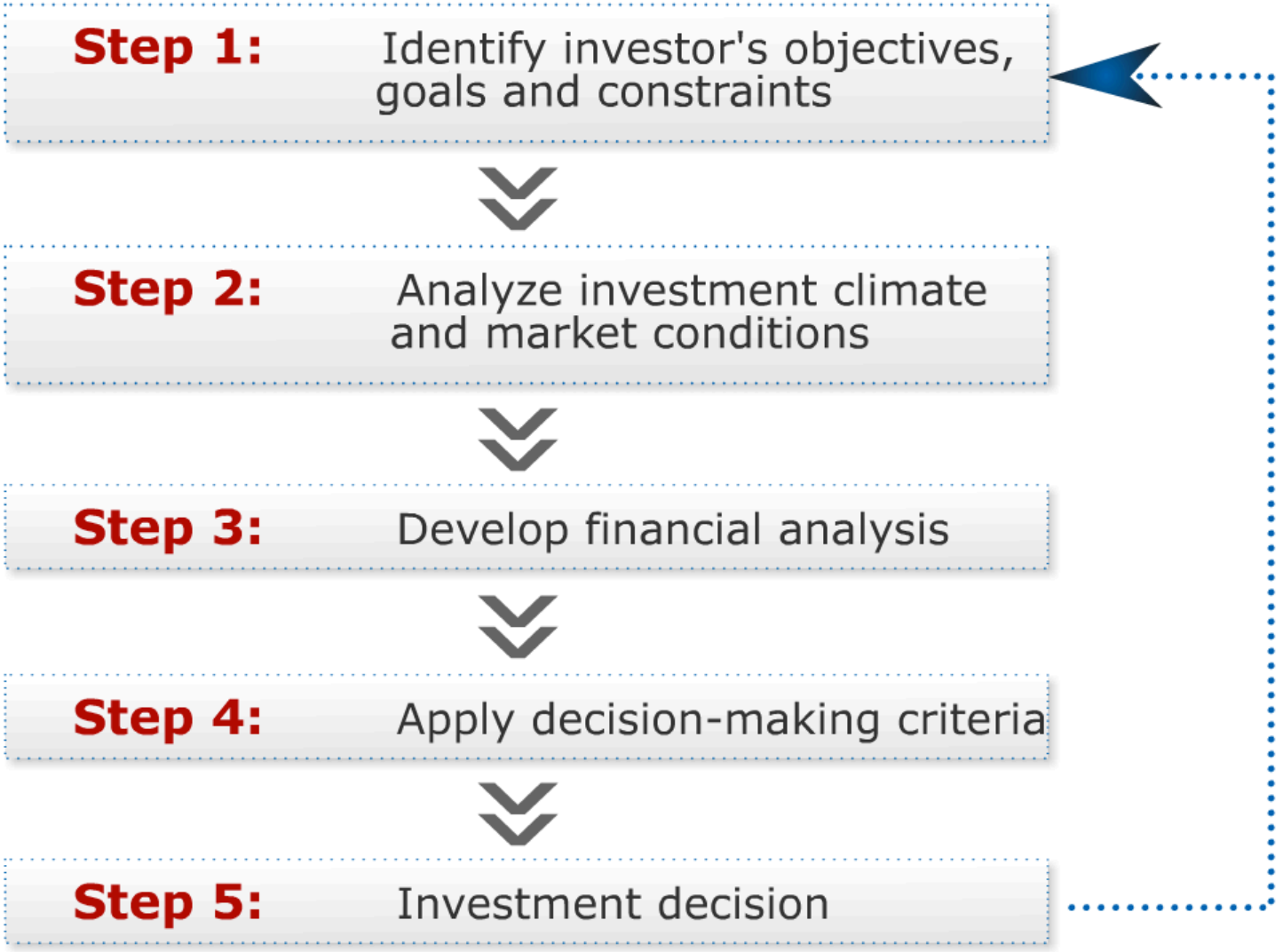
The Real Estate Investment Process

You are restricted by two-step:

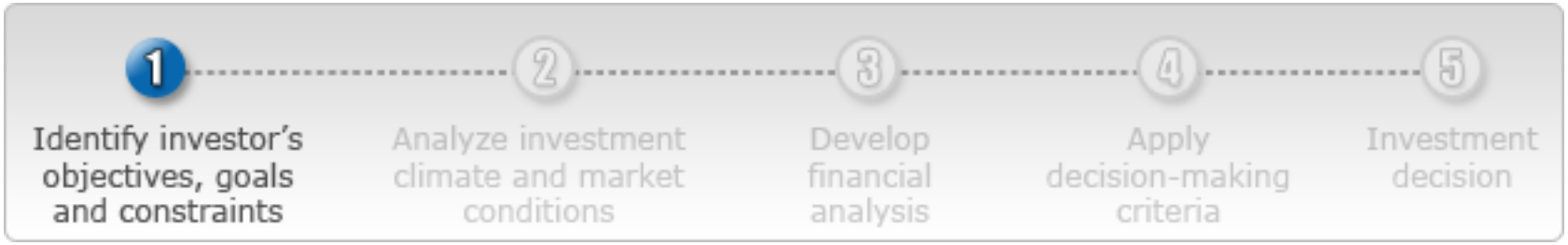
- Wealth: Identify how much money you have as down payment, what is the level of risk you can handle and wha the expected return. You need some kind of money to buy the property, or to put a down payment.
- Who will lend you the money, at what rate, am I allowed this property, am I allowed to buy this property and us in a specific way.

The Real Estate Investment Process



Replay

The Real Estate Investment Process



Step 1: Identify Investor's Objectives, Goals and Constraints

It is important to start the REI process by understanding that major participants (equity investor, mortgage lender, tenant and government) bring their own expectations and limitations to the REI.

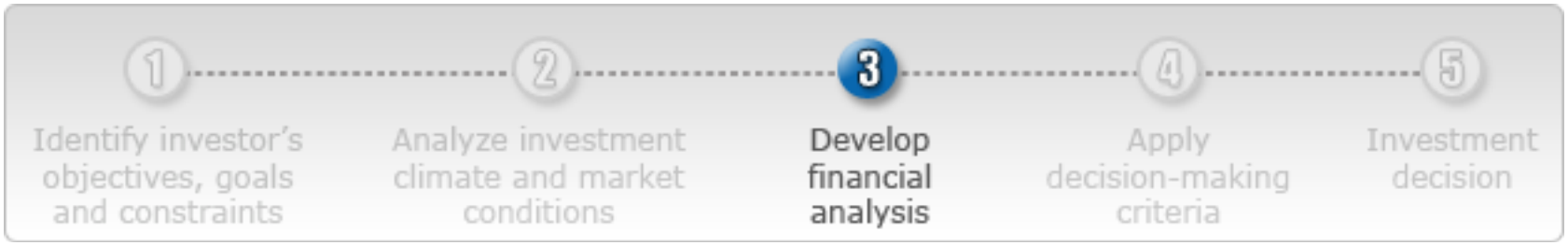
- **The equity investor** is interested in the cash flow that will generate the REI.
- **The mortgage lender**'s goal is to obtain a rate of return from the money lent to the equity investor.
- **The tenant** does not receive an immediate income, but will be concerned with the legal rights to use the property.
- **The government** is responsible for regulating the relationships between the other major participants in the REI process, and it also places restrictions on real estate.

Step 2: Analyze Investment Climate and Market Conditions

The second step in the REI process is learning about the market, legal, financing and tax environment. The result of th analysis will have a great impact on your decision-making throughout the process. We will discuss these environments detail in later lessons; here is a brief overview of what you will learn.

- **The market environment.** This analysis identifies supply and demand in the real estate market at local, provincial, and state levels and how they affect the REI.
- **The legal environment.** A complex legal system regulates REI and the relationships between its participants. Analyzing the legal opportunities and limitations that a REI may entail will play an important role in the acquisiti decision and also in the rest of the REI process.
- **The financing environment.** The analysis of the cost of debt or interest rate, and the cost of equity or rate of retu shows how feasible the REI is and how profitable it might be.
- **The tax environment.** Taxes decrease the REI's income; therefore, knowing the taxation system and the impact th it will have on the expected income will help in making the right investment decision to save money or to increas gains.

The Real Estate Investment Process (Cont'd)



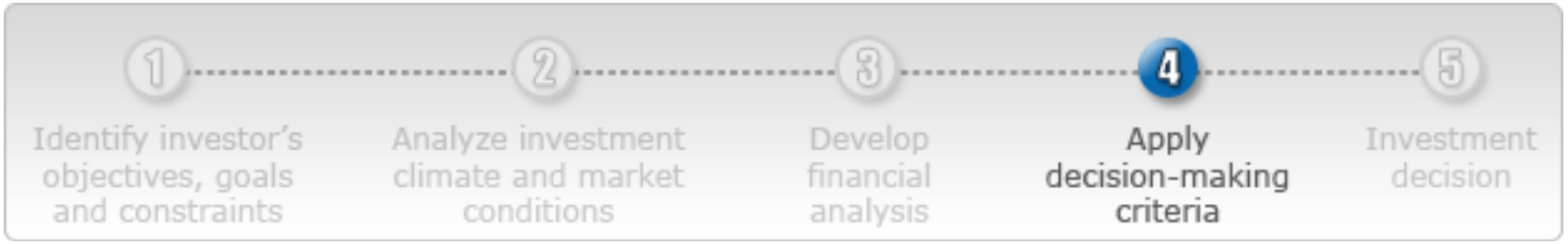
Step 3: Develop Financial Analysis

The financial analysis deals with financial calculations that will allow you to anticipate the cash flow of the REI. At the e of the analysis you will be able to answer questions such as:

- How much is profit per year?
- How much is the mortgage payment?
- How much is the capital gain when I sell?
- How much will taxes diminish my profit?
- How much will taxes decrease my capital gains?

What strategies should I use to reduce taxes on profits and capital gains?

The Real Estate Investment Process (Cont'd)

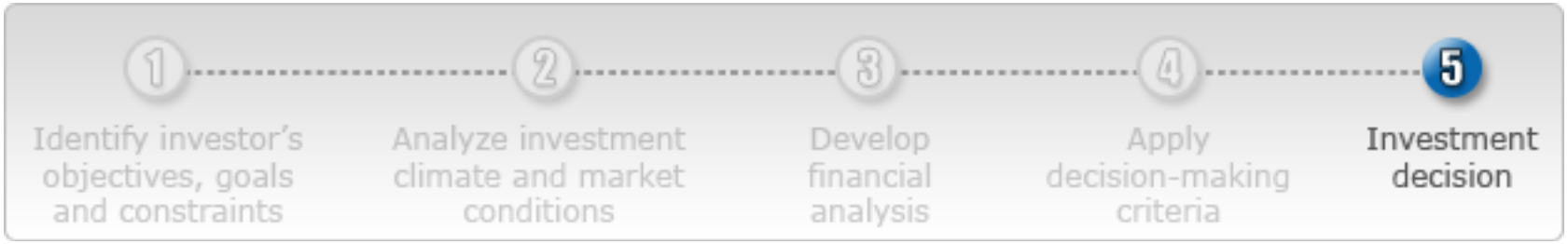


Step 4: Apply Decision-Making Criteria

In this step, you apply decision-making criteria to decide how much you are able or willing to pay for a property to obt the desired rate of return. To do so, you may use three criteria:

- **Rules of Thumb Techniques,** which measure the payback period necessary to regain what was invested to acquire property, and the methods needed to achieve the highest rate of return. Techniques are: payback method, retur on investment (ROI), return on equity (ROE), return on asset (ROA), gross income multiplier (GIM), net operatir multiplier (NIM) and overall capitalization method (OCR).
- **Discounted Cash Flow Techniques,** which calculate the value today of the REI future cash flow. These technique take time value of money into consideration and include discounted payback period method, net present value method, and internal rate of return and profitability index method.
- **Traditional Valuation Techniques,** which estimate the value of the property that will be used in the REI. These techniques are: cost approach, net income approach and market (sales) comparable approach.

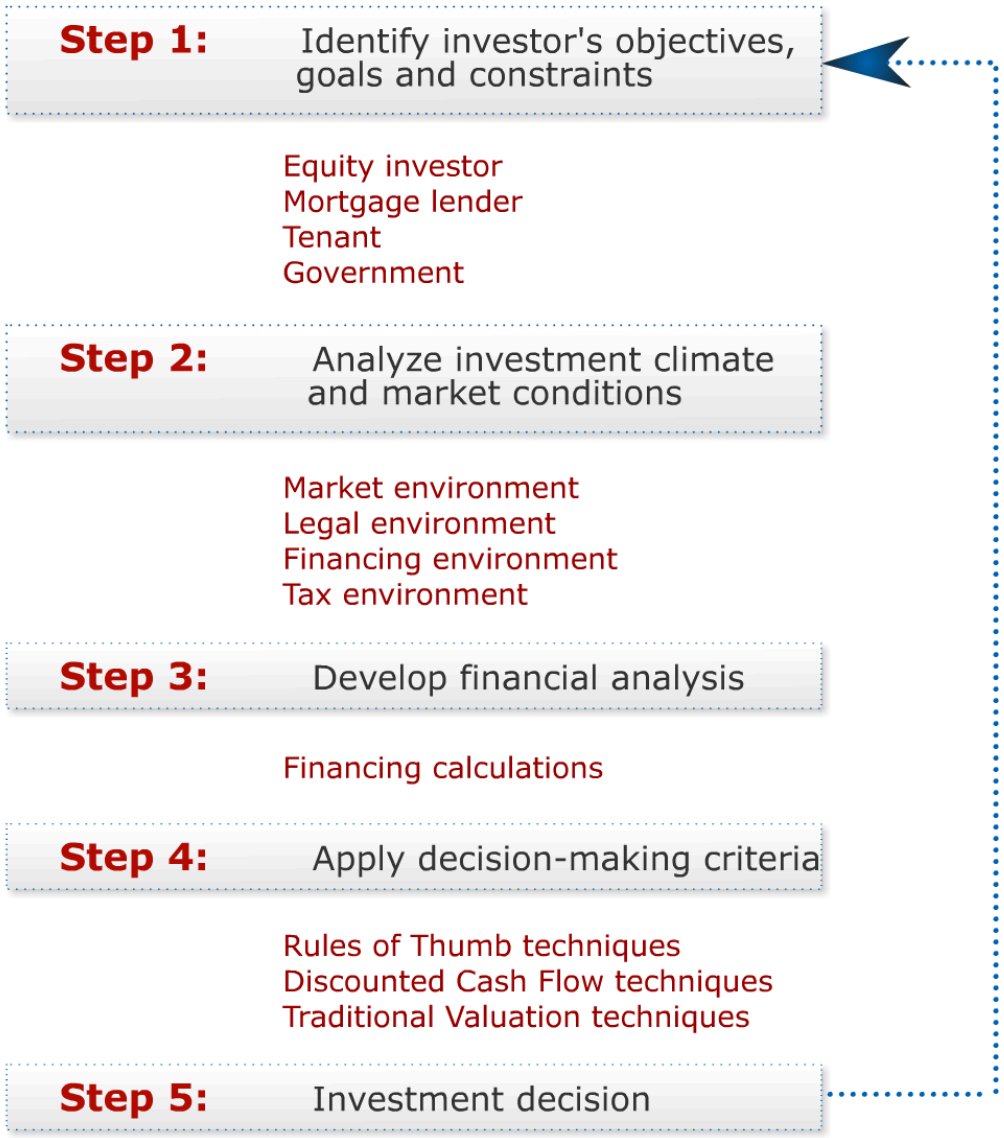
The Real Estate Investment Process (Cont'd)



Step 5: Investment Decision
The previous steps will give you the necessary information to decide whether to acquire REI or not. If the result of the analysis is not what you expect, you will repeat the process assessing another REI until you find what meets your financial goals.

In the following lessons we will discuss each step of the process in greater detail. You will also have exercises and self-assessments to practice what you learned and to help build your confidence in order to start your real estate investme

The Real Estate Investment Process



Replay

EAR (Effective Annual Rate) = $(1 + [1/m]^n) - 1$

EXAMPLES:

3. You have $50,000 in your bank account. You plan to save $5,000 at the end of each year for the next 10 years. The interest rate is 8% per annum, compounded monthly. **What is the future value of the $50,000?**

a) $107,946
b) $94,832
c) $110,983
d) $106,456
e) $105,180

PV=50000
Use the EAR, as the (I/Y)=8.3%
N=10 (10 years)
PMT=0 ->because there's no payments, its not a question concerning annuity).

4. You have $50,000 in your bank account. You plan to save $5,000 at the end of each year for the next 10 years. The interest rate is 8% per annum, compounded monthly. **What is the future value of the annuity (ordinary)?**

a) $73,473
b) $72,785
c) $71,919
d) $72,433
e) $71,477

PMT=5000
PV=0 (because there's no present value)
I/Y=8.3 (using EAR)
N=10 (number of years)

5. You have $50,000 in your bank account. You plan to save $5,000 at the end of each year for the next 10 years. The interest rate is 8% per annum, compounded monthly. **What is the future value of all the cash flows?**

a) $180,931
b) $166,751
c) $178,889
d) $176,657
e) $184,456

PV=50000
PMT=5000
I/Y=8.3
N=10
FV=??=**184,456**

6. You expect $50,000 at the end of the 10th year. You also expect $5,000 at the end of each year for the next 10 years. The interest rate is 7% per annum, compounded semi-annually. **What is the nominal rate per annum?**

a) 7.00%
b) 7.12%
c) 6.88%
d) 6.78%
e) 7.23%

Nominal Rate is basically the "interest rate per annum".

7. You expect $50,000 at the end of the 10th year. You also expect $5,000 at the end of each year for the next 10 years. The interest rate is 7% per annum, compounded semi-annually. **What is the effective annual rate (EAR)?**

a) 7.00%
b) 6.88%
c) 7.23%
d) 7.12%
e) 6.78%

EAR=[(1+ 0.08/2)^2] – 1
m=2 because it's semi-annually (twice a year).