located around the periphery of downtowns, or CBD's, because of rail transportation. Now often in industrial parks, with lower-cost land and locations close to power sources, or various transportation facilities like major road interchanges. Self-storage units were first conceived as cheap improvements that could generate income until a more permanent use for the land could be identified. Demand rose as on-line retailers increasingly needed warehouse space for storing and shipping their goods, but was slowing by late 2023, because of both overbuilding of warehouses in some areas and the post-Covid return to on-site shopping – particularly for more upscale goods.[8]

E. Agricultural – Farms and timber lands

Used to be owned largely by small farmers or wealthy individuals; now there is much institutional and even foreign ownership. All real estate is taxed by local government based on a measure of its value, with agricultural land usually taxed at the lowest tax rate among the various property types.

F. Other
1. Private institutional property – Clubhouses, union halls, private schools
2. Private recreation property – Land, resorts
3. Government recreation property – Parks, preserves
4. Other government real estate – Includes roads, schools, military bases, post offices, prisons [Government owns about ⅓ of all land in the U.S. – much is in western states, of course]
5. Oddball examples – Private roads, landfills, "parks" for mobile and manufactured housing [the latter usually do not become real estate until placed on a permanent foundation]

IV. Careers in Real Estate

Much flexibility as a career field, with positions for entrepreneurs, independent professionals, and corporate types. People interested in production, marketing, finance, and management can all enjoy rewarding real estate careers. Abilities needed can range from technical financial/accounting/analytical to construction to the "people" side. (The application of data analytics and other technology tools to real estate market analysis is called "proptech," just as we see similar situations in the broader financial world referred to as "fintech.") Negotiating and communication skills often are keys to success in career applications relating to real estate.

A. Brokers – use specialized knowledge of the market to bring buyers and sellers together. You must have a broker's license to represent someone other than yourself in a real estate transaction. A broker usually is paid a commission that is a percentage of the transaction price. The holder of a broker's license often is a "Realtor®," but not necessarily. In Illinois there are two categories of real estate sales licensure: "broker" and "managing broker," with the broker supervised by/reporting to a managing broker, and added education plus two years of experience is needed before someone can take the managing broker's license exam.
B. Subdividers/Developers – buy land to subdivide (break a large parcel into small individual lots) and/or build on; buy older properties to improve/renovate.
C. Builders – construct buildings or other improvements. Builders often are general contractors who subcontract much of the actual work to others with expertise in specific areas, like plumbing or concrete work.
D. Inspectors – specialists in construction and operating systems who do careful inspections, either as part of the government approval process for new construction or to advise individual property buyers in private transactions. In recent years home buyers have made increasing use of private sector home inspectors, who do careful analysis and write reports on the strong and weak points of particular properties' physical components.
E. Appraisers – valuation specialists who work for any interested client (fee appraisers), one employer (staff appraisers), or a government taxing body (assessors). Appraisers need state licenses to do most types of appraisals for non-employer clients, and many go beyond basic license requirements to earn professional designations through private professional groups. MAI, or Member of Appraisal Institute, is the most prominent.
F. Mortgage lenders – work for banks, thrifts, insurance companies, loan brokers. Jobs: loan officer, credit analyst (doing the numbers work), loan originator (managing the paper work), loan servicer (collecting payments).
G. Investment analysts – analyze real estate investments for investment firms (including Real Estate Investment Trusts that let small investors diversify), insurance companies, pension funds, large banks. They may be counselors who advise on individual purchases or portfolio managers who advise on broad investment planning, including the use of real estate-related securities. Some obtain the Counselor of Real Estate (CRE) designation, and/or the same Chartered Financial Analyst (CFA®) designation that stock and bond analysts often hold.
H. Property managers – manage buildings for their owners. Property managers advertise the availability of space, negotiate leases, provide maintenance and other services for tenants. May work "in-house" or independently. Some complete the Certified Property Manager (CPM) certification program.
I. Asset managers – select sites for/acquire, manage, and dispose of a portfolio of real estate assets for a corporation or other client.
J. Lawyers and paralegals that specialize in real estate law and transactions.
K. Public sector personnel – land use planners, zoning board personnel, specialists in acquisition and leasing (in addition to inspectors and assessors discussed earlier).
L. Educators – colleges, trade schools, seminars/continuing education.

V. The Real Estate Market – the mechanism by which buyers and sellers (or landlords and tenants) are brought together to complete transactions.

A. Characteristics of the real estate market
1. Local in nature – the local economy has major impact. Can not import/export when there is a shortage/ surplus. (In about the year 1960, when Bloomington-based State Farm was growing and hiring large numbers of people from outside the area, the company actually ran ads in the *Pantagraph* seeking home owners who would rent out extra rooms until the housing situation could straighten out – an insight provided by long-time columnist Bill Flick in the newspaper's August 18, 2021 edition.)
2. Not organized – uniqueness of properties prevents centralized markets. Each deal must be negotiated separately. Sales prices can be difficult to verify (unlike with easily verified stock market transactions). We see individual transactions, with no organized dealer network to facilitate sales. Of course, modern information technology and the emergence of firms like Zillow are causing changes.
3. Long lead time needed for supply to increase, or to sell off/reconfigure surplus properties.
4. Renting plays a major role due to high prices (tenants may not be able to afford to buy) and unique locations (an owner who is reluctant to sell might be willing to give up use temporarily through leasing).

B. Factors that affect demand for real estate

1. Nominal and real prices of components of real estate services (land, labor, materials)
2. Demographic Issues
   a. Rate of household formations (millennials?), business formations
   b. Migration of population into or out of various local areas
   c. Lifestyle preferences
   More people with high incomes – more vacation homes
   People living longer, healthier, more affluent – impacts retirement communities
   Uncertainty regarding job security, or other reasons for wanting to stay mobile, could lead more in groups who traditionally bought houses to prefer renting – which might or might not suggest that different kinds of rental property improvements are needed (houses *vs.* apartments)
3. Economic/Financial Issues
   a. Current and expected household disposable incomes (according to the National Association of Realtors,® pending home sales, meaning purchases agreed to but not yet "closed" or finalized, in April 2020 amid the uncertainty of the Covid-19 economic shutdown's impact on incomes, were more than 34% lower than the similar April 2019 figure – the largest yearly drop ever recorded).
   b. Savings available for down-payments – a big down payment provides for better financing options
   c. Availability and cost of financing – higher interest rates make it harder to purchase (or do they?)
   d. Income tax issues relating to home ownership (longstanding benefits were reduced in late 2017)
   e. Technology: think of
   Residential – a National Bureau of Economic Research study determined that much of the 45% increase in U.S. home values from early 2020 until mid 2022 could be explained by technology that allowed people to work remotely; families relocated because they could work from anyplace, and wanted larger houses with more amenities since they would be spending so much time there.
   Retail – will on-line purchasing technology continue to reduce the need for "bricks and mortar" retail space? In fall of 2022 a once-prominent three-level shopping mall in North Attleborough, Massachusetts sold for $29 million – after having been valued at $167 million ten years earlier.
   Warehouse – materials handling equipment means warehouses can be taller. On-line purchasing technology means that warehouses must be configured for the ability to handle small orders (*vs.* traditional large shipments from warehouses). Shipping containers are essentially warehouses in themselves, but they need places to be stored between being unloaded from ships and loaded onto trains or trucks; a June 15, 2022 *Wall Street Journal* article reported that vacant land near ports where containers could be stacked/stored was in high demand.
   Office buildings – optimal size, location, configuration change in an era of telecommuting and shared work spaces/office "hotelling."
   Land – microorganisms that break down rotting garbage make landfills valuable real estate for extracting renewable natural gas. A Pennsylvania trash-fed facility produces enough gas each day to supply more than 65,000 homes, according to the December 6, 2022 *Wall Street Journal*.

C. Measures of real estate market activity

[It can be difficult to directly measure how strong the market is, but these are indirect measures that can provide us with ideas about current or expected future market activity.]

1. Vacancy rates
2. Number of transfers (sales) of property
3. Number of foreclosures (seizure of the real estate by the lender) when borrowers do not pay back loans
4. Construction activity – permits issued, starts, demolitions
5. Price indexes – measures of general price movements in the housing, farm land, commercial sectors
6. Increases in prices at which transactions close (relative to other assets' value changes) •

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