A BASIC GUIDE TO

REAL ESTATE

Things Every Reporter Should Know

Excerpted from a Manual on Real Estate Investment and Appraisal by Howard Jackson, Jr.

WHAT IS REAL ESTATE

Real estate could be defined as land and all the improvements constructed thereon including natural resources and air rights. Owning real estate is an inherent right in the United States often not found in other countries. It is often called realty or real property.

Along with the physical aspects of real estate is a concept of ownership called the "bundle of rights". This means someone owning real estate could build on it, lease it, mortgage it, sell it, give it away or do none of these things. Each of these rights could be appraised separately meaning they could be marketed as individual items.

When a property is owned with all of the bundle rights intact, it is said to be owned in fee simple estate. If a property is owned with less than all of the bundle rights, it has some other name. For example:

Leased Fee Estate - A landlord's interest
Leasehold Interest - A tenant's interest

However, these rights are limited by government restrictions. They are as follows:

1. Police Power: This mainly involves zoning which regulates the use and density of real estate. More will be discussed about zoning for it has a major influence on value.

2. Eminent Domain: Government can take private property (real estate) for public use as long as the owner is paid just compensation (courts have held this to be market value). The act of taking a property is called just compensation

3. Taxation: The government can levy real property taxes to finance its operation. It becomes a lien until paid. Excessive taxes can adversely affect real estate values

4. Escheat: Should a property owner die without a will and the state can't find any heirs then the property will revert back to the state

Real estate is immovable and limited in supply. It's use can be changed, but only through legislative action. Even in very active, high demand markets, lower density uses of real estate may be dictated by zoning laws which cannot be changed due to resistance from government, landowners or residents in the neighborhood, conservation, landmarket groups and other special interest groups.

Since it is immovable, it is subject to outside forces (economic, social, political, environmental) over which it has not control. These forces could enhance or detract from a property's value. Some of these forces are:

1. Reputation of a neighborhood
2. Inharmonies uses; a poorly placed residential area near an industrial zone
3. Available transportation roads
4. Zoning policy
5. Availability of jobs - stability of the business community
6. Natural resources

RULES OF THUMB FOR INVESTING IN REAL ESTATE

RULES OF THUMB FOR INVESTING

One of the misconceptions about investing in real estate is the existence of Rules of Thumb about values. There are no such things. This means that there are no constants that can be applied to partial knowledge of some facts about real estate that can convert it into consistently reliable indications of value around the United States.

However, there are certain "measures," "relationships," or "yardsticks" that investors do use to gauge what they might pay for a parcel of property. The things that might change the value are the economic components located within these "measures" or "yardsticks". Once these economic or financial components are ascertained, these "yardsticks" could give reliable value estimates.

For the purpose of this article let's refer to these "measures" or "yardsticks" of value as basic financial relationships of value or value relationships.

This article will explore the most common value relationships used by investors today. These items will be defined and all component items explained as well as practical examples indicated.

OVERALL CAPITALIZATION RATE

Now that we have explored many of the motivational considerations for investing in real estate here are the predominate value relationships that are used by investors.

One of the fundamental premises of valuation is that the value of income producing real estate is a function of its ability to produce income. The basic formula is as follows:

$$\text{Value} = \frac{I}{R}$$

Where I = Net Operating Income (Income after Operating Expenses not including mortgage payments)
R = Overall Capitalization Rate

A capitalization rate is computed using a combination of a percent of the mortgage and equity requirements of real estate as the investment properties are generally purchased with both mortgage and equity However, if the property is purchased entirely with equity money (cash), then the capitalization rate is equal to the equity dividend rate.

There are three methods of obtaining an overall capitalization rate.

1. Directly from the market

In this method, the selling price of similar or comparable properties are used. The net operating income at the time of sale must also be known. The formula to compute the overall capitalization rate is:

$$\text{Overall Cap. Rate} = \frac{\text{Net Oper. Income}}{\text{Selling Price}} = \frac{15{,}000}{150{,}000} = .10$$

If a property sold for $150,000 and had a net income of $15,000 the overall capitalization rate would be .10.

2. Band of Investment Method

This method of computing an overall capitalization rate is based upon the fact that an investment into real estate is comprised of a mortgage position (bank financing) and an equity position (your money).

The return on the equity position is referred to as an equity dividend rate or "cash on cash" return. It includes return on the investment and return of the investment.

The Band of Investment Method synthesizes both the mortgage and equity positions into a weighted rate. All of the component elements required to calculate this rate are readily accessible from financial market data. Assume the following facts:

Mortgage Money	$ 70,000
Equity Money	+ 30,000
Purchase Price of Property	$100,000
Mortgage Position: (Loan to Value Ratio)	.70*
Equity Position:	.30
Equity Dividend Rate:	.125
Mortgage Constant: (12 1/2% interest, 25 years end of period payments)	.130842

We now have the necessary ingredients for the execution of this technique.

MORTGAGE POSITION		MORTGAGE CONSTANT		WEIGHTED RATE
.70	x	.130842	=	.0915894
EQUITY POSITION		**EQUITY DIV.RATE**		
.30	x	.125	=	.0375
This is the Indicated Capitalization Rate:				.1290894

* Investors typically seek optimum leveraging arrangements. In this example, a 70% loan to value ratio for the subject property is utilized.

Rounded off to: .1291

3. Mortgage Equity

This method differs from the Band of Investment Method in that the equity portion represents an equity yield rate as opposed to an equity dividend rate. The equity yield rate is used to account for the future projection of property values as they relate to the various competitive investment alternatives available. In the development of an Equity Yield Rate for a given property, consideration is given to the risk, liquidity, and the time and expense of asset management.

An Equity Yield Rate can be computed as follows:

Money Market Rate	7.0%
Equipment Write-Off	0.5%
Liquidity (10 yr. holding period)	0.5%
Asset Management	0.5%
Risk (including capital improvement program	0.5%
Indicated Equity Yield Rate	9.0%

The exact Equity Yield Rate can only be computed after a property has been sold.

Loan to Value Ratio:	70%
Mortgage Interest Rate:	.1250
Effective Mortgage Constant:	.130842 (10 year payout 25 year amortization
Equity Ratio:	30%
Equity Yield:	9.00%

The following is indicated:

MORTGAGE RATIO		MORTGAGE CONSTANT		WEIGHTED RATE
.70	x	.130842	=	.091589

EQUITY RATIO		EQUITY YIELD		WEIGHTED RATE
.30	x	.0900	=	.0270

Weighted Basic Rate: .1186

LESS Property Appreciation
(.30 x .065820) -.0197

Indic. Overall Rate: .0989
RD to .099

In this example the Mortgage/Equity Analysis Resulted in an overall rate of .099.

Value Estimate

Here is an example for developing a value estimate of an income producing property with a net annual income estimated at $100,000. With an overall capitalization rate developed using the Band of Investment Technique of .10, the value would be computed as follows:

$$\text{Value} = \frac{\text{Net Income}}{\text{Capitalization Rate}}$$

$$\text{Value} = \frac{\$\ 100,000}{.10}$$

$$\text{Value} = \$1,000,000$$

Note: The actual capitalization rate method that would be used in any particular case would depend upon the type of property and the type of information available to develop that rate. This is determined by market research and analysis.

EQUITY CAPITALIZATION RATE

Some investors will compute the price they will pay for a property based upon the monies they personally have to put into it (equity position) divided by the return they want on their money called an equity capitalization rate. The current mortgage balance is added to this to determine their investment price.

The equity capitalization rate is determined by careful and specific market analysis.

The formula for value is:

$$\text{Value} = \text{Equity} + \text{Mortgage}$$

$$\text{Equity} = \frac{\text{Cash Flow to Equity}}{\text{Equity Capitalization Rate}}$$

For example:

$$\text{Value} = \frac{\$\ 50{,}000}{.10} + \$1{,}000{,}000$$

$$\text{Value} = \$\ 500{,}000 + \$1{,}000{,}000$$

$$\text{Value} = \$1{,}500{,}000$$

Investors use this technique as one method of determining how much they will pay for a property. This capitalization rate may be considered difficult to quantity as its development by traditional market research methods is difficult due to lack of information.

GROSS INCOME MULTIPLIER

In certain situations, the market value of a property may be determined as a multiple of a property's gross income such as seven times the rent.

The way this is determined in the market is by an analysis of comparable sales. You must know two things - sales price and gross income at the time of sale. The formula is:

$$\text{Gross Income Multiplier (GIM)} = \frac{\text{Selling Price}}{\text{Gross Income}}$$

This is then applied in the field. After examining a number of actual sales, you may find a GIM range of 4.5 to 5.0 times the rent. If you are looking at a property that has a gross income of $100,000, the indicated market value range via this technique would be $450,000 to $500,000. To restate this practical use of the GIM:

$$\text{Value} = \text{GIM} \times \text{Gross Rent}$$
$$\text{Value} = 4.5 \times \$100{,}000 = \$450{,}000$$
$$\text{Value} = 5.0 \times \$100{,}000 = \$500{,}000$$

$$\text{Value} = \$500{,}000$$

This gross rent is the actual rent in force and effect at time of the sale. In certain instances an investor might feel that the rent could be raised somewhat during the next few months. That higher rent might be used as a basis of the formula. Great care must be taken when exercising this method, for this is one way investors use a valuation technique to develop a "bid" price on a property.

One weakness of this method is that the underlying expenses of property operations are not considered. If not explored while utilizing this technique it could produce an erroneous over or under valuation.

DEBT COVERAGE RATIO

This is used by lenders as a measure of security on property. It is the ratio of net operating income to a property's annual debt service. The formula is thus:

$$\text{Debt Coverage Ratio} = \frac{\text{Net Operating Income}}{\text{Annual Debt Service}}$$

$$\text{Debt Coverage Ratio} = \frac{\$100,000}{50,000}$$

$$\text{Debt Coverage Ratio} = 2$$

The higher the Debt Coverage Ratio (DCR) the more secure the loan on the property usually is.

PRICE PER SQUARE FOOT

This is a very common unit of comparison used for many different types of properties including commercial and industrial. It is computed as follows:

$$\text{Sale Price Per Square Foot} = \frac{\text{Selling Price}}{\text{Square Foot Area of Building}}$$

A potential problem arises with the definition of "square foot area." In certain types of property the gross building area is used (computed by outside building measurements). An example would be an industrial building. In other types of property such as shopping centers, the net rentable area or net leasable area is used (how much space is actually available to be rented). When analyzing these units of comparison be careful what type of area is being used as a basis for comparison.

To find the indicated value, multiply the building area (100,000) by the value per square foot ($25.00) = $2,500,000 (indicated value).

PRICE PER FRONT FOOT

This unit of comparison is often used where site exposure is important. If a property had a frontage of 100 feet along a major highway or 100 feet of oceanfront property, it would be said to have 100 front feet.

When analyzing sales of land (comparables) dividing the sales price by the number of front feet would indicate the sale price per front foot.

$$\text{Sale Price Per Front Foot} = \frac{\text{Selling Price}}{\text{\# of Front Feet}}$$

INTERNAL RATE OF RETURN

This is a complex unit of comparison which measures a property's return on investment for a specific holding period. The Internal Rate of Return is one measure of performance used by investors to gauge investment performance. The expression "internal rate of return" is used synonymously with "discount rate" or "equity yield rate."

The Internal Rate of Return is a rate which weighs all financial benefits to the property including property appreciation (if any).

There are usually three methods of computing the Internal Rate of Return.

1. Graphic
2. Interpolation
3. Iterative

Following is a straightforward example which can be utilized as a model for more complex investments.

The Problem

Mr. Jackson bought a property four years ago for $10,000. Annual equity dividends are $720. The property was sold for $11,000. What is the equity yield rate?

Original Investment:	$10,000	
Holding Period:	4 Years	
Gain at Resale:	$ 1,000	(10% gain)
Annual Equity Dividend:	$720.00	
Equity Dividend Rate:	7.2%	
Total Profit:	$ 3,880	(dividends + gain)
Average Yearly Profit:	$970.00	
Average Rate of Profit:	9.7%	

The equity dividend rate of 7.2% is lower than the true yield rate since it doe not reflect the final gain. The average rate of annual profit of 9.7% is higher than the true yield rate because the final gain was deferred and was not actually received as a stream of income. Although neither of these rates reflects true yield, they immediately reveal upper and lower limits and are applicable in the trial-and-error process of finding the

actual yield somewhere between the extremes. In this particular problem, the average rate of profit is higher than the equity dividend rate because of a gain. If there has been a loss, the average rate of yearly profit would have been less than the equity dividend rate. In either event, these two rates always reveal the extremes and the true yield rate can be assumed to be somewhere between.

GRAPHIC METHODS

Using $10,000 investment value as target, try 9% yield.

Value of Income	$ 720	x 3.240	=	$ 2,332
Value of Reversion	$11,000	x .7084	=	$ 7,782
				$10,125
				(Target $10,000)

Try 10% Yield:

Value of Income	$ 720	x 3.170	=	$ 2,282
Value of Reversion	$11,000	x .6830	=	$ 7,513
				$ 9,795
				(Target $100,000)

PUT IN GRAPH

Yield = Equity Dividend

(Change in Value x Sinking Fund Factor @ Target Yield Rate)

Equity Dividend Rate = Equity Yield Rate - % Gain x Sinking Fund Factor. Try Equity Yields of 9% and 10%.

.09 - .10(.2187) = .06813 (Target .072)
.10 - .10(.2155) = .07845 (Target .072)

PUT IN GRAPH

INTERPOLATION

Using $100 investment value as Target, try 9% Yield

Value of Income	$ 720	x 3.240	= $ 2,332	
Value of Reversion	$11,000	x .7084	= $ 7,792	
				$10,125

Try 10% Yield:

Value of Income	$ 720	x 3.170	= $ 2,282	
Value of Reversion	$11,000	x .6830	= $ 7,513	
				$ 9,795

Total Difference for 1% Spread $ 330

Partial Difference 9% to Target $10,125 - $10,000 = $ 125

Interpolate:

9% + ($125 - $330) = 9.38%
Rounded to 9.4%

Equity Dividend Rate = Equity Yield Rate - % Gain x Sinking Fund Factor. Using 7.2% Equity Dividend Rate as Target, try yields of 9% and 10%.

.10 - .10(.2155) =	.07845	.07200 Target
.09 - .10(.2187) =	.06813	.06813
.01 Differences	.01032	.00387

Interpolate:

.09 = .01 x .00387 - .01032 = .09375
Rounded to 9.4%

ITERATIVE

Using the unknown yield rate as the target, the equity yield rate equals the equity dividend rate plus the growth rate (or minus the loss rate). The growth rate (or loss rate) is the fraction appreciated (or depreciated) times the sinking fund factor for the equity yield rate and holding period.

Using a trial yield rate, look up the sinking fund factor and calculate a trial growth rate. When the trial growth rate is combined with the equity yield dividend rate, the result may be viewed as an approximation of the true equity yield rate. For closer approximation, the process can be repeated using successive substitutions for the trial rate. If the difference between the trial rate and the result approaches zero, the computations are converging, and the iterations can be continued until the desired accuracy is achieved. If the computations do not converge, it may be necessary to use a modified iterative technique with bracketing and interpolation as explained above. Since the equity yield rate itself is the target, the objective is to compute a yield rate that is equal to the trial rate.

Try 9%:

Sinking Fund Factor for 9%, 4 Yrs:		.2187
Growth Rate is 10% of Sinking Fund Factor:		.02187
Equity Dividend Rate:	.07200	
Equity Growth Rate:	.02187	
Approximate Equity Yield:	.09387	(off target .00387)

Try 9.5% (nearest table rate to .09387)

Sinking Fund Factor for 9.5%, 4 Yrs:		.2171
Growth Rate is 10% of Sinking Fund Factor:		.02171
Equity Dividend Rate:	.07200	
Equity Growth Rate:	.02171	
Approximate Equity Yield:	.09371	(off target .00129)

Following is another example of how the Internal Rate of Return could be calculated.

If we assume the following for ease of visual and conceptual understanding, the Internal Rate of Return can be demonstrated.

Projection term: 5 years*
Interest Rate (IRR): 10% annual compounding
Initial Investment: $10,000

The "interest" payments received will be $1,000 per year. As the payments are received further into the future, they are worth less. It is important to reiterate that money received in the future is worth less <u>less</u> than money received today. How much less is a function of <u>when</u> it is received, <u>what</u> the frequency of compounding is, and <u>what</u> is the interest rate being used. The internal rate of return is found when all discounted future returns - the original equity investment = 0 (net present value). It is usually found by trial and error method or computer analysis.

Discounted Future Returns + Original Equity Investment = 0

YEAR	CASH FLOW	x	DISCOUNT RATE @ 10%	=	PRESENT VALUE
0	-$10,000		1		-$10,000
1	$ 1,000		.909		909.09
2	$ 1,000		.826		826.44
3	$ 1,000		.751		751.31
4	$ 1,000		.683		683.01
5	$11,000		.620		6830.13

Net Present Value: -0-

*A projection term is used because the only way a yield can be computed is to consider the property's sale price. Absent that, the technique presumes a time of sale in the future.

When the cash flows become more complicated, the internal rate of return could become more difficult to calculate. Sometimes this rate could be considered unreliable because there is a possibility that more than one rate could simultaneously solve the Internal Rate of Return Equation.

INTERNAL RATE OF RETURN EQUATION

$$CFO + \frac{CF1}{1+IRR} \pm \frac{CF2}{(1+IRR)^2} \pm \frac{CF3}{(1+IRR)^3} \pm \frac{CF4}{(1+IRR)^4} \ldots \frac{CFN}{(1+IRR)^N} = 0$$

CF0 is the initial cash flow (negative #)
CF1 is the cash flow for year 1
CF2 is the cash flow for year 2
CF3 is the cash flow for year 3
CF4 is the cash flow for year 4
CFN is the cash flow for the last period
N is the number of years

One method of solving for the IRR is the iterative method whereby trial and error is utilized. A number of trials are computed and are plotted on a curve. As the sign changes, it signifies that the IRR has been "overshot." At this point, linear interpolation is used.

HOW TO SOLVE FOR THE INTERNAL RATE OF RETURN

One widely used definition of the Internal Rate of Return is: The rate of discount which makes the net present value of an investment equal to zero.

By trial and error, we will start at a trial rate and compute the net present value until we get zero (the IRR) or a negative number.

Once we see a negative number we then know that the IRR is between the current rate and the one prior to that. By using linear interpolation we can "focus in" on the rate more precisely.

Following are the trial rate computations:

FIGURE 1

YEAR	CASH FLOW	x	DISCOUNT RATE @ 15%	=	PRESENT VALUE
0	-$14,500		-0-		-$14,500
1	3,000		.8696		2,609
2	3,500		.7561		2,647
3	4,000		.6575		2,630
4	4,500		.5718		2,573
5	2,000		.4972		994
6	1,800		.4323		778
7	1,700		.3759		639
8	1,600		.3269		523
9	1,100		.2843		313
10	10,250		.2472		2,534
	NET PRESENT VALUE				$ 1,739

FIGURE 2

YEAR	CASH FLOW	x	DISCOUNT RATE @ 16%	=	PRESENT VALUE
0	-$14,500		-0-		-$14,500
1	3,000		.8621		2,586
2	3,500		.7432		2,601
3	4,000		.6407		2,563
4	4,500		.5523		2,485
5	2,000		.4761		952
6	1,800		.4104		739
7	1,700		.3538		602
8	1,600		.3050		488
9	1,100		.2630		289
10	10,250		.2267		2,324
	NET PRESENT VALUE				1,129

FIGURE 3

YEAR	CASH FLOW	x	DISCOUNT RATE @ 17%	=	PRESENT VALUE
0	-$14,500		-0-		-$14,500
1	3,000		.8547		2,564
2	3,500		.7305		2,557
3	4,000		.6244		2,497
4	4,500		.5337		2,401
5	2,000		.4561		912
6	1,800		.3898		702
7	1,700		.3332		566
8	1,600		.2848		456
9	1,100		.2434		268
10	10,250		.2080		2,132
	NET PRESENT VALUE				556

FIGURE 4

YEAR	CASH FLOW	x	DISCOUNT RATE @ 18%	=	PRESENT VALUE
0	-$14,500		-0-		-$14,500
1	3,000		.8475		2,542
2	3,500		.7182		2,514
3	4,000		.6086		2,435
4	4,500		.5158		2,321
5	2,000		.4371		874
6	1,800		.3704		667
7	1,700		.3139		534
8	1,600		.2660		426
9	1,100		.2255		248
10	10,250		.1911		1,958
	NET PRESENT VALUE				18

FIGURE 5

YEAR	CASH FLOW	x	DISCOUNT RATE @ 19%	=	PRESENT VALUE
0	-$14,500		-0-		-$14,500
1	3,000		.8403		2,521
2	3,500		.7062		2,472
3	4,000		.5934		2,374
4	4,500		.4987		2,244
5	2,000		.4190		838
6	1,800		.3521		634
7	1,700		.2959		503
8	1,600		.2487		398
9	1,100		.2090		230
10	10,250		.1756		1,800
	TOTAL SUM OF THE REVERSIONS				-487

By looking at the graph we can see the IRR is between 18% and 19%.

By Interpolation

$$18\% + \frac{99}{99 + 487} = 18.1689\%$$

The Internal Rate of Return can thus be rounded to 18.2%.

Problems

There is one major problem. That of multiple IRR's. When there is more than one negative cash flow there is more than one solution (roots). By calculus, it has been determined that the number of roots = to the number of negative numbers.(1)

(1)See "Monogram" By Charles Ackerson and "Roots of the IRR" unpublished work by Dr. Kogelman and Howard F. Jackson, Jr.

MODIFIED INTERNAL RATE OF RETURN

In the internal rate of return an assumption is that the "interest" is taken out each year. In this approach, it assumes that the "interest" is reinvested. It produces a slightly higher estimate of the internal rate of return. There are a number of schools of thought about which one is "correct."

This rate of return is also referred to as the Financial Management Rate of Return (FMRR) or the Modified Internal Rate of Return (MIRR). This expressly differs from the IRR in that it considers the reinvestment of annual cash inflows at market rates of return.

NET OPERATING INCOME

In analyzing income producing property one of the most important criterion is its net operating income. That is the income the property generates after the deduction of operating expenses. The value of property is based upon this.

Example:

Actual Income		$ 50,000
Less Operating Expenses		
Management	$ 2,000	
Real Estate Taxes	13,000	
Utilities	3,000	
Repairs & Maintenance	3,000	
Miscellaneous	3,000	
Total Operating Expenses		$ 22,000
Net Operating Income		$ 28,000

This net operating income is available to be used to pay debt service (mortgage payments) and provide a return on the equity investment. This is a critical factor in determining the value of income producing real estate. In the field, this also is referred to as "NOI", the "bottom line" or "net income."

Each property could have different income and expenses associated with it. For example, apartment houses pay most of the operating expenses such as heat, maintenance, real estate taxes etc. In other types of properties the landlord could receive a "net" rent and the tenant pays for all the operating expenses. There are some properties which fall into the middle. It is of paramount importance that a thorough analysis of all items be performed. This includes reading leases and investigating other similar types of properties in the area. The trend now is to have absolute "net" leases and let the tenant pay for all expenses such as utilities. This might not be possible for some properties because of legal restrictions or it may be unfeasible (no individual metering). Properties with these associated parameters bear potential problems because expenses could rise very rapidly (such as the energy problems in the 1970's) and the landlord could be left with negative cash flows.

SELLING PRICE PER UNIT

This unit of comparison is prevalent in properties such as apartment houses and motels. Two elements are required:

1) The selling price of the property
2) The number of units

$$\text{Selling Price Per Unit} = \frac{\text{Selling Price}}{\text{No. of Units}}$$

If a property sold for $1,000,000 and had 100 units the selling price per unit would be $10,000. After developing a range of $9,750 to $10,250 per unit, a number of units an investor might conclude that a price per unit of $10,000 is applicable and can be used to bid on a comparable property. Assuming the investor sees a property with 250 units, the bid price would be developed as follows:

Value = # of Units x Value Per Unit

Value = 250 x $10,000

Value = $2,500,000

DEBT SERVICE

Most real estate is bought with two types of money:

1) Your (buyers) money (equity)
2) the bank's money (mortgage)

In order to determine such things as affordability, value, etc., one of the factors that must be known is how much it will cost each year to pay off the mortgage. This is called debt service and is usually determined by negotiation with the bank. It is comprised of two factors

1. Mortgage Interest Ratio
2. Amortization - paying back the principal (loan)

There are financial tables available which provide these (factors) for any interest rate for any time period. In technical terms this factor will indicate the periodic installment payment (principal and interest) which will amortize (pay off) a debt in a determined period of time.

For a loan of $100,000 at a 10% interest rate (annual payments) over a 15 year period, the payment factor would be .131474. This is also referred to as a "mortgage constant". It is utilized in developing a capitalization rate. If the mortgage was a "variable rate" type the mortgage constant would be much more difficult to compute. See chapter on "The Development of a Mortgage Constant Utilizing a Variable Rate Mortgage".

The annual debt service would be computed as follows:

Mortgage		Mortgage Constant Payment Factor 10% Interest/15 Years	Annual Debt Service
100,000	x	.131474	$13,147.40

The debt service over 15 years will be equal to $197,211.00. This area of mortgages can become highly complex. By changing time periods, interest rates and frequency of payments the annual debt service could change. Separate books are available

on this subject. Its impact on real estate and its values is considerable.

By looking at the Financial Calculator Keystrokes in the Addenda, you can use your financial calculator to determine a mortage payment for any number of years and for any interest rate. By plugging in various combinations, you can see the difference in payments. By shortening the term of the mortgage, you can actually reduce the amount of interest paid.

CASH ON CASH RETURN ON EQUITY

In lay terms, this is how much you make on your equity investment each year.

Assume the following:

Equity Investment	$10,000
Net Operating Income	$15,000
Annual Debt Service	$13,000

The cash on cash return would be computed as follows:

Net Operating Income	$15,000
Less Debt Service	$13,000
Return on Equity	$ 2,000

$$\text{Cash on Cash Return} = \frac{\text{Return on Equity}}{\text{Equity Investment}}$$

$$20\% = \frac{\$2,000}{\$10,000}$$

Another term for this is called the EQUITY DIVIDEND RATE.

LOAN TO VALUE RATIO

An L. to V.R. is used to measure the amount of money a bank will loan on a particular transaction. It is a ratio of a property's value to the amount a bank will lend based upon a percentage of value.

Assume a bank's lending policy is a 70% loan to value ratio. If a property has been appraised for $100,000, than, the bank's maximum loan for that particular property will be $70,000.

Appraised Value		Loan To Value Ratio		Maximum Loan a Bank Can Make
$100,000	x	70%	=	$ 70,000

With Private Mortgage Insurance (PMI) you can actually borrow up to 95% of the property's value, however, there is an insurance charge built into each payment.

DISCOUNTED CASH FLOW ANALYSIS

The most widely utilized and readily accepted valuation procedure for income producing real estate has been direct capitalization of a stabilized net operating income. Capitalization is defined as "the process of converting into present value, or obtaining the present worth of, a series of anticipated future periodic installments of net income."

Direct capitalization employs an overall rate derived from market sales. The periodic installments are comprised of a series of cash distributions, or net income, for a specified holding period. In leveraged transactions, a third component, that of debt reduction, may also contribute to property value.

Discounted Cash Flow Analysis incorporates a year by year projection of income and expenses, a risk rate, and the projected holding period most appropriate for highest yield on the investment. This method is applicable to income streams that do not follow a regular pattern, with intermittent installments treated as a separate reversion and individually discounted. It can also be applied on a before tax or after tax basis, to accommodate individual investment criteria (investment value). The discounting process recognizes time preference, liquidity, uncertainty and risk, utilizing a rate that will attract purchase capital to similar investments.

Selection of a Discount Rate

All investments - real estate or other - are in competition with alternative forms of investment, such as government or industrial bonds, certificates of deposit, stocks and other securities. They are all available at varying rates of return depending upon the holding period and degree of risk involved. The rate of return acceptable on real estate investments incorporate consideration of risk and the term on the investment, but also considers area trends, tenant profile, burden of management, degree of liquidity, and other factors. Income or Cash Flow is analyzed in terms of quantity, quality and duration, and the selected discount rate reflects the extent to which these factors are present in the given investment.

As a long-term investment vehicle, real estate investments may be compared with alternative investments in the marketplace. Real estate investments are typically considered to be at

greater risk than relatively "risk free" investments such as government securities, however, real estate investments provide an opportunity to shelter income through depreciation or interest deduction. Long-term leases and/or highly rated tenants tend to increase the security of the investment and support a lower discount rate. On the other hand, properties which feel the immediate effects of recessionary economy, will command a higher discount rate of return to compensate for the additional risk.

A future capitalization rate of 13.00% was selected for the subject analysis, reflecting the location and physical characteristics of the subject property, and the prospects for future growth.

When selecting an appropriate discount (yield) rate, the investment criteria and risk associated with such an undertaking were taken into consideration. An analysis of several alternative investments were undertaken. Triple A tax free bonds were analyzed. Presently, typical bond yields range from 9% to 10%. To this rate was added 1% for burden of management, 1.00% for lack of liquidity, 1% for location facilities, and 2% for inflation, cost of capital, and miscellaneous. Based upon the preceding, a developed rate of 14.00% to 15.00% was indicated, with the appraisers selecting a discount rate of 15.00%.

CASH FLOW ANALYSIS

A ten (10) year present value cash flow analysis has been prepared. The cash flow model was prepared on the assumption the property unencumbered basis, (free and clear of any underlying or proposed financing). This method of analysis is in conformance with Federal Home Loan Bank Board Regulation 41C and is considered the most appropriate method in estimating the subject's Market Value. It also assumes prudent management.

For the Cash Flow Analysis example, the following assumptions were maintained:

* Rental income based upon current market rentals and projected rental increases as of January 1, 1985.

* Income growth rate assumed to be 5% in years 1 to 10.

The present value cash flows depict the income and expenses as increasing each year. The first chart indicates the actual dollar amounts by year and classification. The second chart depicts the rate of increase by year expressed as a percentage. The vacancy rate was projected at 10% in all years. A projected eleventh (11) year net income estimate of $223,771 was indicated.

The Gross Annual Income projection was based on an annual rate of increase of 5% in years 1 thru 10. Subject's projected operating expenses were based on annual expense increases ranging from 5% to 7% per annum. All projections were based on market derived findings and/or historical trending patterns.

The selection of an appropriate discount and terminal capitalization rate considered such factors as: cost of capital, risk, burden of management, risk perception, lack of liquidity, price/earnings decisions, and inflation. A 13% terminal capitalization rate and a 15.00% discount rate is reasonable, and falls in the general range of alternate types of investments.

Based on the foregoing, the following investment model resulted in a present value of $3,423,855 and a future residual value forecast of $4,770,998. Following is the discounted cash flow analysis.

Note: This technique is covered in more detail and in conjunction with three other approaches to value as used in an actual appraisal report. See EXHIBITS AND FORMS.

The cash flow for each year is being discounted at the appropriate Present Value Discount Factor of 12%.

YEAR	AFTER DS* CASH FLOW REVERSION	PRESENT DISCOUNT FACTOR @ 12%	PRESENT VALUE
1	$ 93,962	.892857	$ 83,895
2	104,063	.797194	82,958
3	114,751	.711780	81,677
4	131,007	.635518	83,257
5	148,276	.567427	84,136
6	168,978	.506631	85,609
7**	1,109,716	.452349	501,979
			$1,003,512

*DS is debt service or mortgage payment. DS money received in the future is worth less than money received today.

**The net property reversion is added to year 7's income.

HIGHEST AND BEST USE

This is a key term in the analysis of any parcel of real estate whether it be vacant land or a high rise office building. It exemplifies the concept of change, which is continuously operating within the real estate market. In determining the highest and best use for a particular piece of property, the current use of the property may not necessarily be the most profitable use. Society of Real Estate Appraisers and The American Institute of Real Estate Appraisers is as follows:

Highest and Best Use is frequently defined as the reasonable and probable use of the property that would support the highest present value. Stated another way, highest and best use is the most profitable use of the property in its current state or as renovated. This use should persis until it is more profitable to charge it and construct something new.

The highest and best use is usually found for the site as vacant and for the site in its present condition. For example, a highest and best use study may show that a large estate with deteriorated mansion could, in fact, be demolished and the property subdivides for the purpose of constructing 10 new sites with newly constructed homes. If a value was placed on the property, based upon its present use, it would be an erroneous reflection of Highest and Best Use.

Zoning ordinances must be reviewed as various restrictions may limite the probable land use. In certain cases where zoning may permit 10 or more uses, it is sometimes necessary to perform a highest and best use analysis on each possible condition.

Although highest and best use does not directly give the investor a direct rule of thumb it provides for general direction of property value growth (or decline), possible change of use and stability of value.

NET PAYBACK PERIOD

This is the amount of time it takes an investor to recover the amount of equity investment in a parcel of real estate.

For example:

Equity Investment:	$10,000
Property's Annual Cash Flow To Equity (After Paying Mortgage):	$ 2,500

The net payback period is equal to the Equity Investment/Cash Flow to Equity or in this case 4 years.

$$NPP = \frac{EI}{CF \text{ to } E} = \frac{10,000}{2,500} = 4$$

CASH EQUIVALENCY

Cash equivalency is the process of adjusting to normal financing conditions, a sale that has favorable (Atypical) financing.

Market data and comparable sales are the essential ingredients in the Direct Sales Approach. Sales are then adjusted for a given property to reflect any differences. Sometimes, actual sales may appear "normal on the surface", yet there may be a deviation from normal in connection with mortgage interest rates and terms that are not representative of the market. The mortgage terms and rates for conventional financing should be determined at the time of sale and the availability of these mortgages should be established. All sales should be weighed against standards to determine if the financing is within market parameters.

Market financing is generally represented by a new first mortgage obtained through a bank, savings and loan or insurance company. Favorable financing could include purchase money mortgages, deferred payments, 2nd mortgages, mortgage assumptions, wraparound mortgages, etc.

The function of the adjustment for cash equivalency is to permit an adjustment of the sale price which may have been inflated as a result of favorable financing. The adjustment to the sale price is the present value of the difference between the financing obtained at the time of sale and current market mortgage rates.

Assume the following:

Sale Price:	$3,000,000
Assumed Mortgage:	$2,000,000 @ 9% interest, 25 years,
Down Payment:	$1,000,000
Mortgage Constant:	@ 9% - .100704 @ 12% - .126387 (This is market rate for mortgage)
Cash Equivalency:	.100704/.126387 = .796791

	.796791 x $2,000,000 =	$1,593,582
Add Down Payment:		+1,000,000
Cash Equivalent Value:		$2,593,582
Rounded To:		$2,600,000

An Alternative Solution

Sale Price:	$3,000,000	
Assumed Mortgage:	$2,000,000 @ 9% interest, 25 years,	
Down Payment:	$1,000,000	
Mortgage Constant @ 9%:	.100704	
Annual Debt Service:	$2,000,000 x .100704 = $	201,408
Mortgage Constant @ 12% (Market Rate):	.126387	
Mortgage Value @ 12%:	$201,408/.126387 =	$1,593,582
Add Down Payment:		+1,000,000
*Cash Equivalent Sale Price:		$2,593,582
Rounded To:		$2,600,000

The financing in effect at the time of sale must be weighed against the current market financing rates.

THE REAL ESTATE APPRAISAL?

ECONOMIC CONSIDERATIONS

A real estate appraisal is a logical, defendable estimate of value prepared by a designated real estate appraiser. The report is reduced to writing and is supplemented by appropriate documentation and exhibits. Following are various sections which lead the reader through the appraisal process. There are economic occurrences which have an influence or impact on real estate, albeit indirectly.

We live in a free market economy whereby each one acting in our own self-interest, will ultimately cause the need and desires of society to be fulfilled efficiently. The basic questions of what to produce, how to produce, and for whom to produce are answered. Price is the message to both producer and consumer, which ultimately correlates this.

This sounds like an ideal environment, however, there is a major influence - government. Here are three examples:

1. Energy Prices - In the 1960's and early 1970's gasoline was 20 to 30 cents per gallon, while in Europe, it was $1.50 to $2.25. Much of the U.S. economy developed around a false sense of energy prices. The oil embargo in the 1970's produced major economic and political problems. This situation was greatly exaserbated by price controls in 1978 by President Nixon and later by President Ford. In 1979, President Carter started phasing out controls.

2. Rent Control - During WWII price controls were on everything. After the war they were lifted but New York City retained them on apartments. As landlord's expenses were free to rise while income increases were constrained the profitability was reduced. To maintain that profitability, short cuts were taken, repairs deferred, etc. Upper income tenants moved out and supporting retail merchants also moved out. They were replaced by lower income tenants and merchants. This cycle continued downward until the neighborhood became blighted.

3. Usury Laws - In New York there were (still in place) usury laws in place in the 1960's and 1970's. Outside

of New York where developing states paid higher interest rates. The banks loaned New York deposits to these states. This allowed the states to develop, prosper. These states then lured New York based corporations and firms to them.

As can be seen when governments steps into the free market system ostensibly to do good, that action seems to ultimately result in negative results to the people it was intending to help. This section could be greatly expanded upon with additional economic technical expertise and graphs. This would be well beyond the scope of this book.

Ideally, government's role should be to:

1. Defend the County
2. Provide law and order
3. Provide stable currency and a very strong banking system
4. Help promote free trade internationally
5. Provide environment for a strong, free market economy.
6. Be a lender of last resort

Government can use fiscal and monetary policy to do this. To the non-economist indicators such as interest rates, tax rates, balanced budgets, balance of payments, unemployment rates, inflation rates and gross national product are factors which measure economic performance. They can also impact real estate values.

Mortage rates (high or low), people's desires and ability to pay for them and inflations rates are three identifiable economic indicators directly impacting real estate values.

Note that these relationships do exist. By following the financial news, many investors can let other experts synthesize and analyze the financial news for them.

1. The Fedwatcher
2. Business Week
3. The Wall Street Journal
4. The Federal Reserve System Publication
5. Fortune

FACTORS THAT CONTRIBUTE TO THE VALUE OF REAL ESTATE

It has value because people need it to live and work on, play on, commute to it and for other purposes. Quoted by many real estate organizations "Under all, is the land." Land is also in supply.

There are factors that can affect value:

1. Social - Community services, schools, shopping, recreational facilities, presence or absence of crime, presence or absence of letter are some of the factors under this category.

2. Economic - The type and mixtures of employment, income levels, age levels, interest rates, inflation rates are factors included in this area.

3. Political - The taxes and assessment on property in area plus the zoning are factors under this category.

4. Environmental - Items such as water, garbage, energy, transportation and pollution fall into this area.

There are also major principles that affect value. They are:

These are defined briefly as follows:

1. Supply and Demand - If there is a low supply and high demand the price will rise. Should the reverse be true the price will fall.

2. Change - There are many forces always at work. They are legal, social, economic and political. The interaction of these forces cause changes in all aspects of our lives however it may be imperceptible at first.

3. Anticipation - People purchase real estate not on what the real estate will produce for them in the future but what they anticipate it will produce for them in the future.

4. Balance - Value of real estate is affected by the environment in which it exists. There are other economic forces operating. When there is stable value yo will usually find the forces in balance. This means that competing land uses function

together harmoniously. For example, in a good residential area you will also find a balance of shopping, schools, transportation, central business, etc.

5. Competition - This is connected with supply and demand. It means that two or more entities are actively seeking to use items in short supply.

6. Substitution - If two or more products are available with similar utility the one that is the cheapest will be used.

7. Conformity - A property has a relationship with surrounding properties. This is important because real estate is immovable.

8. Contribution - This applies to the theory of how much does a particular component of a piece of real estate contribute to its value such as a two car garage on a one family house.

9. Highest & Best Use - It is that legal, reasonable, probable physically possible and financially feasible use supporting the highest present defined value as of the date of valuation. It considers that use from reasonably legal, probable and financially feasible which support the highest land value. (See Real Estate Appraisal Terminology).

VALUE

A real estate appraisal is a quasi-scientific process by which valuation techniques are applied to input data to determine the Market Value of a parcel of real estate. There are various techniques that could be used depending upon and the type of value being sought. Value is the present worth of anticipated future benefits. Anticipated or perceived benefits often hold more influence than actual benefits.

A valuation analysis is usually reduced to writing and is called an appraisal report. A logical explanation of how this valuation was arrived at, is presented. All the supporting and periphal data are usually included. This would depend upon the scope of the assignment.

The appraisal report is also subject to a strict code of ethics which are enforced by the real estate appraisal organizations. Some of the highlights are:

1) Certification that the appraiser has no interest, present or prospective, in the results of the real estate appraisal.
2) The appraiser has the educational qualifications and experience to professionally handle the assignment.
3) The value is not based upon a contingency.
4) The property has been personally inspected by the appraiser.
5) All substantial facts have been disclosed and no material fact affecting value has been omitted.

The profession of real estate appraising incorporates various facets of other disciplines. Some of these are: mathematics, marketing, law, psychology, accounting, and engineering. Not only must the practitioner have an understanding of these disciplines, but he must also be aware of their interrelationships. The fundamental reason for this is that the value of real estate is a result of the interactions within the real estate market. There are many forces in this market that must be analyzed. All of these forces, in some way, influence the value of real estate.

THE APPRAISAL PROCESS

The appraisal process could be described as follows:

1. Define problem, interests being appraised and value defined. Issues such as the date of appraisal would be resolved here.

2. Gather data and inspect property. In this section the regional, neighborhood and area would be described in economic terms relating to the property. The property would be thoroughly described and analyzed for later use in the report. Comparable data would also be gathered, inspected and analyzed.

3. Analyze neighborhood and area. Define Highest & Best Use of the property.

4. Perform the three approaches to value - Cost Approach, Direct Sales Approach and Income Approach.

   a. Cost Approach - A replacement cost new of the property is developed using materials of similar quality and utility. All forms of depreciation (if any) are deducted. They are physical (wear and tear), functional (layout), or economic (loss in value from sources outside the property). After depreciation is deducted, the land value is then added to the net result. This gives a value estimate using a brick and mortar approach.

   b. Direct Sales Approach - Transactions of similar properties are gathered and analyzed for the purpose of developing a value estimate. The transactions (comparable sales) are then adjusted to the subject property to reflect any differences. Such differences could be size, utility, quality of construction, financing terms, etc. This approach could be a very reliable indication of value provided there is a sufficient quality and quantity of data.

   c. Income Approach - In situations where the property under appraisal produces income, this technique usually gives a reliable value indication. It considers present and future cash flows, mortgage interest rates, and equity returns. The information necessary to perform this approach is usually directly and readily available from the market. Some of the

techniques that would be used here would be: Direct Capitalization, Mortgage Equity, Band of Investment, and Discounted Cash Flow Analysis.

5. Correlate the three approaches and develop a final value estimate. This is the point where the appraiser looks at the value indications which were developed by the three approaches to value. Based upon what the property is will determine which approach will produce the most reliable indication.

6. Write the report. A full narrative (form report where appropriate) should be written conforming to all ethical guidelines of the appraisal organization. No material fact affecting valuation should be omitted.

This gives the reader a brief insight into what an appraiser goes through. Had this section been written for appraisers, it could have easily taken many more pages. You are referred to the addenda for an actual example of The Direct Sales Approach, Cost Approach and Income Approach to value along with a correlation of these value indications and a final conclusion of Market Value. This presentation is informative, detailed, technical, insightful and lengthy. It is highly recommended reading AFTER reading the rest of the book. By going over that section the reader will see how appraisers put it all together.

THE REAL ESTATE APPRAISER

In order to become a real estate appraiser, the following requisites must be satisfied.

1. Education: An undergraduate degree, successful completion of required appraisal courses with written demonstration reports. Post graduate continuing education is required to maintain status as an appraiser otherwise the designation will be revoked.

2. Experience: In order to become a designated appraiser in a real estate appraisal organization, the candidate must meet certain professional standards relating to actual working experience. The appraiser in training must work under the supervision of a designated appraiser for a minimum of 5 years in order to gain the experience and knowledge of the appraisal process.

3. Reputation: The appraiser must uphold a good reputation within the community.

4. Membership in The Organizations: After having completed all of the above requirements, an appraiser will be awaded a designation and memebership granted. There are two types of designations; one just for residential and one for all kinds of property.

5. Code of Ethics: The appraisal organizations will send out a copy of the code of ethics upon written request.

6. Recertification: Designated appraisers must be recertified every 5 years. The designation is not awarded for life. This is done by attending classes, teaching and authoring real estate works.

NON-DESIGNATED APPRAISERS

In an article published in The Wall Street Journal in July of 1985, author Kathleen Sullivan indicates that there are some 250,000± appraisers throughout the United States, of which only 4,000 or so are designated members. As a result, the majority of persons performing appraisals are doing so with inadequate educational background and experience. Particularly guilty of such practices are those group of persons who regularly offer to do "free appraisals." Most often, free appraisals turn out to be an incomplete attempt at the beginning of a market analysis.

There are ulterior motives behind the "free appraisals." The "free appraisals" aren't free at all but are performed as a vehicle through which a listing for the sale of the property may be obtained.

This is considered unethical practice in the real estate appraisal field as there are obviously undisclosed conflicts of interests.

It may be assumed that persons performing appraisals without proper designation are doing so with inadequate experience, education, professionalism, and ethics.

WHEN DO YOU NEED A REAL ESTATE APPRAISAL?

There are many situations where a real estate appraisal is required. Here is a brief list of some of the more common areas in which an appraisal is utilized.

1. Buying or selling property
2. Tax assessment proceedings
3. Establishing for IRS the basis for component depreciation, estate taxes, etc.
4. Insurance purposes
5. Market analysis
6. Establishing damages after a public taking (just compensation)
7. Zoning changes
8. Valuation of corporate assets

9. Investment analysis

10. Equitable distribution

11. Mortgage financing

12. Tax syndication

13. To settle disputes between parties

14. To determine a rental payment

15. Leveraged buyouts

16. Stock portfolio analysis

WHERE TO FIND A REAL ESTATE APPRAISER

A. Request a list of real estate appraisers from the local chapter of one of the real estate appraisal organizations or write to the national headquarters and request a membership directory.

B. Consult your attorney for a referral. Attorneys involved in real estate transactions have liasons with real estate appraisers.

C. Inquire at banks which are actively making real estate loans. They will have data on the designated real estate appraisers they do business with regularly.

D. Consult the "yellow pages" or commmercial directory under Real Estate Appraisers.

Taking these steps, one could be reasonably assured of contacting a qualified professional appraiser. Once a list of qualified appraisers has been assembled, it is suggested that additional steps be undertaken to further qualify the appraiser for the assignment being undertaken, as some assignments require the use of a specialist.

ENGAGING THE RIGHT APPRAISER FOR THE JOB

First, establish the scope and requirements of the appraisal assignment. It is then necessary to establish the appraiser's qualifications, background, and interests to determine if he is

suitable for the job. The client should request a copy of the appraiser's qualifications and some references.

The appraiser should also be a designated member of at least one of the following organizations:

*American Society of Appraisers
*American Society of Real Estate Counselors
*Society of Real Estate Appraisers
*American Institute of Real Estate Appraisers
*National Association of Review Appraisers and Mortgage Underwriters
*National Association of Independent Fee Appraisers
*National Association of Real Estate Appraisers 1. Determine if the appraiser has an "interest" of any kind in the property being appraised. This doesn't suggest that the appraisal would be rendered invalid, but circumstances could arise where an appraiser's interest in the property could have negative ramifications. The most obvious is bias. For example, assume you are the executor of an estate consisting of a one family house. You get an appraisal from someone who also happens to sell houses in the area and that person is also competing for the listing. It is advisable to scrutinize this situation carefully. This could constitute a conflict of interest.

2. Discuss time frame and logistics of appraisal.

3. Discussion of the appraiser's fee. This is left up to each appraiser and client. Bare in mind that the lowest fee is not always the best situation because you are paying for expertise and experience which may be difficult to assess from appraiser to appraiser. Also, a good part of the fee is made up of the "details" actually contained in the report. Many times, a well prepared and documented appraisal can be the end of the matter. This is especially true in mortgage and adversary proceeding situations. Each case is technically different and no advice to the resolution of this situation could be given except to say that ultimately, the client must weight the facts of the case and make the decision he deems appropriate.

4. The client should clearly communicate all pertinent information and circumstances which may affect the outcome of the appraisal report. For example, a client may need to know the value of a piece of real estate under particular circumstances. It is important that there be a mutual understanding and a meeting of the minds between client and appraiser.

This can eliminate a potentially embarassing situation where a client or appraiser might say "I didn't know you meant that . . . etc."

5. The appraiser must have the ability to communicate his findings effectively. The appraisal could be worthless if the appraiser could not effectively communicate the findings to a third party which is especially important in adversary proceedings.

The appraiser's creativity could be a critical factor in a changing market. Traditional valuation techniques may have to be refined to account for conditions not considered within a traditional approach.

WHAT TO EXPECT WHEN DEALING WITH REAL ESTATE PROFESSIONALS

The scope of this chapter is not to provide basic insight into all aspects of real property but rather to carefully describe and analyze the players involved. More often than not you will find yourself interacting with one or more of these people when dealing with real estate. Following will be a careful description of the people involved with real estate along with their basic operating philosophies. Knowing this will enhance your possibilities of success when dealing with them.

The Players In The Real Estate Marketplace

Operating within the real estate market can be complicated, possibly dangerous, for the novice as well as the regular operator. That's why there are these professionals involved in various aspects which permit orderly and secure transactions. Many of these players have nothing to do with the financial success of a transaction. They only insure a legal and orderly transaction according to the specifications of the people involved within the transaction.

Here are a list of the players in real estate that will be covered:

1. Buyer
2. Seller
3. Investor
4. Attorney
5. Title Company
6. Bank
7. Broker - Realtor
8. Appraiser
9. County Clerk
10. Building Inspector
11. Assessor
12. Engineer
13. Architect
14. Contractor
15. Developer
16. Planner
17. Insurance Agent
18. Landlord
19. Tenant
20. Property Management

BUYER

This is one of the basic players in the game. The motivations for the buyer could vary. In terms of dealing with housing, there are some things common to most.

First-time home buyers are looking for affordable housing, in a good school district and, most importantly, low monthly mortgage payments and carrying costs.

In a very active market there are usually many more buyers than sellers. This results in prices rising and the terms being very favorably biased towards the seller. This is called a "seller's market".

In a slow market, the reverse is true. Buyers can usually cut very good deals with the sellers. This means better prices for the buyers and better terms. This is called a "buyer's market."

Buyers of homes are usually concerned with value in use as a primary motivation. Secondarily, they are concerned with the property as an investment. Although, it usually provides an excellent vehicle for capital appreciation.

On the other hand, buyers of property other than single family homes for their own use have different motivations. This will be discussed in a section called "Investor."

SELLER

The seller is the other major player in the market. Talking about a seller from the point of view of single family housing there are generally two types. One is trying to move up to a larger house while the other is looking to downsize their house or possibly move to a retirement community.

Many times sellers are playing dual roles simultaneously since they may be buying another property to move to. Their needs usually are more acute since they are performing a balancing act. In this type of situation negotiations could become more delicate since timing is of prime importance. This leaves this type of person in a much more financially vulnerable position and, as a result, possibly a much weaker bargaining position. This is known as a "motivated" seller. One of the first places to look for a bargain is by looking for a "motivated" seller.

All sellers are motivated by some factor. Carefully exploring the motivations behind a sale can sometimes enhance a negotiating position. After sales have been made discovering what the seller's motivation was can give clear insight into the market.

INVESTOR

The investor could be both a buyer or a seller. The motivations for an investor could be:

1. A good cash-on-cash return on investment
2. Property appreciation
5. Liquidate property to minimize losses
3. Tax shelter benefits
4. Possible use of the property

Other types of investors look for slow markets, changing markets or sellers who are in financial distress. In this way they can acquire property at below market value and at good terms. The property can then be held, possibly rehabilitated and then sold at a high profit margin with tax shelter benefits as well.

There are numerous types of financial scenarios that investors could get involved with. A few of the most prevalent are

1. Purchasing an income producing property with a positive cash flow that is expected to increase over time. This could also mean that the value of the property will rise as well, thus the investor's equity will grow.

2. Buying a "handyman special" at below market value, rehabilitating it and then selling it at a profit. This requires physical work on the part of the investor but, in a good neighborhood, the returns are usually good. (See Section - Tips on Home Buying, Selling and Investing).

3. Buying a two family home, living in one of the units and renting the other. The rent would amortize much of the mortgage payment. This is an excellent way to live almost rent free and at the same time enjoy capital appreciation and tax shelter benefits.

4. Purchasing a contract to buy a condominium at the "insider" price or slightly above it. Renting it for a few years and then selling it at a very high profit. This is a good investment in terms of capital appreciation at this time.

5. Buying a good property but with a short term negative cash flow. The investor can currently take these losses and transfer them to other types of earned income, thus sheltering it from taxes. The new tax laws might limit these deductions. The property's income will rise over time thus generating cash returns each year. This scenario is not good for all investors. It presumes a large increase in value. As such the investors, competing for this property, have bid down the initial returns. (Paying more for the same initial cash flow.)

6. Buying a home, living in it for a while, refinancing it and taking that new equity and investing it into more property. Many successful investors have had their beginning in real estate investing using this method. This is something that most all homeowners could easily start with.

7. Buying a parcel of vacant land and then developing it.

There are other types of properties investors could get involved with but these represent the general types.

Investors could also go into an area and purchase a group of properties. (This is called assembly). Demolish all the structures and build a large high-rise building.

As the economy continues to grow and change there will be new and unique properties being built and developed but, for the most part, the basic underlying principles will apply.

ATTORNEY

In a highly complex world of finance, economics, law and real estate, there are interests that have to be protected and certain formalities executed so that real estate transactions can be processed.

The role of the attorney is to prepare the legal documents and advise clients as to how to protect their interests in these areas. However, an attorney is representing a particular client such as a buyer, seller, bank, etc. The attorney has the obligation to protect that client's rights, not necessarily to "make the deal." This could cause frustration for some.

Many people experience a high degree of frustration when dealing with attorneys. While the feelings of frustration may be justifiable in certain cases, a lawyer who specializes in real property can usually facilitate a smooth transaction. Often, a consultation with one before signing an agreement can prevent future problems.

TITLE COMPANY

Ownership of land is something that is not obvious or apparent to the naked eye. Real property ownership is usually evidenced by a duly executed deed filed and recorded in the County Hall of Records.

There are possible complications such as, does the person who sold the property really own it? Title companies are in the business of researching titles and then guaranteeing them to the buyer or bank for a fee. If there is a problem with the title, the title insurance company will pay for it. This is called title insurance.

When buying real property, it is highly recommended that title insurance always be purchased. It is not possible to obtain third party financing, in most cases, without title insurance. There have been many cases where purchasers acquire a property only to discover that they don't in fact own it. Since they didn't purchase title insurance they lost all their money.

BANK

Most people can't afford to buy a house for cash. Investors want to use as little of their own cash as possible. These are two primary motivations why banks make mortgage loans.

From the bank's viewpoint, the property has been appraised and their loan percentage to value can vary greatly. Banks have very strict federal regulations and operating policies that they must adhere to. Should loan applications not fall into their guidelines, they reject it.

The banks are a major player. They have the money. Without them, most transactions couldn't occur.

BROKER (REALTOR TM)

A broker is one who is in the business of making sales and finding sources of mortgage money for buyers. In real estate, the broker can be the primary point of contact in a buyer's first involvement with real estate. The broker could also be a source of general information.

The broker is usually engaged by the seller (in the form of a listing) to sell a piece of property. The broker then acts as the seller's agent in dealing with prospective buyers. This is called an agency. There are generally three types of listings.

1. Open: Where any broker who sells the property earns the commission.
2. Exclusive Agency: Where only one broker is given the right to sell and earn a commission but the owner retains the right to sell the property.
3. Exclusive Right to Sell: This is the same as #2 except that if the owner sells the property, the listing broker still receives a commission.

In many states, the broker is required to explain in writing the differences before signing the listing agreement.

The first function of the broker generally is that of an agent of the seller. The role of the broker when dealing with a buyer can often be expanded to that of someone who can help find sources of financing, information, and can assist in other aspects of the transaction.

Many people often misunderstand the role of the real estate broker and often feel that their services are unnecessary. The broker usually can save people a lot of time and, as an experienced negotiator, money by being able to get the seller a good price at the terms the buyer can handle.

APPRAISER

The appraiser could play a number of roles for a number of purposes. See section "What is an Appraisal".

The appraiser is going to estimate market value using generally accepted appraisal techniques. Market value could be defined as the most probable selling price that a willing buyer, not forced to buy, would pay to a willing seller, not forced to sell, with both parties being fully informed and with neither party acting under duress.*

As far as banks are concerned, they are usually going to make a loan on the property based upon a certain percentage of the Contract Price or Appraised Value, whichever of the two is lower.

The appraiser has to provide a written, fully documented, logical and defendable estimate of value which is in accordance with standards set by appraisal organizations.

When using an appraiser, it should be established whether or not the appraiser is designated. See Chapter "What Is An Appraisal".

(*)See Appraisal Terminology Handbook jointly published by the Society of Real Estate Appraisers and the American Institute of Real Estate Appraisers, also see Bibliography.

COUNTY CLERK

Title of real property is evidenced by the deed. These deeds are recorded in the County Clerk's Office.

Other records such as mortgages, bonds, leases, judgements are also recorded in this office. This could be the primary source of information about what is going on in the local real estate market and about a particular parcel of property. A good investor knows how to get at this information and also how to interpret it. One way for the beginner to learn is to go to the County Clerk's Office, locate someone who works for a title company and ask that person how the deed recording system works. Another way is to ask a representative of the County Clerk's Office for help.

In real estate law, many documents are not fully valid and enforceable unless duly recorded. The exact syntax of these requirements vary from state to state.

BUILDING INSPECTOR

There are a number of laws which govern the use of real property. The major ones are called zoning ordinances (police power) which not only restrict the use of property, but also govern what materials can be used to construct the improvements on the property (building codes).

The building inspector, usually working out of the building department, is charged with the enforcement of these regulations. The inspector is most noticed when there are improvements made to existing property or when there is new construction.

Most problems usually occur because of incorrect materials being used for construction and excessive construction. This type of problem is evidenced by not being able to obtain a Certificate of Occupancy or completion. When dealing with a contractor for building or renovation of property, it is highly recommended that the contractor be responsible for obtaining the Certificate of Occupancy.

ASSESSOR

One of the inherent rights of government is the power of taxation. Real property is taxed but differently than ordinary income.

A value is placed on the property by an assessor. The value is generally called assessed value. It may not be the same as market value (the value found by appraisers) although it may theoretically relate to market value. The assessor generally uses "mass appraisal" techniques. The results, if done correctly, should initially produce uniform assessments.

Most people tend only to notice assessments when taxes begin to rise. The only way to lower taxes is to either reduce the assessment or have the government reduce its budget. The latter can be a long political process. The former can be done by instituting what is called a "writ of certiorari". You will usually need two professionals, an appraiser, and an attorney for there are a number of formalitiess that must be complied with. See Chapter "How To Determine If Real Property Is Over-Assessed".

ENGINEER

An engineer can be of many types such as mechanical, electrical, aerospace. Concerning real estate, most people come in contact with an engineer when they want to have a report to determine the construction and the soundness of a particular building or the physical attributes of a tract of land.

This is often a good idea when purchasing an older building for it will point out any serious defects and can also give some peace of mind to the prospective buyer.

The engineer that performs this service is usually a member of an organization and has the initials PE after the name. Some states have licensing laws that affect the regulation of engineers.

ARCHITECT

When new construction is planned or an addition is contemplated, plans and specifications have to be drawn. The role of an architect is to prepare the renderings, plans and specifications so that they can be submitted to the building department for consideration. In new construction this could be a highly creative process since new market conditions, energy and financial efficiency are critical elements in building.

The architect is usually a member of a professional organization. The major organization is the American Institute of Architects.

CONTRACTOR

Constructing a building on a piece of real estate can be a very complex, labor intensive undertaking. A contractor is one who is in the business of constructing a building from start to finish including the obtaining of all necessary plans, specifications, permits and the final certificate of completion.

You should deal only with a highly reputable contractor who is licensed and has a list of references. The entire agreement, including the completion schedule, should be reduced to writing and reviewed by counsel before signing. This will help reduce many problems that might occur in the future.

DEVELOPER

A developer is a type of investor that converts vacant land into some kind of improved property. This investor could also take improved property and alter it to some other use. This person generally can also be a contractor/builder and could also have a very good understanding of investment analysis.

In a sense, a developer is a combination of a speculator, investor, seller, buyer, and contractor. This person is usually one who is on the leading edge of the market in terms of new building and new ideas.

Property development can be very profitable but also can be extremely hazardous. The first time investor is cautioned against developing property as a first time venture into real estate except under very stringent conditions. One exception would be building a new home in a good area with the help of a good contractor, achitect, appraiser, and attorney. Another exception would be to co-venture a project with a good developer.

PLANNER

Land is regulated with respect to its use via zoning ordinances. Real property can't exist in a vacuum. It is functionally and economically dependent upon other properties, some even being remotely located.

Communities have needs such as schools, churches, central business districts, residential, industrial, etc. To be successful these needs must be satisfied in an orderly manner. Planners are a group of people who are involved with the design and implementation of a master plan of the community from which the zoning laws evolve.

Most novices in real estate are unaware of this professional. A good understanding of the planning concepts of a community can yield pertinent information as to how future property values will behave.

INSURANCE AGENT

Real property can sustain losses. Some examples might be fire, flood, theft, etc. People may become injured while on a property by tripping on the sidewalk. The owner of the property is responsible financially for these losses.

Insurance agents act as an intermediary between the owner/tenant of real property and the insurance company for the express purpose of obtaining appropriate insurance coverage. Usually these agents possess sufficient knowledge to procure property coverage for a good and fair price. In the more complicated forms of realty ownership, asking a few insurance agents for coverage quotations would be advisable. The requests and subsequent quotations should be in writing to avoid any misunderstanding should a subsequent loss occur.

LANDLORD

When an acquisition of income producing property is made, a number of benefits flow to the owner. One of these is the ability to let someone else use some or all of the property for a fee. This arrangement is called a lease which specifies the terms and conditions. The owner who leases the property is called the landlord or lessor.

There are many rules and regulations that govern this relationship. They vary from state to state.

TENANT

Someone can acquire the right to use part or all of a property from an owner. This arrangement is called a lease. The person who is using the owner's property is called a tenant or lessee.

A tenant could lease a number of interests of real property from a landlord. Some of these items are:

1. An apartment within a building
2. A store or office
3. An entire building
4. The air rights over a building
5. The right to use part of the landlord's land to build a new building

If the tenant has a long term lease at $10,000 per year and the tenant leases the property to another tenant for $30,000, he has created a Sub-Lease. This sub-lease could be mortgaged or sold in many instances.

There are many rules and regulations that govern this relationship that vary from state to state.

PROPERTY MANAGEMENT

On most kinds of property there are two important functions-maintenance and day to day operations of the property that keep it intact as an investment.

This can be handled in two ways. At the time of leasing this function could be contractually assigned to the tenant in which case there would be minimum responsibilities on the part of the landlord. Should this not be the case it then becomes the responsibility of the landlord to insure that the property is maintained, tenants kept current with rents, taxes paid and any tenant problems handled. This takes time and some expense. If not done correctly it could cause problems for the property in terms of items of deferred maintenance occurring, tenant turn-over etc., which all translates into lost income and hence lost value.

The property manager's function is to handle this for the landlord. There are companies which specialize in this area of real estate. They charge a percent (%) of the property's gross income as their fee depending upon how much income the property generates. Good management is always worth the investment.

Properties that have poor management almost always either suffer losses in value or do not realize full value potential.

WHAT IS VALUE?

In today's economy, in particular the econometric and financial sections of it and the legal aspects as well, there seems to be many wide ranging definitions of Value. This article will attempt to explore the historical definitions of value as they have been used throughout recorded history. Through this exploration this article will put into perspective many of the constituant elements that make up value. This article will also show that under different circumstances there could be two or more types of Market Value on the same property with each one being correct for that stated purpose.

What is Market Value? Market Value is defined "as the most probable price in terms of money which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not effected by undue stimulus.

Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. Buyer and seller are typically motivated.

2. Both parties are well informed or well advised, and each acting in what they consider their own best interest.

3. A reasonable time is allowed for exposure in the open market.

4. Payment is made in cash or its equivalent.

5. Financing, if any, is on terms generally available in the community at the specified date and typical for the property type and its local.

6. The property represents a normal consideration for the property sold uneffected by special financing amounts and/or terms, services, fees, costs, or credits incurred in the transaction."(2)

(2)Real Estate Appraisal Terminology, rev. ed, American Institute of Real Estate Appraisers, Society of Real Estate Appraisers. Ballinger Publishing Company, page 160-161.

Value or Market Value is defined from an economic viewpoint in more succinct mathematical terms. It is a function of supply and demand. If one draws out the graph of what prices suppliers would be willing to supply certain items at and then superimposes upon it the graph at which the buyers would be willing to buy certain quantities of that item at the point where the two graphs meet would be considered market value or equilibrium price. This is sometimes referred to as market price.

DIFFERENT TYPES OF VALUE FOR THE SAME PROPERTY

There might be situations where a definition of value is altered as certain people seek a value estimate for their particular purposes. The people seeking a value estimate have an absolute right to this. The practitioners must have the freedom to measure and report this. Before we get into that, let's examine what types of values we normally deal with.

DIFFERENT TYPES OF "VALUE"

1. ECONOMIC VALUE
The value for a commodity usually expressed in economic terms. This is a type of definition used in economics.

2. COST VALUE
This is also known as replacement cost. It is the cost to replace something with like materials and having similar utility. It is one of the techniques used in preparation of a real estate appraisal.

3. INCOME VALUE
This is a technique where a property's financial characteristics are valued. Expressed another way it is the present worth of a property's anticipated future income streams.

4. INSURABLE VALUE
This is a value, usually computed via the Cost Approach, which is used as a basis for placing insurance on a property. In different states there are slightly different criterior for computing this number.

5. SALVAGE VALUE
The price expectable for the whole (that is, a house) or a part of the whole (that is, a plumbing fixture) for removal from the premises, usually for use elsewhere.(3)

6. RESIDUAL VALUE
This is the value of a property at some future time. It is commonly used in a discounted cash flow analysis technique.

(3) Ibid

7. MARGINAL VALUE
The value of something after adding an additional increment of something; such as what is the marginal value after adding incremental rent of $1.00 per square foot.

8. MARKET EQUILIBRIUM VALUE
This is the value where the supply and demand curves meet. It usually assumes a "perfect" market.

9. ASSESSED VALUATION
1. The figure at which the property is put on the assessment roll and, unless altered by a higher authority, the basis upon which the property tax levy is distributed among the property owners. Assessed values may differ from market values for these major reasons: fractional assessment laws, partial exemption, and problems in keeping assessed values current.
2. The assessor's estimate of market value before deductions for partial exemptions and before the application of any factor prescribed by law or tradition concerning the level of assessment.(4)

10. INVESTMENT VALUE
This is the value of a property under very particular circumstances to a particular investor.

11. EXPECTED VALUE (MOST PROBABLE SELLING PRICE)
An event weighted by the probability of its occurance. The sum of a series of possible events each weighted by their probability of occurance,(5) sometimes this can be synonomous with market value.

12. MARKET VALUE
See previous section.

13. MARKET VALUE FOR LEGAL PURPOSES
This is market value modified by the direction of legal authority usually the court. It allows for the blending of case law into the appraisal. The doctrine of STARE DECISIS sets the precedent for this. There could be no direct relation to a property's actual market value for the cases used might be considered "Bad Law". Some of the deciding aspects of the past cases might not even apply to the present case. It takes a professional appraiser skilled in courtwork to be able to make these distinctions.

(4)Ibid
(5)Ibid

14. BOOK VALUE
The capital amount at which property is shown on the books of account. Usually, it is the original cost less reserves for depreciation plus additions to capital.(6)

15. Goodwill Value
1. The advantage which a business has developed due to intangible values applicable to the specific business concern itself, such as name, certain types of patents, and trademarks, or similar rights or benefits. Primarily, these are of an intangible nature which may not freely be enjoyed by competitors.
2. That part of the value of a going enterprise which is in excess of the capital investment and is an ingredient of going concern value.(7)

16. INTRINSIC VALUE
The amount of money, which is equivalent to the worth inherent in the thing itself; for example, the intrinsic value of a bronze medal, applies to the value of tangible assets separated from the intangible assets, but assuming the existence of the latter in a property. Strictly a misuse of the word value, since value depends upon extrinsic things; that is, the attitude of persons toward the thing valuable. Should never be used in the looser sense as simply adding emphasis to the value estimated for the whole.(8)

17. LEASEHOLD VALUE
The value of a leasehold interest; the right to use, enjoyment, and profit existing by virtue of the rights granted under a lease instrument. The value of a leasehold interest is the present (discounted) worth of the rent saving, which contractural rent at the time of appraisal is less than the current market rent. If land is improved by the lessee, then the value of the leasehold interest is the present value of the saving in ground rent, if any, in addition to the value (not cost) of the improvements of the lessee. If the contractural rent is greater than the currently established market rent, the present worth of the difference is subtracted from the value of the improvements.(9)

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(6) Ibid
(7) Ibid
(8) Ibid
(9) Ibid

18. PLOTTAGE VALUE
An increment of value as a consequence of the combining of two or more sites so as to develop one site having a greater utility than the aggregate of each when separately considered or the value of an existing site of abnormal size or special shape which has greater utility than average lots or more conventional future payments.(10)

19. PRESENT VALUE
The current monetary value. Sometimes it is used synonymously, and inadvisably, with the term present worth. It is the today's lump sum which represents the current value of the right to collect future payments. It is the discounted value of aggregate future payments.(11) (See Rules of Thumb for Investing Rule #1)

20. SCARCITY VALUE
Value caused by a demand for a good, the supply of which cannot be increased. Antique furniture is an example.(12)

21. SENTIMENTAL VALUE
An emotional relationship between a person (usually the owner) and a property. Not related to market value.(13)

(10) Ibid
(11) Ibid
(12) Ibid
(13) Ibid

HOW A PROPERTY CAN HAVE TECHNICALLY DIFFERENT VALUES SIMULTANEOUSLY

For the purpose of this discussion, assume the following data for this commercial property. Also assume a full appraisal on the property has been performed and that the Income Approach to Value will be afforded the most weight and reliance. This is a synthesized version of the Income Approach.

Effective Gross Income:	$85,000
Total Expenses (of which 12,000 is Real Estate Taxes)	$50,000
Loan to Value Ratio:	.70
Mortgage Constant:	.1155
Equity Dividend Rate:	.075
Composite Tax Rate:	35.855
Equalization Rate:	.1095

Valuing the property via the Income Approach, the Market Value would be computed as follows:

Effective Gross Income:	$85,000
Less Operating Expenses:	-50,000
Net Operating Income:	$35,000

$$\frac{\text{Net Operating Income}}{\text{Capitalization Rate (See below)}} = \text{Value}$$

$$\frac{\$35,000}{.1034} = \$338,491$$

Capitalization Rate Development:

Mortgage	.70 x .1155	=	.0809
Equity	.30 x .075	=	.0225
Capitalization Rate		=	.1034

Via the Band of Investment Technique

To value the property for tax certiorari purposes the scenario is somewhat different. The law (since real estate taxes are an issue) doesn't allow the actual taxes to be deducted. Instead the tax rate is built into the capitalization rate. Here are the computations.

Composite Tax Rate	35.855 per $100 of assessment
x Equalization Rate	.1095
Effective Tax Rate	.0393

Thus, the value would be computed as follows:

Net Operating Income = $35,000 + $12,000
Overall Composite Capitalization Rate = .1034 + .0393

$47,000 = $329,452
.1427

Economists in a perfect market might calculate through modeling techniques the mortgage constant to be .116002* due to this econometric model.

The value would thus be computed as follows:

.70 x .116002 = .0812
.30 x .075 = .0225
.1037

Overall capitalization rate via The Band of Investment Technique.

Net Operating Income = $35,000 = Value ($337,508)
Capitalization Rate .1037

*This figure is a "given" just for the purposes of this example. I would be developed from a complex econometric model, which is beyond the scope of this book.

Thus it can be seen that a property valued for a different purpose can have a different value with all values being correct for the stated purpose. For example, a property could have a market value of $338,491, a market value for tax certiorari purposes of $329,452 and a market equilibrium value of $337,508. All of these would be technically correct. It is up to the appraiser to clearly define the type of value being sought, for the client has an absolute right to know the value under any circumstances. The appraiser has an inherent duty to appraise the property and if the appraisal is reduced to writing, present the findings in a clear and concise manner so that the reader of the report will be absolutely sure of all material facts.

When we are talking about Market Value, what then are we referring to? First, a market is defined. What does it consist of? (Product) Who are the players?(Buyer and Seller) Second, what are the financial components of the market? (Typical financing terms) Third, are there constraints operating within the market (usually government imposed)? For example, a market value under Regulation 41-B of the Federal Home Loan Bank Board or market value for tax certiorari purposes. This suggests that a restriction is placed on the Market Value definition or freedom of Market Value.

CONCLUSION

The term Market Value means, "the most probable price that a willing buyer would pay to a willing seller (freedom of price) with both parties being duly informed (open, defined and intelligent market) and with neither acting under duress (no outside pressures)". We can see that this is the purest form of value but that for certain purposes this definition gets redefined slightly to be in conformance with law and thus there could be technically different values for the same property. Which one is correct?

The market value as described in the first section is correct. However, as other factors enter into this picture (legal, financial, etc.) their parameters are superimposed on to the market value definition. This, however crudely, is perhaps the only way the other forces operating in the economic, legal and social environment can properly interact. There probably will continue to be some inadequacies present as the process continues its evolutionary process. Why?

Basically, there are two reasons. The principle of change is always operating. But the most important one is that of STARE DECISIS. This is previously resolved and adjudicated court cases being used as the basis for deciding current cases. The problem is that there have been "bad" court decisions (referred to as bad case law). When new cases are decided, in part, based upon bad case law, a distortion is promulgated throughout all aspects of our environment, social, financial, legal. Often, to correct these distortions, certain adjustments are built into new case laws which may satisfy the current case but builds into the system yet more distortion. It is hoped that as the force of buyers and sellers continue to interact, in a free market, they can do it in a free, informed and ratio manner without having to deal with the convolutions often brought about by poor legal and political decisions.

REAL ESTATE LIMITED PARTNERSHIP INVESTMENTS FROM MOTIVATIONAL CONSIDERATIONS TO OFFERING MEMORANDUM ANALYSIS

This paper will be a short treatise on the emergence of Limited Partnerships in the Real Estate Field. In the last decade this industry has grown into the multi-billion dollar area. There are a number of reasons why these limited partnerships have emerged as a growing economic force within the real estate community. Normally, the wealthy or large corporations could own significant parcels of income producing real estate. Limited partnerships allow many small investors to pool their money together to buy large parcels of real estate. This allows more people, who normally on their own could not get into the market, the ability to now do so. All of the benefits associated with real estate ownership flow to the individuals. Although this vehicle has been present since 1935, it only started to gain momentum in early 1972 with very large impetus in 1981 due to the very attractive benefits real estate offers. This article is designed for the person in the real estate field and tries to present a number of topics in a concise and simple manner so that possible investments in these vehicles may be accommodated.

WHY INVEST IN REAL ESTATE?

Why invest in real estate? This question often brings about many responses from many people, but there are a number of sound fundamental reasons why people invest in real estate. These reasons are that it is a hedge against inflation, it is a source of annual cash flow, it is an excellent vehicle for the accumulation of wealth and there are also tax advantages. It is one of the few investments where these four factors are present.

As in many other fields, investors feel compelled to look for certain rules of thumb as to how they should operate in these areas. In real estate there is a very simple sounding expression that is quoted in many different environments. That expression is "location, location, location." The reason for this is that real estate is immovable and as a result is influenced by many factors located outside of the property. Therefore, when looking to purchase real estate the primary concern should be location.

Inherent with this is the fact that a good location means that it's in a good economic environment; the property usually will have a good occupancy rate; the probability for future rent increases is very good, which will result in an increase in

market value and as a result the owner of the property will get an increase in capital appreciation.

Real estate also has another significant advantage. It is a tax shelter meaning that money or income earned during a particular year of operation can be sheltered against taxes for that year and in certain circumstances other tax years. There are reasons for this. One of them is that real estate is capital intensive and in order to attract money into this area the Internal Revenue Service allows for certain favorable treatments of income. These guidelines are originally promulgated by the Congress and other legislative inputs. Although there has been much talk of great tax reform, real estate will always be in demand for the supply is finite, and everyone must use it in some way. This translates into continuing higher prices or rental income. Since it is essentialy a business the deductions for depreciation and interest should be preserved to some degree. Hence it will remain as it is now a unique investment where, when properly chosen, an investor can have return on capital, return of capital, capital appreciation and some tax shelter benefits. Additionally as debt becomes smaller and the value increases the property can be refinanced which results in tax free money (being paid for by current earnings of the property) which the investor can use to buy additional real estate. Most investors use this new money to purchase additional real estate which continues the investors ability to maximize wealth and achieve financial independence.

THE BENEFITS OF OWNERSHIP

Why does real estate have value? The value of real estate is determined in the marketplace. It is the function of a willing buyer and a willing seller both being fully informed and neither acting under duress. If we are talking about income producing real estate, the rental income less operating expenses result in a net cash flow. This net cash flow will ultimately determine what the property will sell for or conversely what is its market value. This net income is converted into value via a financial rate most commonly referred to as a capitalization rate or "Cap Rate". Most people either own homes or rent apartments and the idea of valuing a property based upon its financial elements as opposed to its brick and mortar components may seem like a new idea. In the professional marketplace, however, the idea of net cash flows to an investor is of paramount importance.

Looking over the last ten years or so two questions emerge. Why has real estate become an effective hedge against inflation and tended to even stay ahead of inflation? There are two economic reasons for this. One is demand pull and the other is cost push. Concerning demand pull, prices go up simply because the demand for these items far exceeds supply. In certain areas of the country, many more people move into an area than there are available housing units. As a result, the demand for the housing increases greater than the supply. A basic economic premise dictates that the price of the units will go up because of this demand pull. The other side of the coin which is cost push dictates that as the cost of component elements of the building, land, labor, and capital go up rent must be charged accordingl to cover these costs. Unless this occurs, no one would build such a property until the level of rent can cover it. There are other properties in the marketplace, unless and until these properties are absorbed theoretically no new construction will occur.

Tax benefits in real estate also play an important role for the investor. Consider a property purchase for $10 million consisting of $4,000,000 in cash and a $6,000,000 mortgage, if we deduct an amount for the land value which we cannot depreciate the remainder might be entirely depreciable. Additionally, the interest on any mortgage is also deductable as it is paid. Real estate is the only investment where your losses can exceed the amount invested, meaning that you can get more than $4 million worth of losses in terms of depreciation and mortgage interest on the property. How depreciation can shelter the rental income cash flow from taxes is a most important aspect of a successful real estate investment. Considering our $10 million investment, let us assume that there is $1 million worth of land and that there is $9,000,000 worth of real estate depreciable over 15 years. This will allow the investor $600,000 a year of depreciation. This means that the investors are allowed to lower the partnerships taxable income by the amount of $600,000 per year. Should the amount of depreciation exceed the net income of the property, the investor not only gets the net income from this real estate venture tax free, the investors can use the remaining depreciation on their personal tax returns. Tax laws are bound to change over the passage of time. Due to the capital intensive nature of real estate, it is anticipated that these tax benefits, in some form, will be in effect.

WHAT TYPES OF PROPERTY SHOULD THE PARTNERSHIP INVEST IN?

If you are investing in real estate using a limited partnership what types of investments should you be considering? There are actually a number of types which are usually handled by these types of investment vehicles. These types of investments suit the limited partnership's investment goals and objectives in terms of risk, cash flow, depreciation and capital appreciation. There have been limited partnerships designed and implemented primarily for tax reasons only. With the advent of the new tax law these should be eliminated.

One type of property usually under consideration is some form of multi-family housing located in an area where there is a growing demand and a small supply of housing, which is often acute. This is a typical investment because people tend to satisfy their need for shelter first. As prices of housing continue to rise disproportionately, a larger share of the people will be forced to continue to rent. There is a housing shortage currently within most of the United States and new housing starts are running at a historically low rate. Another phenomenon is occuring and that is many numbers of existing apartment rentals are being converted into cooperative and condominium usage which takes much of the rental housing off the market. Ironically, rent control which is used to protect tenants (hold rents down) actually hurts them for under rent control there is a disincentive to build new housing (which will stabilize rents) and actually helps the market into cooperative or condominium conversion. Except for areas like New York, many of the apartment rentals expressed in terms of leases are written for periods of less than one year. This means that there is a large turnover and rent increases tend to rise at a quick rate.

Another type of investment that would be considered is office buildings. These investments are usually located in or adjacent to either residential areas or planned office areas and usually have greater economic stability than apartment houses provided they are well located and have an appropriate tenant mix. Usually leasing terms on these investment properties range in terms longer than one year, usually in the five year range, with options to renew. The owner of the property is able to recover additional operating expenses such as increases in taxes or electricity and other types of expenses.

Thus, it can be said that the income and cash flow attributable to office buildings is generally more predictable and stable than that of apartment houses. There is a downside risk, however, in terms of shifts in general economic conditions. If an area undergoes a change or migration to other types of office

properties than the office under consideration is subject to the vicissitudes of the economy and thus, could be subject to a loss in value. It therefore is prudent that the site selection for the office building be of utmost importance and great care should be undertaken to insure that the site is in a growing area or where business is most probable to grow.

Shopping centers also provide investment vehicles for limited partnerships. Usually shopping centers are either adjacent to or abutting residential development. They support the needs of a residential community in terms of shopping requirements such as food shopping, retail stores, drug stores, and other types of sundry items. There are three typical types of shopping centers; large regional shopping centers which service wide retail markets. Second are neighborhood shopping centers, which usually service a community, and finally there are local shopping centers which usually service part of a neighborhood. Depending upon the types of shopping centers involved you will see particular types of tenant mixes that are associated with it. The rental structure that is normally associated with shopping centers is commonly in terms of a base rent plus overages. These overages are usually calculated in terms of increases in the retailers' business. The landlord also is usually able to capture additional rent in terms of passing through additional costs of electricity, taxes and other associated operating expenses.

Other types of investments that are suitable for limited partnerships could be industrial type properties, mobile home parks, and hotels. Because these types of properties are also able to generate income and pass through any additional operating expenses and usually have stable and predictable cash flows. However, these types of properties usually are more management intensive and as a result some of the degree of success and future increases in value are a direct function of the quality of management. Therefore, if one gets involved in a limited partnership investment concerning these types of properties, it is encumbrant upon the investor to carefully scrutinize not only the property but also the quality of the management that's associated with it.

These consist of different types of properties made to a private group of investors and sometimes are governed by a different set of security laws if the number of investors is small. Generally, these are not marketed on the stock exchange and the buy-in price per share is large.

HOW TO GET INVOLVED IN A LIMITED PARTNERSHIP

How does one actually get involved in a limited partnership? The answer is in two ways. The first way is by a group of private investors getting together and acquiring and operating a property. The second way is for a company who is in the business of syndicating to form a partnership and register it with the securities and exchange commission. Then shares of these properties can actually be sold on the open market or the stock exchange. This is called a public offering. In a public offering, the guidelines imposed by the securities and exchange commission are rather stringent with regards to the actual property and the syndicators are forced to get a real estate appraisal and a due dilligence report. Ostensibly, this is to protect the investors because the investors are not normally able to look at or review these documents for themselves. Even if they could get these documents they might not be in a position technically to evaluate them. There are also private offerings which are not made to the general public.

One of the requirements of a limited partnership is a filing of a document which is called an offering memorandum. An offer of sale must be accompanied by this document. This is usually assembled by groups of attorneys and accountants who try and satisfy all of the legal requirements as promulgated by the Attorney General at the time of the inception of the partnership. The formulation of this offering memorandum is guided by a myriad of legal constraints and other requirements.

The size of this document often ranges in excess of 100 pages and to the untrained eye it can be a formidable treatise to have to analyze. Although the legislative intent of the offering memorandum appears to have the protection of the investor in mind, there are other things that the investor should consider above and beyond what is contained within the body of this document. There are a number of things that can be examined by a potential investor and although they may not be completely understood, they can serve as a useful starting point in terms of questions to outside professionals.

HOW TO READ THE OFFERING MEMORANDUM

Before starting with the analysis of the offering memorandum, it should be noted that the following dissertation is designed to

give an in-depth interview into this formidable document. The investor always has the option to retain outside expertise in pursuing the analysis of an offering memorandum.

The most important asset of a limited partnership and often times given minimal treatment in an offering memorandum is the property itself. Two things should be spelled out in a clear and concise manner: 1) the location of the property 2) a full description of the property.

In the location description, a concise overview of the actual location and neighborhood attributes should be spelled out. Any supporting economic data that would support the viability of the property should be included here. Concerning the description of the property, there should be full documentation as to what property rights are being acquired. For example, there are certain types of real estate ventures where only the improvements are the subject of the parternship. A wary investor should be aware of such facts for it could have substantial repercussions during the life of the partnership. Also contained here should be a fairly detailed description and analysis of exactly what types of improvements are there. For example, if the property is an apartment house, there should be a description of the brick and mortar components, the physical size, the number of units along with the unit layout, and other such salient features. Some offerings actually contain a copy of the real estate appraisal upon which the structure of the limited partnership is based. The investor should insist on seeing a copy of it should it not be contained within the offering memorandum.

Another aspect of the offering memorandum is the accounting forecasts and the appropriate cash flow analysis or financial projections that often are contained in this section. To digress a moment, one might also find an actual accounting statement within the body of an offering memorandum. There are a number of things to consider when attempting to analyze an accounting statement. The first place to start would be in the auditor's report for this will spell out anything that the auditors found not consistent with the original financial statements. Should such a situation be discovered, further investigation is appropriate. A note of caution, a good report by the auditors does not mean the company is in good financial health. It simply means that the examined statements have been prepared in conformance with generally accepted accounting principal.

HOW TO READ THE FINANCIAL STATEMENTS

On financial statements, there is usually some notes of which the first one generally outlines accounting policies in force and effect by the company. A typical example would be what type of depreciation were used on real estate assets for handling depreciation. Depending upon which method is used, the amount of depreciation could raise or lower earnings.

When reading an accounting statement, be prepared to read it not like a book, but rather as a document where "skipping around" is the rule of thumb. Many corporations do not try to go out of their way to make sure people really understand the numbers contained within the body of these reports. There are a couple of factors to keep in mind when reading through these statements.

1. Be prepared to skim through the report.

2. There are usually a number of trends that might be presented within the report. These trends often are excellent units of comparison and projections.

3. Usually contained within the report are key operating ratios which have very difinitive meanings.

There are three typical ratios that are often considered.

1. The debt to equity ratio which is a function of dividing the total shareholder's equity into the total long-term debt. The higher the figure means that outside creditors can have more influence over what goes on within the company.

2. Earnings per share. Even on the stock market this seems to be a very forceful unit of comparison because the better the figure, usually the better the company. This is computed by dividing the number of shares into the total earnings. A careful eye should be kept on what has been happening with this figure over time.

3. Working capital. This is often used as a further refinement to earnings per share for it is another measure of financial health; without it, a company might not be able to continue its day-to-day operations.

After reading through the financial statements, there are a number of questions that should be considered and these questions basically are as follows:

1. Is the company in too much debt?

2. Are the assets and liabilities in a heathly situation?

3. Is there enough working capital?

In the extreme cases these answers can usually be found within the report. Not so true in borderline cases which means more questions must be asked and perhaps an expert must be brought in.

An intriguing aspect of the accountant's report are the actual cash flow analysis or expected revenues of the particular property. This is often based upon expected first year operations and the associated income and expenses that go along with it. Sometimes this first year of income is contingent upon certain events occurring such as the completion of renovations etc. These are then trended into the future at various growth rates which show how a property along with its anticipated benefits to the investor will behave over time. These must be examined very carefully, for after all, they are numbers on a piece of paper and must be scrutinized.

To begin with, first look at the company that prepared the numbers. Are they accountants or appraisers or other people? Do they have the technical expertise required to gather, prepare, analyze and produce such a report? Are they really just raw numbers and simply trended forward? Obviously, these are rhetorical questions; however, these types of rhetorical questons can give the reader crystal clear insight into the assumptions that have been used to prepare them. It often gives the reader a number of unanswered questions which must be explored in great detail. To summarize, who prepared the cash flow analysis, what where the basic first year numbers and what were the assumptions for the projections, are all questions that deserve answers. Hopefully, these answers could be contained within the body of the offering memorandum; however, this is optimistic at best and the investor, if not satisfied, may have to go outside the offering memorandum for answers.

As with any projections, there will also be amounts of tax benefits that are associated with this type of investments. These are called write-offs and sometimes they are expressed in terms of a ratio. For example, a 2 to 1 ratio might mean two dollars of tax deduction for every dollar invested. It should be clearly spelled out within the body of the offering memorandum what these ratios are, for investors sometimes use this as a method by which to compare certain types of real estate limited partnerships. It is suggested that tax consideration be secondary and that the viability of any type of real estate limited partnership be given highest priority.

There are other items that should be discussed within the body of an offering memorandum and these are:

OTHER IMPORTANT FACTORS IN THE OFFERING MEMORANDUM

1. Staged investments - The term means that investors are able to buy into the property over a period of time as opposed to having to put up all of the money in one lump sum investment.

2. Who is behind the investment? Any potential investor should know who are the general partners who are going to be controlling the operation of the investment. Who are the accountants? Who are the attorneys? And possibly who are other experts involved in putting together this syndication? One crucial factor in investments of this type is the company that will manage the property. Property management has a very important role

particularly in multi-tenant operations. The investor should look for a track record with the management company. With poor management, the expected results may not be obtained.

3. Guarantees - Has the promoter of this investment offered any guarantees within the body of this memorandum? Some of these guarantees might be in the form of a return on investment for the first couple of years. If there are any guarantees, they should be clearly spelled out within the body of this report.

4. What happens if things don't work out according to plan? There are basically two things to consider. 1) Are there unsold units and how are those disposed of and 2) Unfavorable IRS rulings. In the case of unsold units, if there are many of them, the terms of the partnership may call for returning of the money to the individual investors. Concerning unfavorable IRS rulings, generally, that means that each individual investor will have to file an amended return and perhaps pay a penalty.

It is evident that an offering memorandum can be a highly complex document and have a number of far reaching repercussions. Although ways have been discussed as to how to analyze an offering memorandum, they are complete in terms of an overview but yet disceptively simple for there are many degrees of detail that must go into each one of the aforementioned areas. It is recommended that an investor who is not knowledgeable seek the advise of an expert. This degression into the area of analyzing offering memorandums could have taken a few volumes. Certain types of memorandums suggest much more research which is not within the scope of this article.

In conclusion, this article has generally touched on what a limited partnership is, what types of investments that are normally associated with limited partnerships and what the two forms of partnerships generally are. It is strongly recommended that if one desires to get involved with property the advice of an expert should be considered. It should be only after advice is obtained from an expert that an investor actually go through with any type of transaction. This may be difficult in terms of the public offerings, but some of the syndicators involved with public offerings do make these documents available to the investors. It is also suggested that seeking advice from legal and tax counsel might be appropriate.

For the more technical minded investor or practitioner, there are three other technical articles that might merit some perusal. These articles are:

1. "Limited Partnerships - A Real Estate Tax Shelter; Appraisers Beware" by Howard F. Jackson, Jr., Author

2. "Limited Partnerships - A Real Estate Tax Shelter; What the Reviewers Concern Should Be", by Howard F. Jackson, Jr., Author

3. "Component Depreciation: The Critical Element In A Real Estate Tax Shelter", by Howard F. Jackson, Jr., Author

These articles get into many of the technical aspects and legal details of Limited Partnership Investments and these articles are referred to simply as a source of additional data.

Note: This article was published by The Society of Real Estate Appraisers Winter 1985 and is reprinted with permission.

MORTGAGES - FROM A TO Z

There are a number of elements absolutely essential to successful investing in real estate. Once you have found the "right" property you now have to consider paying for it.

There have been many seminars offering "that you could become a millionaire in one day", "no cash down", "no credit rating", and even "no job". In the real world this is far from reality. You will have to pay for monthly mortgage costs as well as closing costs. Special thanks to the National Association of Realtors for some of their suggestions.

Here are some examples of closing costs:

*Title Insurance

*Discount points - bank fees

*Escrow fees

*Termite report

*Legal Fees

*Recording Fees

*Proration of Expenses such as taxes

*Appraisal fees

*Notary fees

*Document preparation fees

*Mortgage insurance

Closing costs generally run about 3%-5% of the purchase price. This can vary from locality to locality. In many states the banks are required to give advance notice of these costs. Should you be acquiring the property through a REALTOR, that agency should provide you with a reasonably accurate itemization of the costs. In many states the bank must provide this information.

Concerning discount points these are common bank charges in addition to interest rates. They get it at one lump sum and they increase the cost of the loan.

This discussion will focus upon mortgages; that is the money the bank will lend. A mortgage is a lien on real estate given by the purchaser (mortgagor) as security for money borrowed from a lender (mortgagee). This is security of the debt. Usually a bond is also signed at the time of the mortgage. This is evidence for the debt.

QUALIFYING FOR THE MORTGAGE LOAN

One of the items that a bank looks at before making a mortgage, besides the property, is your ability to pay. This is called qualifying for the loan. This qualification is based upon how big the mortgage is (amount), the interest rate, the length of the mortgage and two "non-bank" items--taxes and insurance. Thus the bank looks at the following expressed as a trite sounding term: PITI

P= principal of loan

I= interest to be paid on loan

T= real estate taxes

I= property and casualty insurance

This is the real "financing" cost of your property each month.

HOW MUCH INCOME DO YOU NEED FOR AN $100,000 MORTGAGE?

(at different interest rates - 30 year term)

	MONTHLY PAYMENT			INCOME TO QUALIFY	
INTEREST RATE	P+I	T+I	TOTAL	MONTHLY	ANNUAL
10%	$ 930	$200	$1130	$3,525	$42,300
11%	$ 995	$200	$1195	$3,728	$44,736
12%	$1063	$200	$1263	$3,940	$47,280
13%	$1133	$200	$1333	$4,159	$49,908

Visually by raising or lowering the interest rates the

corresponding annual or monthly income necessary to qualify can be determined. It is still a good idea to shop around and compare. These ratios can very somewhat from lender to lender.

Following is a Mortgage Spreadsheet which is helpful in determining cash available for a cash down payment.

THE MORTGAGE ANALYSIS SPREADSHEET

Mortgage Payment	
Gross monthly income	$_____
Less long and short-term debt such as car payments	-_____
Multiply by .28 for a 90% loan; .32 for 80%	x_____
Monthly payment you could afford	$_____
Down Payment	
Total cash available	$_____
Less closing costs (as a rough estimate on a new 1st mortgage with about two points, figure 4% to 5% the mortgage amount for closing costs)	-_____
Cash available for down payment	$_____

NOTE: Lenders generally use "income ratios" of about .28 for a 90% loan with 10% down payment and about .32 for an 80% loan with 20% down payment. These can vary from bank to bank. Shop around. This is a standard formula used by many lending institutions.

We all want bigger and larger properties but are confined by reality - our income. The following chart will indicate how much of a monthly payment you can afford given a particular mortgage amount and interest rate. Notice the monthly payments are in round numbers. In reality it's the mortgage amounts that are in round numbers and the monthly payments are in odd

numbers. It was presented this way to make it easy to visualize. With the use of a financial calculator any payment for any interest rate for any term can be directly computed. (SEE CHAPTER ON FINANCIAL KEYSTROKES)

Following is a monthly payment/loan finder chart:

MAXIMUM PAYMENT/LOAN FINDER CHART

Current Interest Rate For Mortgage Loans ($)

MONTHLY PAYMENT	9%	10%	11%	12%	13%	14%	15%
$ 250	31,704	28,488	26,252	24,305	22,600	21,099	19,772
$ 500	62,141	56,975	52,503	48,609	45,200	42,199	39,543
$ 750	93,211	85,463	78,755	72,914	67,800	63,298	59,315
$1000	124,282	113,951	105,006	97,218	90,400	84,397	79,086
$1250	155,352	142,438	131,258	121,523	112,999	105,497	98,858
$1500	186,423	170,927	157,509	145,827	135,599	126,596	118,629
$2000	248,563	227,902	210,013	194,437	180,799	168,795	158,172
$3000	372,846	341,852	315,019	291,655	271,199	253,192	237,259

Note: The chart describes the approximate amount of a loan, assuming 30 year term, at the given interest rate. To use it, locate the maximum payment you can afford down the left side, then read across to the current interest rate. Where interest rates and affordable monthly payments cross, you will find your approximate maximum mortgage amount.

There are also adjustable rate mortgages. They are good when the interest rates are falling because your payments are reduced. However, when rates are going up your payments also will go up.

There is a section called "Financial Calculator Keystrokes - Six Functions of $1" by Howard F. Jackson, Jr., which shows how to compute any mortgage factor for any number of years for any interest rates.

For all practical purposes, there are generally three types of loans.

1. Fixed term, fixed payment
2. Variable terms and payments
3. Interest only

Most of the mortgages being written today fall into one of the three categories. Variable mortgages are sometimes called "Adjustable Rate Mortgages" or "Graduated Payment Mortgages"

THE A-B-C'S OF MORTGAGE LOANS

FIXED MORTGAGES

TYPE OF LOAN	POSITIVES	NEGATIVES
I. Fixed-Rate, Fixed-Payment		
A. Conventional 30-year mortgage	Fixed monthly payments for 30 years provide absolute certainty on housing costs.	Higher initial rate than variable rates.
B. Conventional 15-year mortgage	Lower rate than 30-year fixed; faster equity buildup and quicker payoff of loan.	Much higher monthly payments.
C. FHA/VA fixed-rate mortgages (15 year & 30 year)	Low down payment requirements and fully assumable with no prepayment penalties.	Almost always requires substantial points; may have application red tape and delays. This situation could change in the future.
D. "Balloon" loans (5-20 year terms)	May carry discount rates and other favorable terms, particularly when the loan is provided by the homeseller.	At the end of the mortgage term, the entire remaining balance is due in a lump-sum or "balloon" payment forcing the borrower to find new financing. There is no equity build-up in the mortgage. This type of financing is

generally not
available from banks

THE A-B-C'S OF MORTGAGE LOANS

(CONT'D) VARIABLE MORTGAGES

TYPE OF LOAN	POSITIVES	NEGATIVES
II. Variable-Rate, Variable-Payment		
A. Adjustable-rate mortgage (ARM) payment changes on 1 year, 3 year, or 5 year schedules. This varies from bank to bank.	Generally lower initial rates than fixed-rate loans, particularly on the 1-year adjustables. Generally assumable by new buyers. Offers possibility of future rate and payment decreases. Loans with rate "caps" may protect borrowers against large increases in rates. In some cases, may be convertible to fixed rate plans after 3 years.	Transfer the greater interest-rate increase risk onto borrowers than fixed-rate loans. Without "caps", usually pushes up monthly payments in future years significantly. "Caps" is defined as a ceiling on how much an interest rate may increase.
B. Graduated payment mortgage (GPM) The payment increases by prearranged increments during first 3-8 years, then stabilizes.	Permits buyers with marginal incomes to qualify. Higher incomes over next 3-8 years expected to cover gradual payment increases. Could be combined with variable rate mortgage to lower further initial rate and payment.	Could have higher annual percentage rate (APR) than standard fixed-rate or adjustable-rate loans. May involve negative amortization increasing debt owed to lender. This could be risky in a down market.
C. Growing equity mortgage (GEM).	Smaller up-front payments, quicker	May have higher effective rates and

Distributes increasing portions of monthly payments to payoff of principal debt. Typically pays off in 12-18 years, rather than 25-30.	loan payoff than conventional fixed-rate or adjustable. Lower overall interest payments through life of loan.	higher down payments than other mortgages available. Tax deductions for interest payments decrease over time.	

OTHER MORTGAGE TERMS

Here are some other terms commonly used in real estate financing.

Permanent Loan: - a commercial type loan used on leased commercial property. this represents "typical" institutional financing.

Construction Loans: (With Takeouts) - this is typically used to finance property until a permanent type can be secured. These are usually "interest only" loans.

Standby Loan: This is used typically to repay a construction loan when other repayment sources are not available.

Foreclosure: Repossession of a property by a lender for failure to meet the mortgage payments. Any deficiencies not covered by the real estate could be assessed against the borrower personally. This is one of the problems of debt.

CREATIVE FINANCING

One type of mortgage not mentioned falls into an area known as "creative financing". This type of mortgage is called a "wrap around" mortgage. It technically involves a property on which there is an existing mortgage and the new mortgage wraps around the existing mortgage. The lender of this type of mortgage (bank or individual) assumes the payments on the existing mortgage and collects the payments on the wrap around mortgage from the person who receives it. This type of mortgage could be dangerous for the novice for if the individual making the payments to the wrap around mortgage holder defaults, the wrap around mortgage holder has to pay the underlying mortgage without the benefits of income.

For example, assume a building worth $1,000,000 financed with a $750,000 mortgage @ 6% interest for 25 years. Ten years later (today), the mortgage balance is $570,000 and the property is now worth $1,500,000. Assume a bank will give a wrap mortgage of $1,125,000 @ 8-1/2% for 25 years. The payments would be $1,125,000 x .0977(constant payment) which equals $109,913. The bank takes over the payments of $750,000 X .07823 (constant payment @6%) which equals $58,673. The bank will not disburse the full mortgage so you will get net proceeds of $1,125,000 (new mortgage) less $570,000 (mortgage balance of old mortgage) which equals $555,000 (new cash received TAX FREE).

Another type of mortgage is called a purchase money mortgage. Assume a purchase price of $100,000, an existing mortgage of $50,000 and a cash down payment of $25,000. To close the sale the sellers would take back a purchase money mortgage in the amount of $25,000.

WHAT IS AMORTIZATION AND HOW DOES IT WORK ?

What Is Amortization?

This is the systematic paying back of the principal amount of a loan. Most banks and financing companies require it. The periodic amount is dependent upon the frequency of payment,

interest rate and length of loan. A financial calculator can compute the amount directly.

How does amortization work?

One of the benefits of paying a mortgage is that you are reducing your debt and building up equity in the property. How it is done is interesting. In the beginning years of the mortgage most of your payment is applied to INTEREST not to the principal. In the later years the reverse is true. Following is a printout of an amortization schedule which shows how the payments are applied.

MORTGAGE PAYMENT RECORD

AMOUNT BORROWED	$100000.00	MONTHLY PAYMENT	$804.62
FIRST INTEREST RATE	.0900	FIRST PAYMENT DATE	1/1986
MONTHS TO REPAY	360		

PAYMENT DATE	OLD BALANCE	INTEREST PAID	PRINCIPAL PAID	NEW BALANCE	YEARLY INTEREST
YEAR 1					
1/1986	$100000.00	$750.00	$54.62	$ 99945.37	
2/1986	$ 99945.37	$749.59	$55.03	$ 99890.34	
3/1986	$ 99890.34	$749.18	$55.45	$ 99834.89	
4/1986	$ 99834.89	$748.76	$55.86	$ 99779.03	
5/1986	$ 99779.03	$748.34	$56.28	$ 99722.75	
6/1986	$ 99722.75	$747.92	$56.70	$ 99666.05	
7/1986	$ 99666.05	$747.50	$57.13	$ 99608.92	
8/1986	$ 99608.92	$747.07	$57.56	$ 99551.36	
9/1986	$ 99551.36	$746.64	$57.99	$ 99493.37	
10/1986	$ 99493.37	$746.20	$58.42	$ 99434.95	
11/1986	$ 99434.95	$745.76	$58.86	$ 99376.09	
12/1986	$ 99945.37	$745.32	$59.30	$ 99316.80	$8972.27
YEAR 2					
1/1987	$ 99316.80	$744.88	$59.75	$ 99257.05	
2/1987	$ 99257.05	$744.43	$60.20	$ 99196.84	
3/1987	$ 99196.84	$743.98	$60.65	$ 99136.20	
4/1987	$ 99136.20	$743.52	$61.10	$ 99075.09	
5/1987	$ 99075.09	$743.06	$61.56	$ 99013.53	
6/1987	$ 99013.53	$742.60	$62.02	$ 98951.52	
7/1987	$ 98951.52	$742.14	$62.49	$ 98889.03	
8/1987	$ 98889.03	$741.67	$62.96	$ 98826.08	
9/1987	$ 98826.08	$741.20	$64.43	$ 98762.66	
10/1987	$ 98762.66	$740.72	$63.90	$ 98698.75	
11/1987	$ 98698.75	$740.24	$64.38	$ 98634.36	
12/1987	$ 98634.36	$739.76	$64.87	$ 98569.50	$8908.18
YEAR 3					
1/1988	$ 98569.50	$739.27	$65.35	$ 98504.14	
2/1988	$ 98504.14	$738.78	$65.84	$ 98438.30	
3/1988	$ 98438.30	$738.29	$66.34	$ 98371.95	
4/1988	$ 98371.95	$737.79	$66.83	$ 98305.12	
5/1988	$ 98305.12	$737.29	$67.34	$ 98237.80	
6/1988	$ 98237.80	$736.78	$67.84	$ 98169.95	
7/1988	$ 98169.95	$736.27	$68.35	$ 98101.61	

8/1988	$ 98101.61	$735.76	$68.86	$ 98032.75
9/1988	$ 98032.75	$735.25	$69.38	$ 97963.37
10/1988	$ 97963.37	$734.73	$69.90	$ 97893.48

PAYMENT DATE	OLD BALANCE	INTEREST PAID	PRINCIPAL PAID	NEW BALANCE	YEARLY INTEREST
YEAR 4					
1/1989	$ 97752.11	$733.14	$71.48	$ 97680.62	
2/1989	$ 97680.62	$732.60	$72.02	$ 97608.61	
3/1989	$ 97608.61	$732.06	$72.56	$ 97536.05	
4/1989	$ 97536.05	$731.52	$73.10	$ 97462.94	
5/1989	$ 97462.94	$730.97	$73.65	$ 97389.28	
6/1989	$ 97389.28	$730.42	$74.20	$ 97315.08	
7/1989	$ 97315.08	$729.86	$74.76	$ 97240.31	
8/1989	$ 97240.31	$729.30	$75.32	$ 97164.98	
9/1989	$ 97164.98	$728.74	$75.89	$ 97089.09	
10/1989	$ 97089.09	$728.17	$76.46	$ 97012.64	
11/1989	$ 97012.64	$727.59	$77.03	$ 96935.61	
12/1989	$ 96935.61	$727.02	$77.61	$ 96858.00	$8761.41
YEAR 5					
1/1990	$ 96858.00	$726.44	$78.19	$ 96779.81	
2/1990	$ 96779.81	$725.85	$78.77	$ 96701.03	
3/1990	$ 96701.03	$725.26	$79.37	$ 96621.67	
4/1990	$ 96621.67	$724.66	$79.96	$ 96541.72	
5/1990	$ 96541.72	$724.06	$80.56	$ 96461.16	
6/1990	$ 96461.16	$723.46	$81.16	$ 96379.98	
7/1990	$ 96379.98	$722.85	$81.77	$ 96298.20	
8/1990	$ 96298.20	$722.24	$82.39	$ 96215.81	
9/1990	$ 96215.81	$721.62	$83.00	$ 96132.81	
10/1990	$ 96132.81	$721.00	$83.63	$ 96049.19	
11/1990	$ 96049.19	$720.37	$84.25	$ 95964.94	
12/1990	$ 95964.94	$719.74	$84.89	$ 95880.05	$8677.53
YEAR 6					
1/1991	$ 95880.05	$719.10	$85.52	$ 95794.53	
2/1991	$ 95794.53	$718.46	$86.16	$ 95708.36	
3/1991	$ 95708.36	$717.81	$86.81	$ 95621.55	
4/1991	$ 95621.55	$717.16	$87.46	$ 95534.08	
5/1991	$ 95534.08	$716.51	$88.12	$ 95445.95	
6/1991	$ 95445.95	$715.84	$88.78	$ 95357.17	
7/1991	$ 95357.17	$715.18	$89.44	$ 95267.73	
8/1991	$ 95267.73	$714.51	$90.12	$ 95177.62	
9/1991	$ 95177.62	$713.83	$90.79	$ 95086.83	
10/1991	$ 95086.83	$713.15	$91.47	$ 94995.36	
11/1991	$ 94995.36	$712.47	$92.16	$ 94903.20	
12/1991	$ 94903.20	$711.77	$92.85	$ 94810.36	$8585.79

PAYMENT DATE	OLD BALANCE	INTEREST PAID	PRINCIPAL PAID	NEW BALANCE	YEARLY INTEREST
YEAR 7					
1/1992	$ 94810.36	$790.09	$79.69	$ 94730.67	
2/1992	$ 94730.67	$789.42	$80.36	$ 94650.31	
3/1992	$ 94650.31	$788.75	$81.02	$ 94569.28	
4/1992	$ 94569.28	$788.08	$81.70	$ 94487.58	
5/1992	$ 94487.58	$787.40	$82.38	$ 94405.20	
6/1992	$ 94405.20	$786.71	$83.07	$ 94322.14	
7/1992	$ 94322.14	$786.02	$83.76	$ 94238.37	
8/1992	$ 94238.37	$785.32	$84.46	$ 94153.92	
9/1992	$ 94153.92	$784.62	$85.16	$ 94068.77	
10/1992	$ 94068.77	$783.91	$85.87	$ 93982.89	
11/1992	$ 93982.89	$783.19	$86.59	$ 93896.30	
12/1992	$ 93896.30	$782.47	$87.31	$ 93808.98	$9435.96
YEAR 8					
1/1993	$ 93808.98	$781.74	$88.04	$ 93720.95	
2/1993	$ 93720.95	$781.01	$88.77	$ 93632.19	
3/1993	$ 93632.19	$780.27	$89.51	$ 93542.67	
4/1993	$ 93542.67	$779.52	$90.26	$ 93452.42	
5/1993	$ 93452.42	$778.77	$91.01	$ 93361.42	
6/1993	$ 93361.42	$778.01	$91.77	$ 93269.66	
7/1993	$ 93269.66	$777.25	$92.53	$ 93177.12	
8/1993	$ 93177.12	$776.48	$93.30	$ 93083.83	
9/1993	$ 93083.83	$775.70	$94.08	$ 92989.75	
10/1993	$ 92989.75	$774.91	$94.86	$ 92894.89	
11/1993	$ 92894.89	$774.12	$95.65	$ 92799.23	
12/1993	$ 92799.23	$773.33	$96.45	$ 92702.78	$9331.11
YEAR 9					
1/1994	$ 92702.78	$772.52	$97.25	$ 92605.53	
2/1994	$ 92605.53	$771.71	$98.06	$ 92507.47	
3/1994	$ 92507.47	$770.90	$98.88	$ 92408.59	
4/1994	$ 92408.59	$770.07	$99.71	$ 92308.89	
5/1994	$ 92308.89	$769.24	$100.54	$ 92208.36	
6/1994	$ 92208.36	$768.40	$101.37	$ 92106.98	
7/1994	$ 92106.98	$767.56	$102.22	$ 92004.77	
8/1994	$ 92004.77	$766.71	$103.07	$ 91901.69	
9/1994	$ 91901.69	$765.85	$103.93	$ 91797.75	
10/1994	$ 91797.75	$764.98	$104.80	$ 91692.95	
11/1994	$ 91692.95	$764.11	$105.67	$ 91587.28	
12/1994	$ 91587.28	$763.23	$106.55	$ 91480.73	$9215.28

PAYMENT DATE	OLD BALANCE	INTEREST PAID	PRINCIPAL PAID	NEW BALANCE	YEARLY INTEREST
YEAR 10					
1/1995	$ 91480.73	$762.34	$107.44	$ 91373.30	
2/1995	$ 91373.30	$761.44	$108.33	$ 91264.97	
3/1995	$ 91264.97	$760.54	$109.24	$ 91155.73	
4/1995	$ 91155.73	$759.63	$110.15	$ 91045.59	
5/1995	$ 91045.59	$758.71	$111.06	$ 90934.53	
6/1995	$ 90934.53	$757.79	$111.99	$ 90822.55	
7/1995	$ 90822.55	$756.85	$112.92	$ 90709.62	
8/1995	$ 90709.62	$755.91	$113.86	$ 90595.77	
9/1995	$ 90595.77	$754.96	$114.81	$ 90480.95	
10/1995	$ 90480.95	$754.01	$115.77	$ 90365.19	
11/1995	$ 90365.19	$753.04	$116.73	$ 90248.45	
12/1995	$ 90248.45	$752.07	$117.71	$ 90130.75	$9087.31
YEAR 11					
1/1996	$ 90130.75	$751.09	$118.69	$ 90012.06	
2/1996	$ 90012.06	$750.10	$119.68	$ 89892.39	
3/1996	$ 89892.39	$749.10	$120.67	$ 89771.72	
4/1996	$ 89771.72	$748.10	$121.68	$ 89650.03	
5/1996	$ 89650.03	$747.08	$122.69	$ 89527.34	
6/1996	$ 89527.34	$746.06	$123.72	$ 89403.62	
7/1996	$ 89403.62	$745.03	$124.75	$ 89278.87	
8/1996	$ 89278.87	$743.99	$125.79	$ 89153.09	
9/1996	$ 89153.09	$742.94	$126.84	$ 89026.27	
10/1996	$ 89026.27	$741.89	$127.89	$ 88898.37	
11/1996	$ 88898.37	$740.82	$128.96	$ 88769.42	
12/1996	$ 88769.42	$739.75	$130.03	$ 88639.39	$8945.95
YEAR 12					
1/1997	$ 88639.39	$738.66	$131.12	$ 88508.28	
2/1997	$ 88508.28	$737.57	$132.21	$ 88376.08	
3/1997	$ 88376.08	$736.47	$133.31	$ 88242.77	
4/1997	$ 88242.77	$735.36	$134.42	$ 88108.34	
5/1997	$ 88108.34	$734.24	$135.54	$ 87972.80	
6/1997	$ 87972.80	$733.11	$136.67	$ 87836.12	
7/1997	$ 87836.12	$731.97	$137.81	$ 87698.31	
8/1997	$ 87698.31	$730.82	$138.96	$ 87559.36	
9/1997	$ 87559.36	$729.66	$140.12	$ 87419.25	
10/1997	$ 87419.25	$728.49	$141.28	$ 87277.97	
11/1997	$ 87277.97	$727.32	$142.46	$ 87135.50	
12/1997	$ 87135.50	$726.13	$143.65	$ 86991.86	$8789.79

PAYMENT DATE	OLD BALANCE	INTEREST PAID	PRINCIPAL PAID	NEW BALANCE	YEARLY INTEREST
YEAR 13					
1/1998	$ 86991.86	$797.43	$129.08	$ 86862.78	
2/1998	$ 86862.78	$796.24	$130.26	$ 86732.52	
3/1998	$ 86732.52	$795.05	$131.46	$ 86601.06	
4/1998	$ 86601.06	$793.84	$132.66	$ 86468.41	
5/1998	$ 86468.41	$792.63	$133.88	$ 86334.53	
6/1998	$ 86334.53	$791.40	$135.11	$ 86199.42	
7/1998	$ 86199.42	$790.16	$136.34	$ 86063.08	
8/1998	$ 86063.08	$788.91	$137.59	$ 85925.48	
9/1998	$ 85925.48	$787.65	$138.86	$ 85786.62	
10/1998	$ 85786.62	$786.38	$140.13	$ 85646.50	
11/1998	$ 85646.50	$785.09	$141.41	$ 85505.09	
12/1998	$ 85505.09	$783.80	$142.71	$ 85362.39	$9488.58
YEAR 14					
1/1999	$ 85362.39	$782.49	$144.02	$ 85218.37	
2/1999	$ 85218.37	$781.17	$145.34	$ 85073.03	
3/1999	$ 85073.03	$779.84	$146.67	$ 84926.36	
4/1999	$ 84926.36	$778.49	$148.01	$ 84778.34	
5/1999	$ 84778.34	$777.13	$149.37	$ 84628.97	
6/1999	$ 84628.97	$775.77	$150.74	$ 84478.23	
7/1999	$ 84478.23	$774.38	$152.12	$ 84326.11	
8/1999	$ 84326.11	$772.99	$153.52	$ 84172.59	
9/1999	$ 84172.59	$771.58	$154.92	$ 84017.67	
10/1999	$ 84017.67	$770.16	$156.34	$ 83861.33	
11/1999	$ 83861.33	$768.73	$157.78	$ 83703.55	
12/1999	$ 83703.55	$767.28	$159.22	$ 83544.33	$9300.02
YEAR 15					
1/2000	$ 83544.33	$765.82	$160.68	$ 83383.64	
2/2000	$ 83383.64	$764.35	$162.16	$ 83221.48	
3/2000	$ 83221.48	$762.86	$163.64	$ 83057.84	
4/2000	$ 83057.84	$761.36	$165.14	$ 82892.70	
5/2000	$ 82892.70	$759.85	$166.66	$ 82726.05	
6/2000	$ 82726.05	$758.32	$168.18	$ 82557.86	
7/2000	$ 82557.86	$756.78	$169.73	$ 82388.14	
8/2000	$ 82388.14	$755.22	$171.28	$ 82216.86	
9/2000	$ 82216.86	$753.65	$172.85	$ 82044.00	
10/2000	$ 82044.00	$752.07	$174.44	$ 81869.56	
11/2000	$ 81869.56	$750.47	$176.04	$ 81693.53	
12/2000	$ 81693.53	$748.86	$177.65	$ 81515.87	$9089.63

PAYMENT DATE	OLD BALANCE	INTEREST PAID	PRINCIPAL PAID	NEW BALANCE	YEARLY INTEREST
YEAR 16					
1/2001	$ 81515.87	$747.23	$179.28	$ 81336.59	
2/2001	$ 81336.59	$745.59	$180.92	$ 81155.67	
3/2001	$ 81155.67	$743.93	$182.58	$ 80973.09	
4/2001	$ 80973.09	$742.25	$184.25	$ 80788.84	
5/2001	$ 80788.84	$740.56	$185.94	$ 80602.91	
6/2001	$ 80602.91	$738.86	$187.65	$ 80415.27	
7/2001	$ 80415.27	$737.14	$189.37	$ 80225.91	
8/2001	$ 80225.91	$735.40	$191.10	$ 80034.80	
9/2001	$ 80034.80	$733.65	$192.85	$ 79841.94	
10/2001	$ 79841.94	$731.88	$194.62	$ 79647.31	
11/2001	$ 79647.31	$730.10	$196.41	$ 79450.91	
12/2001	$ 79450.91	$728.30	$198.21	$ 79252.70	$8854.90
YEAR 17					
1/2002	$ 79252.70	$726.48	$200.02	$ 79052.69	
2/2002	$ 79052.69	$724.65	$201.86	$ 78850.83	
3/2002	$ 78850.83	$722.80	$203.71	$ 78647.12	
4/2002	$ 78647.12	$720.93	$205.57	$ 78441.55	
5/2002	$ 78441.55	$719.05	$207.46	$ 78234.09	
6/2002	$ 78234.09	$717.15	$209.36	$ 78024.73	
7/2002	$ 78024.73	$715.23	$211.28	$ 77813.45	
8/2002	$ 77813.45	$713.29	$213.22	$ 77600.23	
9/2002	$ 77600.23	$711.34	$215.17	$ 77385.06	
10/2002	$ 77385.06	$709.36	$217.14	$ 77167.92	
11/2002	$ 77167.92	$707.37	$219.13	$ 76948.78	
12/2002	$ 76948.78	$705.36	$221.14	$ 76727.64	$8593.01
YEAR 18					
1/2003	$ 76727.64	$703.34	$223.17	$ 76504.47	
2/2003	$ 76504.47	$701.29	$225.22	$ 76279.25	
3/2003	$ 76279.25	$699.23	$227.28	$ 76051.97	
4/2003	$ 76051.97	$697.14	$229.36	$ 75822.61	
5/2003	$ 75822.61	$695.04	$231.47	$ 75591.14	
6/2003	$ 75591.14	$692.92	$233.59	$ 75357.55	
7/2003	$ 75357.55	$690.78	$235.73	$ 75121.81	
8/2003	$ 75121.81	$688.62	$237.89	$ 74883.92	
9/2003	$ 74883.92	$686.44	$240.07	$ 74643.86	
10/2003	$ 74643.86	$684.24	$242.27	$ 74401.59	
11/2003	$ 74401.59	$682.01	$244.49	$ 74157.11	
12/2003	$ 74157.11	$679.77	$246.73	$ 73910.37	$8300.81

PAYMENT DATE	OLD BALANCE	INTEREST PAID	PRINCIPAL PAID	NEW BALANCE	YEARLY INTEREST
YEAR 19					
1/2004	$ 73910.37	$739.10	$231.65	$ 73678.72	
2/2004	$ 73678.72	$736.79	$233.97	$ 73444.75	
3/2004	$ 73444.75	$734.45	$236.31	$ 73208.44	
4/2004	$ 73208.44	$732.08	$238.67	$ 72969.77	
5/2004	$ 72969.77	$729.70	$241.06	$ 72728.70	
6/2004	$ 72728.70	$727.29	$243.47	$ 72485.23	
7/2004	$ 72485.23	$724.85	$245.90	$ 72239.33	
8/2004	$ 72239.33	$722.39	$248.36	$ 71990.97	
9/2004	$ 71990.97	$719.91	$250.84	$ 71740.12	
10/2004	$ 71740.12	$717.40	$253.35	$ 71486.77	
11/2004	$ 71486.77	$714.87	$255.89	$ 71230.87	
12/2004	$ 71230.87	$712.31	$258.45	$ 70972.44	$8711.14
YEAR 20					
1/2005	$ 70972.44	$709.72	$261.03	$ 70711.41	
2/2005	$ 70711.41	$707.11	$263.64	$ 70447.77	
3/2005	$ 70447.77	$704.48	$266.28	$ 70181.48	
4/2005	$ 70181.48	$701.81	$268.94	$ 69912.55	
5/2005	$ 69912.55	$699.13	$271.63	$ 69640.92	
6/2005	$ 69640.92	$696.41	$274.34	$ 69366.58	
7/2005	$ 69366.58	$693.67	$277.09	$ 69089.48	
8/2005	$ 69089.48	$690.89	$279.86	$ 68809.62	
9/2005	$ 68809.62	$688.10	$282.66	$ 68526.97	
10/2005	$ 68526.97	$685.27	$285.48	$ 68241.48	
11/2005	$ 68241.48	$682.41	$288.34	$ 67953.14	
12/2005	$ 67953.14	$679.53	$291.22	$ 67661.92	$8338.54
YEAR 21					
1/2006	$ 67661.92	$676.62	$294.13	$ 67367.78	
2/2006	$ 67367.78	$673.68	$297.08	$ 67070.70	
3/2006	$ 67070.70	$670.71	$300.05	$ 66770.66	
4/2006	$ 66770.66	$667.71	$303.05	$ 66467.61	
5/2006	$ 66467.61	$664.68	$306.08	$ 66161.53	
6/2006	$ 66161.53	$661.62	$309.14	$ 65852.39	
7/2006	$ 65852.39	$658.52	$312.23	$ 65540.16	
8/2006	$ 65540.16	$655.40	$315.35	$ 65224.80	
9/2006	$ 65224.80	$652.25	$318.51	$ 64906.30	
10/2006	$ 64906.30	$649.06	$321.69	$ 64584.61	
11/2006	$ 64584.61	$645.85	$324.91	$ 64259.70	
12/2006	$ 64259.70	$642.60	$328.16	$ 63931.55	$7918.68

PAYMENT DATE	OLD BALANCE	INTEREST PAID	PRINCIPAL PAID	NEW BALANCE	YEARLY INTEREST
YEAR 22					
1/2007	$ 63931.55	$639.32	$331.44	$ 63600.11	
2/2007	$ 63600.11	$636.00	$334.75	$ 63265.36	
3/2007	$ 63265.36	$632.65	$338.10	$ 62927.26	
4/2007	$ 62927.26	$629.27	$341.48	$ 62585.77	
5/2007	$ 62585.77	$625.86	$344.90	$ 62240.87	
6/2007	$ 62240.87	$622.41	$348.35	$ 61892.53	
7/2007	$ 61892.53	$618.93	$351.83	$ 61540.70	
8/2007	$ 61540.70	$615.41	$355.35	$ 61185.36	
9/2007	$ 61185.36	$611.85	$358.90	$ 60826.46	
10/2007	$ 60826.46	$608.26	$362.49	$ 60463.97	
11/2007	$ 60463.97	$604.64	$366.11	$ 60097.85	
12/2007	$ 60097.85	$600.98	$369.78	$ 59728.08	$7445.58
YEAR 23					
1/2008	$ 59728.08	$597.28	$373.47	$ 59354.60	
2/2008	$ 59354.60	$593.55	$377.21	$ 58977.39	
3/2008	$ 58977.39	$589.77	$380.98	$ 58596.41	
4/2008	$ 58596.41	$585.96	$384.79	$ 58211.62	
5/2008	$ 58211.62	$582.12	$388.64	$ 57822.98	
6/2008	$ 57822.98	$578.23	$392.52	$ 57430.46	
7/2008	$ 57430.46	$574.30	$396.45	$ 57034.01	
8/2008	$ 57034.01	$570.34	$400.41	$ 56633.59	
9/2008	$ 56633.59	$566.34	$404.42	$ 56229.17	
10/2008	$ 56229.17	$562.29	$408.46	$ 55820.71	
11/2008	$ 55820.71	$558.21	$412.55	$ 55408.16	
12/2008	$ 55408.16	$554.08	$416.67	$ 54991.49	$6912.47
YEAR 24					
1/2009	$ 54991.49	$549.91	$420.84	$ 54570.66	
2/2009	$ 54570.66	$545.71	$425.05	$ 54145.61	
3/2009	$ 54145.61	$541.46	$429.30	$ 53716.31	
4/2009	$ 53716.31	$537.16	$433.59	$ 53282.72	
5/2009	$ 53282.72	$532.83	$437.93	$ 52844.79	
6/2009	$ 52844.79	$528.45	$442.31	$ 52402.48	
7/2009	$ 52402.48	$524.02	$446.73	$ 51955.76	
8/2009	$ 51955.76	$519.56	$451.20	$ 51504.56	
9/2009	$ 51504.56	$515.05	$455.71	$ 51048.85	
10/2009	$ 51048.85	$510.49	$460.27	$ 50588.59	
11/2009	$ 50588.59	$505.89	$464.87	$ 50123.72	
12/2009	$ 50123.72	$501.24	$469.52	$ 49654.20	$6311.76

PAYMENT DATE	OLD BALANCE	INTEREST PAID	PRINCIPAL PAID	NEW BALANCE	YEARLY INTEREST
YEAR 25					
1/2010	$ 49654.20	$537.92	$458.85	$ 49195.35	
2/2010	$ 49195.35	$532.95	$463.82	$ 48731.53	
3/2010	$ 48731.53	$527.92	$468.85	$ 48262.69	
4/2010	$ 48262.69	$522.85	$473.92	$ 47788.77	
5/2010	$ 47788.77	$517.71	$479.06	$ 47309.70	
6/2010	$ 47309.70	$512.52	$484.25	$ 46825.45	
7/2010	$ 46825.45	$507.28	$489.49	$ 46335.96	
8/2010	$ 46335.96	$501.97	$494.80	$ 45841.16	
9/2010	$ 45841.16	$496.61	$500.16	$ 45341.01	
10/2010	$ 45341.01	$491.19	$505.58	$ 44835.43	
11/2010	$ 44835.43	$485.72	$511.05	$ 44324.37	
12/2010	$ 44324.37	$480.18	$516.59	$ 43807.79	$6114.83
YEAR 26					
1/2011	$ 43807.79	$474.58	$522.19	$ 43285.60	
2/2011	$ 43285.60	$468.93	$527.84	$ 42757.76	
3/2011	$ 42757.76	$463.21	$533.56	$ 42224.20	
4/2011	$ 42224.20	$457.43	$539.34	$ 41684.85	
5/2011	$ 41684.85	$451.59	$545.18	$ 41139.66	
6/2011	$ 41139.66	$445.68	$551.09	$ 40588.57	
7/2011	$ 40588.57	$439.71	$557.06	$ 40031.51	
8/2011	$ 40031.51	$433.67	$563.10	$ 39468.41	
9/2011	$ 39468.41	$427.57	$569.20	$ 38899.22	
10/2011	$ 38899.22	$421.41	$575.36	$ 38323.86	
11/2011	$ 38323.86	$415.18	$581.60	$ 37742.27	
12/2011	$ 37742.27	$408.87	$587.90	$ 37154.37	$5307.83
YEAR 27					
1/2012	$ 37154.37	$402.51	$594.26	$ 36560.10	
2/2012	$ 36560.10	$396.07	$600.70	$ 35959.40	
3/2012	$ 35959.40	$389.56	$607.21	$ 35352.19	
4/2012	$ 35352.19	$382.98	$613.79	$ 34738.40	
5/2012	$ 34738.40	$376.33	$620.44	$ 34117.96	
6/2012	$ 34117.96	$369.61	$627.16	$ 33490.80	
7/2012	$ 33490.80	$362.82	$633.95	$ 32856.85	
8/2012	$ 32856.85	$355.95	$640.82	$ 32216.03	
9/2012	$ 32216.03	$349.01	$647.76	$ 31568.27	
10/2012	$ 31568.27	$341.99	$654.78	$ 30913.49	
11/2012	$ 30913.49	$334.90	$661.87	$ 30251.61	
12/2012	$ 30251.61	$327.73	$669.04	$ 29582.57	$4389.44

PAYMENT DATE	OLD BALANCE	INTEREST PAID	PRINCIPAL PAID	NEW BALANCE	YEARLY INTEREST
YEAR 28					
1/2013	$ 29582.57	$320.48	$676.29	$ 28906.28	
2/2013	$ 28906.28	$313.15	$683.62	$ 28222.66	
3/2013	$ 28222.66	$305.75	$691.02	$ 27531.64	
4/2013	$ 27531.64	$298.26	$698.51	$ 26833.12	
5/2013	$ 26833.12	$290.69	$706.08	$ 26127.05	
6/2013	$ 26127.05	$283.04	$713.73	$ 25413.32	
7/2013	$ 25413.32	$275.31	$721.46	$ 24691.86	
8/2013	$ 24691.86	$267.50	$729.28	$ 23962.59	
9/2013	$ 23962.59	$259.59	$737.18	$ 23225.41	
10/2013	$ 23225.41	$251.61	$745.16	$ 22480.25	
11/2013	$ 22480.25	$243.54	$753.23	$ 21727.02	
12/2013	$ 21727.02	$235.38	$761.39	$ 20965.62	$3344.29
YEAR 29					
1/2014	$ 20965.62	$227.13	$769.64	$ 20195.98	
2/2014	$ 20195.98	$218.79	$777.98	$ 19418.00	
3/2014	$ 19418.00	$210.36	$786.41	$ 18631.59	
4/2014	$ 18631.59	$201.84	$794.93	$ 17836.66	
5/2014	$ 17836.66	$193.23	$803.54	$ 17033.12	
6/2014	$ 17033.12	$184.53	$812.24	$ 16220.87	
7/2014	$ 16220.87	$175.73	$821.04	$ 15399.83	
8/2014	$ 15399.83	$166.83	$829.94	$ 14569.89	
9/2014	$ 14569.89	$157.84	$838.93	$ 13730.96	
10/2014	$ 13730.96	$148.75	$848.02	$ 12882.94	
11/2014	$ 12882.94	$139.57	$857.21	$ 12025.74	
12/2014	$ 12025.74	$130.28	$866.49	$ 11159.24	$2154.87

PAYMENT DATE	OLD BALANCE	INTEREST PAID	PRINCIPAL PAID	NEW BALANCE	YEARLY INTEREST
YEAR 30					
1/2015	$ 11159.24	$120.89	$875.88	$ 10283.37	
2/2015	$ 10283.37	$111.40	$885.37	$ 9398.00	
3/2015	$ 9398.00	$101.81	$894.96	$ 8503.04	
4/2015	$ 8503.04	$ 92.12	$904.65	$ 7598.38	
5/2015	$ 7598.38	$ 82.32	$914.45	$ 6683.93	
6/2015	$ 6683.93	$ 72.41	$924.36	$ 5759.57	
7/2015	$ 5759.57	$ 62.40	$934.37	$ 4825.19	
8/2015	$ 4825.19	$ 52.27	$944.50	$ 3880.70	
9/2015	$ 3880.70	$ 42.04	$954.73	$ 2925.97	
10/2015	$ 2925.97	$ 31.70	$965.07	$ 1960.90	
11/2015	$ 1960.90	$ 21.24	$975.53	$ 985.37	
12/2015	$ 985.37	$ 10.67	$986.00	$ -.73	$ 801.27*
YEAR 31					

****

TOTAL INTEREST PAID $228926.34

INTEREST RATE	# OF YEARS FOR THAT RATE	CONSTANT PAYMENT MONTHLY
.0900	6	804.62
.1000	6	869.78
.1100	6	926.51
.1200	6	970.75
.1300	6	996.77

ments are applied. This schedule was computed using the program "Mortgage Analysis" copyright 1983 by Howard F. Jackson, Jr. This program is available for purchase by contracting the author.

You still have more homework to do. A monthly housing budget still has to be developed because there might be other costs that must be considered.

*The last payment is different due to rounding.

MALPRACTICE AND THE REAL ESTATE APPRAISER

Our society has been acutely law-suit aware lately. This trend is certain to continue and is sure to impact on the real estate community. Looking at the same situation in the medical and municipal area it seems unlikely that the situation will moderate.

Recent newspaper articles have placed the blame for bad real estate loans on real estate appraisers. Borrowers, however, default on real estate loans for a myriad of reasons, such as poor underwriting policies, support documentation failures, construction cost overruns, overly optimistic cash flow projections, lease terminations, market aberrations or fluctuations, interest rate changes, sudden changes in energy prices, or international economic problems. Real estate appraisers are generally not responsible for these situations. However, appraisers do have a fiduciary responsibility. The problem is to whom do appraisers owe this responsibility? The client? All readers of the appraisal report? The whole world? What happens in the case of missuse, such as a poor underwriting decision? or an appraisal wrongly used for the wrong purpose....???. Is the apprai still responsible?

A recent case dealing with accounting malpractice could have a large impact on the financial community because there are distinct parallels between the accounting profession and the appraisal profession. Both are responsible for independently investigating a financial entity, preparing an analysis and a conclusion, and issuing a report that is relied upon by others. Thus, it is important for appraisers to be aware of recent legal developments in the accounting area that could have substantial, harmful side effects on the real estate appraisal profession, as well as the general real estate and financial communities.

Historical Perspective

A brief discussion of law is in order. There had been in effect a longstanding legal precedent concerning liability. If a manufacturer was negligent in the production of a product and that product caused injury to an innocent buyer, the manufacturer was generally held liable for the buyer's injury. Liability was based on a legal theory known as "privity of contract": to those who "contracted" to purchase a product, the manufacturer owed a duty to use reasonable care in the manufacture of that product; that duty did not extend to others. In 1931, in deciding a lawsuit involving an accountant, the legendary judge Benjamin Cardozo called on this theory in

holding that in the preparation of financial statements, accountants were liable only to those parties with whom they had contracted, i.e., their direct clients. Many states soon adopted a similar position.

More recently, the doctrine of privity of contract began to erode. Initially some state courts held that accountants were liable to third parties who relied on the accountants' reports, if the accountants actually knew of that reliance. By 1982-83, other courts had gone further, holding accountants liable to parties whose reliance, while perhaps not known specifically, was "reasonably foreseeable."

Before going on further, there are two terms which should be defined. They are malpractice and negligence. In a lawsuit of this type, one or both of these terms would be utilized.

Malpractice Defined

Malpractice could be defined as follows:

> Professional misconduct or unreasonable lack of skill. Failure of one rendering professional services to exercise that degree of skill and learning commonly applied under all circumstances in the community by the average prudent reputable member of the profession with the result of injury, loss or damage to the recipient of those services or to those entitled to rely upon them. it is any professional misconduct, unreasonable lack of skill or fidelity in professional or fiduciary duties, evil practice, or illegal or immoral conduct. Matthews v. Walker 34 Ohio App. 2d, 128, N.E. 2 569,571, 63 O.O. 2d 208. (1)
>
> Bear in mind that this definition and many others in law evolve from case decisions.(Stare Decisis)

Other definitions are:

> "Malpractice" is treatment in manner contrary to accepted rules and within injurious results; hence any professional misconduct or unreasonable lack of skill or fidelity in performance of professional duties; wrong doing, etc., Sales v. Tauber - 27 Ohio N.P., N.S. 371 (2)
> "Malpractice" means any professional misconduct, unreasonable lack of skill or fidelity in professional or fiduciary duties, evil practice or illegal or immoral conduct, Gregory v. McInnis 134 S.E. 527, 529, 140, S.C. 52 (3)

Negligence Defined

"Negligence" is a departure from the normal or what should be the normal, and is a failure to conform to standard of what a reasonably prudent man would ordinarily have done under the circumstances, or is doing what such man would not have done under the circumstances. Moran v. Pittsburgh - Des Moines Steel Co., D.C. Pa. 86 F. Supp. 255. (4)

"Negligence" being failure to do that which ordinarily prudent man would do or doing of that which such a man would not do under same circumstances, an ordinary custom, while relevant and admissible in evidence of negligence, is not conclusive thereof, especially where it is clearly a careless or dangerous custom. Tite v. Omaha Coliseum Corp., 12 N.W. 2d, 90, 94, 144 Neb. 22, 149, A.L.R. 1164 (5)

Whether or not an act or omission constitutes "negligence" seems to be determined by what under like circumstances would men of ordinary prudence have done. Cleveland C., C., & St. L.R. Co. v. Irvins, 12, O.C.D. 570 (6)

"Negligence: means simply the want of ordinary care under the circumstances surrounding that particular case and the transaction question, and "gegligently" simply means doing an act in such a manner that is lacks the care which men of ordinary prudence and foresight use in the everyday affairs of life under the same or similar circumstances. Smillie v. Cleveland Ry., Ohio 31 O.C.D. 323, 325, 20, Cir. Ct., R.N.S. 302 (7)

"Negligence" is the failure to do what a reasonable and prudent man would ordinarily have done under circumstances of situation or dion what such a person, under existing circumstances, would not have done. Judt v. Reinhardt Transfer Co. 17 Ohio Supp. 105, 197, 32, O.O. 161 (8)

The consensus of definitions indicates that negligence would occur if an appraiser did something that the "reasonable appraiser" would not do. Or he should have done something that the "reasonable appraiser" would have done.

The definitions could also be construed as follows:

The appraiser could be guilty of malpractice if that appraiser did or failed to do something that the standard of the appraisal industry dictated the appraiser should or shouldn't have done.

What constitutes the real estate appraisal industry? Is it all appraisers? Are they just the appraisers who give testimony in a malpractice action? The Wall Street Journal reported that there are some 200,000-300,000 appraisers. However, only 3% to 5% belong to appraisal organizations. Does this define real estate appraisal community? For now it would be up to a judge and/or jury. How the appraisal community is defined cluld make a dramatic difference in a court proceeding.

In the summer of 1985, the privity of contract issue was in the limelight again in the case of Credit Alliance Corp. v. Arthur Anderson & Co. (a "Big Eight" accounting firm). Credit Alliance's business was making speciality loans. In making such a loan to a borrower that went bankrupt, Credit Alliance had relied on financial statements prepared by Arthur Anderson that allegedly misrepresented the borrower's true financial position. Credit Alliance sued Arthur Anderson for negligence when the loan went sour.

In a decision the American Bar Associatin called "the most significant common law decision in the commercial law area in a generation," the New York Court of Appeals unanimously rejected Credit Alliance's claim. The court held that Credit Alliance had "failed to demonstrate the existence of a relationship (between it and Arthur Anderson) sufficiently approaching privity." Drawing from Cardozo's decision almost 35 years earlier, the court noted that to rule otherwise would potentially make accountants liable to "any number of an indeterminant class of creditors, present and prospective, known and unknown." (Unlimited and timeless liability)

The court also, however, described a three-part test under which accountants could be held liable to third parties:

The accountants must have been aware that their (1) reports would be used for a particular purpose, and (2) relied upon by a known party; and (3) there must have been some kinds of conduct on the part of the accountants which would link them to the "injured" third party.

Generally, this would have had no impact in terms of extensive liability since the act of reliance would occur long after the preparation of the report. However, in certain cases, banks are requiring accountants to affirmatively acknowledge that they may rely upon the financial statements prepared by the accountants. This usually formally executed statement effectively relieves the bank of responsibility. This also has the effect of "making

it substantially easier" for an attorney to win a malpractice action.

This impacts on the appraiser because like accountants they are in the business of analyzing the financial "health" of a parcel of real estate. Appraisal business is directly related to banks. By being required to sign these privity documents, the appraisers expose themselves to much additional liability. This is due to the fact much of the attorney's efforts are spent in a case tryin to establish the link between injured client and appraiser.

These reliance documents make it significantly easier for a "non-client" to sustain a liability action against the appraiser. This means that appraisers will have to charge higher fees to recover losses and pay for higher insurance (which is already difficult and expensive to obtain).

The implications of the higher fees are obvious. However, banks may begin not only to select reputable appraisers but also those who could withstand a large judgement. This could negatively impact small appraisal firms. This also could continue to put strong upward pressure on appraisal fees

Here is a compilation of some of the problem areas where appraisers could be held liable.

THE MOST COMMON ERRORS AND DEFICIENCIES IN REAL ESTATE APPRAISAL REPORTS

The following data is taken directly from a study compiled by the National Association of Review Appraisers and Mortgage Underwriters. Their information was based upon a private survey of over 300 Reviewers. It should be noted that results are not in order of frequency as the "errors" varied depending on the type of property and report being made.

1. Contract specifications not followed.
2. Typing, grammatical and punctuation errors.
3. Mathematical errors.
4. Poorly reproduced copies of supporting data and reports.

5. Poor exhibits - quality and relevance.

6. Poor overall format

7. Appraisers failing to understand the client's requirements or procedures.

8. Loading the appraisal with "Chamber of Commerce" type data without relating factual data to subject.

9. Inadequate history of property.

10. Errors in land area or building size.

11. Failure to properly consider zoning or potential zoning.

12. Failure to properly consider easements on the property.

13. Inadequate discussion of "Highest and Best Use".

14. Not adequately searching market for sales and leases.

15. Using comparables too far afield in size and use.

16. Failure to fully analyze and adjust all comparable data.

17. Abundant sales or rental data with little or no discussion relating to the subject.

18. Not using the same methods of measurement between comparables and subject.

19. Inconsistent adjustment patterns.

20. Relying on mathematical exercises, formulas, curves, etc. without relating them to subject property.

21. Failure to follow through in the analysis of data in the factual presentation.

22. Values derived on assumptions not consistent with the "Highest and Best Use" statement.

23. Inconsistencies between cost, market, and income approaches remaining economic life, depreciation and net returns.

24. Making unsupported adjustments for time.

25. Using techniques and procedures not appropriate to the problem.

26. Capitalization rates not current or adequately supported from the market.

27. Lack of clarity or explanation of the appraiser's reasoning or procedures.

28. Photographs of the subject that do not adequately show the property.

29. Report missing neighborhood data; trends of the subject area.

30. Appraiser utilizing inexperienced staff personnel without adequate supervision.

31. Failure to state why an approach to value has not been used.

32. Overall report is too short to adequately cover the property.

33. Positive or negative features of the property not mentioned.

34. Failure to deliver the report in a reasonable time or meet deadlines.

35. Failing to define clearly the property interest being appraised.

AREAS WHERE APPRAISERS SHOULDN'T BE HELD LIABLE

Here are some common areas where appraisers shouldn't be held liable.

There are other professionals that are also involved in a real estate transaction. Appraisers can't be held responsible for their actions. These professionals are relied upon by all in these transactions. Such related services are:

1. Survey
2. Title Search
3. Termite Inspections
4. Chemical Hazard Inspection

5. Blueprints
6. Legal Documents e.g. Certificate of Occupancy
7. Soil Conditions
8. Engineering Reports
9. Other Legal Matters

Appraisers do have to review certain expert reports provided to them during the course of an assignment. The most obvious is accountant's projections or other supplied financial projections. They can't just accept the figures blindly.

In conclusion, this article has discussed the major problems affecting the appraisal community. These problems also impact other areas of the real estate community in terms of uncertainty, higher appraisal costs, longer turn around time and other implications. The problem of malpractice and lawsuits are certainly not going to disappear overnight. There are three directions the real estate community can take 1) exert political pressure to reform federal and state tort law; 2) bring the other 93%-95% of the appraisers who don't belong to any organization under somekind of discipline or organizational oversight; 3) continue to develop and intensify a public awareness effort to the general public, financial institutions, legal professions and others for the need to use designated appraisers.

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RENT STABILIZATION & ILLEGAL TWO AND THREE FAMILY HOUSING:

A DE FACTO CONDEMNATION OF REAL PROPERTY RIGHTS

There has been much press coverage lately of the illegal two and three family homes. The issues of rent stabilization (includes rent control) have been the focal point of heated political debates. This article will attempt to illustrate that these two topics do constitute a defacto condemnation of real property rights and will consider the ramifications of such a conclusion.

Before starting a definition of the three essential aspects (rent stabilization, illegal two and three family housing, bundle of rights) are in order.

Rent Stabilization
This is where rents on multi-family housing are determined by statute rather than the market. In most cases the statute rent is significantly lower than the market rent. Since expenses are free to rise without contraint, the landlords of rent stabilized buildings face a shrinking net income and thus a loss in market value.

Illegal Two & Three Family Housing
This is a situation where certain one-family houses are converted (without permit - and in apparent violation of zoning ordinances) to two and three units. In this case the "convertor" receives rental income and avoids paying increased property taxes. The surrounding property owners suffer a loss in quality of services, higher property taxes and loss of value due to problems associated with rental homes unauthorized in a single family zoned area. This problem is exacerbated by real estate brokers renting these "illegal" units. (They are breaking the Department of State Law) and by lax, if non-existent enforcement by town government officials.

The basic issue stems from the "bundle of rights". The following is a definition.

Bundle of Rights
These rights are inherent with ownership of real property. They include: The right to use, build upon, lease, mortgage the real estate owned. These rights in their most comprehensive form are

called "fee simple estate". These rights are limited by four governmental constraints.

1. Police Power

2. Eminent Domain

3. Taxation

4. Escheat

The focal point is eminent domain which is the taking of private property for public good provided just compensation is paid. There are significant legal steps which must be taken to accomplish this. As can be readily seen, the problems to the real property owner are:

1. Rent Stabilization: The government laws prevent rental income from reaching market levels. Thus, the property owner is deprived from one of the basic "bundle of rights". The property owner has not received just compensation.

2. Illegal Two & Three Family Homes: By government "non-enforcement" of existing housing and tax laws certain property owners are unjustly enrighing themselves at the expense of the community at large. Many of these illegal houses are run down and actually cause a loss in value to surrounding property owners. This loss in value is not compensated by the government.

POSSIBLE SOLUTIONS

1. Class Action: Many of the individual home owners and certain landlords are unaware of their rights. Since millions of dollars are at stake on one hand and political considerations on the other, a suit for legal remedy brought by a single owner would probably be difficult. A class action would engender community spirit, correct delineation of issues and enhance financial and judicial support.

2. Criminal Remedies: Failure to uphold the law, non-payment (evasion of taxes) are two areas of remedy. Since this is on a very wide-spread basis (illegal housing only) a major effort on the part of law enforcement would have to occur. There would probably be political pressure exerted to leave the situation

alone. Law enforcement officials would have to resist that pressure in order to start to correct a long and significant history of these problems. Failure to do this would legitimize illegal activity. This would further hurt surrounding property owners attempting to comply with the laws and would engender a general spirit of non-compliance with other tax laws.

Lawyers are in a dilemma for they must advise their clients of all options. Should, in the case of illegal housing, counsel initiate "inverse condemnation proceedings and bring about a tax investigation? In the case of rent stabilization, should "inverse condemnation proceedings be instituted? The answer should be an unqualified "Yes" in all cases.

In order to accomplish this, it would initially require an expenditure of significant money for legal fees on the part of the client. But to advise the client to do nothing because of only the consideration of legal fees would allow the client to be unjustly deprived of certain rights <u>without</u> just compensation.

These issues have reached epidemic proportions and are sure to continue to grow. Perhaps a step toward an equitable solution for the injured real property owners would start with an investigation by the Bar Association. It would be in a position to resolve any legal and ethical issues and initiate (either as an entity or by directing counsel) appropriate remedy at law.

Should these issues be tried in a court of law and the issue of "inverse condemnation" be found in the affirmative in all cases, the amount of past money damages, for an intermediate sum of money to almost an indeterminate number of people could be in the billions of dollars. This would not include indirect damages or punitive damages.

MYTHS AND REALITIES OF THE "NO CASH DOWN" SEMINARS

THE LAND OF BILK AND MONEY

Over the last half year or so (1985) there have been a number of television programs which have promised financial independence through investment in real estate with "no money down," some despite "no job" and "no credit rating." One even promises that "you can become a millionaire in one day." All of this naturally, can be accomplished by attending such-and-such seminar and/or buying a course and a certain book or set of tapes. This message (often deliverd in hushed, "I-can't-do-enough-to-help-you" tones) is transmitted through a very clever mix of half-truth and fact; e.g., "a millionaire is made every 36 minutes; and of these, 90% made it in real estate." (If these contentions have ever been supported with authoritative documentation, I must have missed that particular airing.)

After having reviewed a number of shows and read their course material, it became obvious to me that, giving the benefit of doubt, hyperbole has reached new heights and the half-truth has become a new art form. Apparently, easy real estate wealth is the "snake oil" of the 80's.

One item that appears to be glossed over and is absolutely essential to successful real estate investing is the concept of value. Without an understanding of value, the possibility of successful investing in real estate becomes remote. This is unfortunate because you can become financially independent in real estate but you must understand value and the "market" in market value.

For example, one show says "buy a property at 50% of value, mortgage it for 75% of value and walk away from this transaction by putting down no money and even take some money out for yourself." We would all like to do this. But where does it tell the viewer how to determine the true market value of the property which is the essential elements in this technique.

Another example aired on the show portrays a man holding up a long computer list of foreclosures or troubled properties. He claims this is a good place to find good buys. This might be so but as an appraiser this would tell me, all things being equal, that the areas covered might be going down in value and not up. A novice investor (for whom this course is apparently intended) could get seriously hurt since there is far more to real estate than meets the eye. What would happen if that person could not

get a renter and could not pay the mortgage (remember no job, no credit and so forth)? The bank would surely foreclose and the novice investor would be in deep financial trouble. (Perhaps there's a follow-up course being developed - which you can also "buy for a song" - that covers such contingencies.)

Some programs describe circuitous methods of getting involved in a property by using "no cash" but, instead, by using a lot of one's time and effort. While these methods certainly are creative and could be put to use, I've always felt that time is money. As such I don't think this should qualify as "no cash down."

There are examples presented which describe common techniques used by real estate professionals for years. Many of these techniques involve finding a "motivated" seller. While this is an ideal situation, the majority of the markets the novice (and most others) will encounter don't have a ready supply of these people. In fact, just the opposite is true. Many investors make money in these regular markets, true, but they put down "low" cash, not "no cash."

Other techniques almost certainly require a minimum background knowledge of real estate and real property law. Some of the terminology mentioned is trust deed, lease, bond, and so forth. Test the general public's understanding of these terms at your next cookout and see what your conclusion is. And remember, the chances are good that your acquaintances are a little more sophisticated than the average would-be-TV-millionaire.

There are numerous other examples of this type of hyperbole. These shows invariably discuss having a "plan" with goals and working toward these goals. One of the steps in this "plan" is to acquire "specialized knowledge" - available for a pittance in light of the rewards soon to be gained. In some fashion, a loose-leaf manual (with lots of blank pages for notes and fill-ins) or a magic set of tapes has replaced classroom instruction, well-written books, field tutelage, and experienced counseling. All have been obviated by the "secret plan," the cure-all for low or lower middle-class financial insecurity.

Recently on the PBS television there was a show dealing with professional selling careers. Not surprisingly, the aspect of image was discussed at considerable length. And, once again, real estate salespeople "shared the low-run honors" with lawyers and car salesman for having the worst perceived image in the public's mind.

While not actually selling real estate, some of these "get-rich-quick" TV pitchmen - kissing-cousins to professional, career-minded real estate salespeople - are hurting the industry. An unsophisticated public does not take the time to differentiate, to apply subtle discernments. Everyone is painted (and tainted) with the same brush.

The major real estate organizations such as the National Association of Realtors, The Society of Real Estate Appraisers, American Institute of Real Estate Appraisers, American Society of Appraisers and other organizations have a stated goal of professional advancement for individuals. Their misssion cannot be faulted except that, in my view, it should be broadened - perhaps to include national public awareness programs on TV.

Real estate agents are on the front lines, so to speak, in dealing with the general public. They should take the initiative and alert the public to the dangers of these nothing down propositions. This probably could best be handled in cooperation with the local real estate board. A few items that could be pointed out to these potential investors is that superior expertise is required and there is exceptional risk. These investors also should be warned about surviving in a down or distressed market and obtaining 100% financing without misrepresenting facts to a lender.

As an appraiser, professor and author, I am greatly troubled to see this type of programming being aired to the public at large. It is bad for real estate's image (which is already deplorable) and there is a high probability that novice investors, who don't understand value and market realities, will sustain financial harm.

It is the inherent duty of the real estate community, professional organizations and publications to bring to the attention of the public issues such as this and to keep the public informed that, for the most part, the only people getting "rich quick" are those who are peddling (a most apt word) bogus elixirs.

THE REALITIES OF RENT CONTROL/STABILIZATION
"AN ECONOMIC DISASTER"

INTRODUCTION

In order to fully comprehend the effects that rent control has on the economy and the people in the economy a definition of rent control and this economic system is in order. (New York City will be the illustrative topic of discussion.)

Rent Control - This was a system devised and implemented during World War II to prevent war profiteering. Unfortunately, after the war, this system remained in effect, mostly because of politics and ignorance on the part of the general public. On one hand, the politicians don't want to remove rent control because the rents in their respective districts would go up to their Fair Market levels and this would make them look bad and ultimately lose votes and their political office. On the other hand, if rent control isn't removed, it could be the major cause of the economic downfall of New York City. In this system of rent control, the rents are frozen at a particular level. Then, after many years, the landlord might get a 7 1/2% increase if certain conditions were met. These conditions are arbitrary and are designed to keep rents practically frozen while expenses are free to rise.

Our Economic System - This system could best be described as a laissez-faire capitalistic system with certain modifications. In this system, the questions of what to produce, how to produce and for whom to produce are decided by the people. Whey they go to the store, they decide what they will buy. If the price is too high, people don't have to buy. Price is a message to both producer and consumer which ultimately correlates these issues effectively. They have alternatives. Technically, under this system government plays a small role but today government plays a larger part than it really should under the guise of social programs, subsidies, etc. When government plays a proper and less obvious role, the economy flourishes. Changing desires of people directed through political pressure will have a continuous changing effect on government's role. This type of economy is very responsive to and compatible with the free market system for, but its own indigenous operating laws, it will prevent a commodity from remaining on the market that people don't want. The pricing system is governed by supply and demand. If the prices at which all supplies would be willing to

supply a commodity were placed on a graph and the points were connected, a line (curvilinear) would be constructed and, if this line were superimposed on the line formed by all prices at which a buyer were willing to buy the commodity, one would see that the lines crossed at a certain point. This is called the market equilibrium price or free market price. The discussion of economics as to what makes price, cost, inflation, money supply would be infinite and is far outside the scope of this article. The important points to remember under the economic system are:

1) Prices are free to fluctuate based upon people's demand for and willingness to pay the prices of commodities. If the prices are too high, people don't have to pay; if they are too low, suppliers don't have to supply.
2) This economic system is a free system with small governmental influences with these influences taking part in social services and providing the stringent disciplines the currency system must have for a strong national and international economy.
3) The economy seems to have very definite internal operating laws where, if the economy isn't tampered with, many economic predictions can be forecast.
4) When the economy is doing well - low unemployment, low taxes, high G.N.P., good trade balances, etc., the general state of mind of the people is excellent for they are living in a free country (security needs fulfilled) and they are working and a making enough money to enjoy life (goals of self actualization being fulfilled).
5) As the readers who are not economists begin to see the economy is a very critical component part of the American way of life and that if the economy is unhealthy it could have very dramatic effects on the American way of life, e.g. W.W.II-which partially resulted from the 1929-30 depression and the energy crisis of 1973. There are other examples of this. Those who are economists already know this.
6) The psychology of the economy plays an important role in the economy's general health, the full impact of which is just beginning to be realized by the nation's leading economists. As this relates to real estate, a good example of psychology would be where the developer builds a 20,000 modular self-contained city. Soon after completion, word gets out that there is a faulty construction or hazardous material involved in the construction which resulted in an injury. Word gets out to the mass media and because of the impact this media has it introduces a negative element into the general public's psychology at this project and before long (even though the problem may not be serious) the development turns out to be a disaster. There are

countless other examples of how the psychology of the economy plays a dominant role in the overall operation of the economy.

With this basic understanding of rent control and the economic system under which we live, this author will demonstrate how rent control is destroying not only our economy but freedom as well. It will also show when one segment of the economy is unrealistically tampered with how (the tamperer) it can have very strange and, more often than not, negative side effects on other segments of the economy. The example utilized to demonstrate this will be rent control.

How Rent Control Started

Rent control had its origins during World War II. It was part of a national price freezing policy devised and implemented by the federal government to insure the "fair" allocation of resources and to prevent wartime profiteering.

After the war was over and conditions reverted back to normal, the federal controls passed to the state and by the late 1950's rent control had virtually disappeared except in New York, and more importantly, New York City.

How Rent Control Destroys

During an emergency such as World War II, rent control is the logical choice as "everything" is controlled. As the situation stands now in New York City, rent is the only item that is controlled. The mechanics of this systematic destruction can be easily seen. The landlord has a relatively fixed income. However, the expenses go up at an alarming rate. The landlord, in order to provide basic services to the tenants, has to forgo building maintenance and repairs, taxes become in arrears and before long, the building is abandoned. The building becomes run down and neglected. Other buildings in the area follow the same pattern. Many fires occur in the area. One fire captain reported to this author that in a certain fire district in an area in Brooklyn he had 27,000 alarms in one year. A fire district comprises only 50-75 square blocks. As a result of this, the area becomes a literal "no man's" land. In any of the seriously devastated areas only one building in fifty is tenable. This causes a serious drop in revenues to the city which forces the city to raise taxes on the already burdened buildings and starts to push them toward the brink of economic distaster. In the City of New York there are basically three types of apartment dwellings:

1) Pre-war old law tenament walk-ups

2) Post-war apartment built up to 1965
3) Buildings built after 1965

In the pre-war old law tenement category, 90% of the buildings are either destroyed or past the point of no return.

In the post-war to 1965 category, these buildings are in very serious trouble. The lending institutions are reporting 14%-20% of the buildings are over three months late in mortgage payments.

In the last class, rent control doesn't have much of an effect yet but most landlords surveyed report that their expenses have increased 60% over the last three years.

The psychology of the people living in these seriously blighted rent controlled areas is worth noting. This author has personally inspected over 1,500 of these old law tenements over the past five years and makes the following observations based on these inspections and various interviews:

1) The people who live in these seriously devastated areas have a market propensity to violently abuse the building in which they reside as well as surrounding real estate. This includes throwing garbage in the street, grafitti, breaking windows, stealing plumbing fixtures and appliances and other forms of destruction.
2) Because of this problem, business moves out of the area.
3) When people in these devastated areas are relocated to another building, usually a newer one, because they were burned out of the only one they were living in, they tend to bring this type of destructive cycle. In the last three months this author has personally seen a brand new FHA project in Brooklyn virtually destroyed in a period of 18 months. There are many other examples of this destructive behavior carried over.

The psychology of the people not living in these areas is noteworthy. They continue to pressure politicians to continue rent control, for they feel why do away with a system that is benefiting them. Obviously, they are ignorant of the economic facts of life.

This type of destructive cycle continues. Every time rent control comes up for a vote, the faster people come out and vote against it. The faster they do that, it seems, the faster their neighborhoods are nearing economic death. The City of New York, if conditions go unchecked, will reach a point where it will no

longer be able to support itself. This last summer may have been a prelude to that end.

Possible Short Term Solutions

In the areas where they are a majority of old law, pre-war tenements, there is no short term solution (eighteen months or less). In the other two previously mentioned housing segments, rent controls would have to be phased out at once but the answer lies only in a long term solution.

Possible Long Term Solutions

One of the major causes of this problem is economic, that is, the lack of investor capital to build new apartments in the city. The other problem is what to do with the devastated areas.

The answer to the first problem is to create a healthy financial climate for investors. This can only be done by having a profit motivation, like there is for any other commodity. When an investor sees he can make a profit, he will go into the city and build. This will increase the revenues to the city and over time the whole economic picture of the city should be greatly changed for the better. A ten year tax abatement program could also be offered to the developer as a further incentive. But, as this is being done, the city must solve the problem of the devastated housing. The only solution is to tear it down. An entire area must be completedly razed and then new projects can be built. It makes no sense to build a new high rise apartment in the middle of one of these disaster areas. A good exaample of a possible solution is Starret City in Brooklyn which is almost a planned urban community within the city consisting of housing, shopping, some offices, recreation, parking and adjacent to mass transportation. Only if this were done on a very large scale could the city turn the corner and finally solve the problem it is now faced with, but it must end rent control in order to even begin.

Conclusions

Rent control has been shown to be a direct cause of the rapid destruction of New York City's housing stock as well as being a major cause of its economic problems. Some of the headlines from the New York Real Estate Newspapers and other quotes read: "3-yr. Phase Out of Controls Demanded by Housing Coalition,"(1) "Landlords Open Drive to End Rent Control"(2), $2.50 Million Tax Arrears Predicted"(3), "Major Owner Groups Call for 3 yr. Phase-Out of Controls"(4), "California Warned Against Rent

Control"(5), "destructive to the free market system in principle..."(6), "Rent Control-Nobody Wins, Everybody Loses"(7).

Any landlord would be happy to show his P & L's of the last five years and almost without exception, he is becoming economically ruined.

Unfortunately, this author feels that rent control will not disappear by itself. It does, however, show signs of becoming the subject itself of some serious fighting in both the courts and the political scene in the upcoming months and years. Rent control/stabilization is a defacto condemnation of real property rights. See chapter in the book of that name.

Note: This is an adaptation of an article originally published in the New York State Bar Journal by Howard F. Jackson, Jr. This was written in 1978.

(1)Realty Vol. XXV, No. 664, June 1, 1976, Page 1.
(2)Real Estate Weekly, Volume 21, No. 16, November 10, 1975, Page 1.
(3)Ibid, articule by Edward Suztberger, President of Metropolitan Fair Rent Committee.
(4)Real Estate Weekly, Volume 21, No. 43, May 27, 1976.
(5)Real Estate Weekly, Volume 22, No. 24, January 10, 1977.
(6)Realtors Review, February 1977, Page 3, Quote by Joseph L. Yousem, President, Institute of Real Estate Management.
(7)Ibid-Front cover.

NEIGHBORHOOD DESCRIPTION

A neighborhood is an entity in which the property being appraised along with other properties exist. The four forces of values - social, political, economic, and environmental operate on properties in the same way.

The importance of understanding and analyzing a neighborhood can't be said often enough. If a neighborhood does well generally the properties in it also do well. Conversely, the reverse also could be true.

Defining the Neighborhood

There are delimiters of a neighborhood that can be seen and those that can't. By taking a large map certain physical items can be underscored such as the village boundaries, roads, land improvements, waterways, bridges, etc.

Items that can't be seen such as zoning classifications, census tract areas, standard metropolitan statistical areas, school districts, fire districts, can all be superimposed on the map.

After compiling this information, it should be cross-checked by field verification at such places as the assessor's office, chamber of commerce, planning commission, and by calling other real estate people.

Analyzing the Neighborhood

A neighborhood has four stages of existence.

1. Growth
2. Stability
3. Decline
4. Renewal

These stages could last many years or could be sudden (relatively speaking). Part of appraisal analysis is to locate the subject neighborhood within the cycle. It will then add further depth to the appraisal report.

Identifying the Factors That Influence Value

Social ...

1. Schools
2. Shopping
3. Community services
4. Police and fire protection
5. Presence or absence of litter
6. Presence or absence of crime

7. Recreational
8. Cultural

Political ...
1. Taxes
2. Assessment
3. Zoning - community planning

Economic ...
1. Employment types and income levels
2. Population demographics
3. Interest rates
4. Inflation rates
5. National economic trends as they relate to local conditions

This type of analysis could be lengthy on a large commercial appraisal. For residential appraisals, there are forms that could be utilized (see preceding section of book for example).

These forms are utilized by many appraisers across the United States.

THE THREE APPROACHES TO VALUE--AN APPRAISAL EXAMPLE

A full real estate appraisal is a report reduced to writing that covers the facts and methodology in arriving at a value estimate for a particular parcel of real property. (See What Is A Real Estate Appraisal? Section)

In the report, there are a number of items which lend to accuracy, clarity, and scope of analysis. They will not be covered in this book but will be mentioned.

1. Letter of Transmittal
2. Limiting Conditions
3. Certification
4. Appraisal Problem
5. Purpose of the Appraisal
6. Highest and Best Use
7. Description of Area and Neighborhood
8. Description of the Property

Following is the essential of an appraisal report showing the relevant analysis and presuming the above requirements of an appraisal have been completed.

The purpose of this section is not to show the reader how to write a report, but to illustrate the valuation concepts mentioned in the book and how they function together to formulate an estimate of value. The example here is an apartment house. On other types of Income Property the techniques would generally be similar but the data would be different.

Study the type of data used and how it was analyzed and presented.

THE COST APPROACH SECTION

COST APPROACH INTRODUCTION

The Cost Approach is one of the techniques utilized in estimating the Market Value of the subject property. This approach involves the estimation of the Replacement Cost NEW of the improvements under consideration. Replacement Cost is the cost of replacing the improvements NEW with one having equivalent utility and design features built with modern materials and according to current standards.

Following the analysis of the replacement cost, the property's accrued depreciation is deducted, resulting in the depreciated value of the improvements.

Depreciation is a loss in value from any cause. It is the difference between the value NEW of a structural improvement and depreciated cost as of the appraisal date.

Depreciation may be broadly classified under three categories:

Physical Depreciation - loss in value due to physical deterioration, wear and tear, and/or deferred maintenance.

Functional Obsolescence - loss in value due to the lack of utility or desirability of part or all the property inherent to the improvement.

Economic Obsolescence - loss in value due to causes outside the property and independent of it.

The remainder, after considering the various forms of depreciation, yields the depreciated value of the improvements. To this depreciated value estimate is added the market derived Land Value and appropriate on-site improvement costs. The result is the indicated value by the Cost Approach method.

Following is a detailed analysis of the Cost Approach as applied to the subject property.

COST ANALYSIS

The subject property was constructed in two phases in 1974 and 1977. It has a weighted effective age of eight (8) to ten (10) years. The remaining economic life is estimated at thirty (30) years. At the time of inspection, the property's overall level of maintenance was considered average with several items of deferred maintenance noted (See Property Description for further details).

In estimating the Replacement Cost NEW of the subject improvements, a study was made of the Marshall Cost Valuation Manual. The purpose of this analysis was to obtain the proper perspective on 1985 building replacement costs which are then adjusted for current and local costs as well as other refinements. Each of the selected unit costs considered the overall utility, quality, and construction characteristics of the existing improvements and was further buttressed by engineering publications.

The following, therefore, was indicated:

Marhsall Cost Service	Multiple Residences
Section 12	Page 13
Class D	Average
Base Unit Cost Selected	$30.00
Manual Date	December 1981

REPLACEMENT COST ESTIMATE

UNIT COMPARISON ESTIMATE/SQ.FT.

Base Unit Cost New/Sq.Ft.		$30.00
COST ADJUSTMENT MULTIPLIERS		
Current Cost (10/85) (1)	1.14	
Local Cost (10/85) (2)	.85	
Patios/Balconies/Fin.	x1.10	
Total Multiplier		x 1.07
Indicated Replacement Cost NEW/Sq.Ft.		$32.10
		RD TO $32.00

(1)This represents the difference between the Manual's Base Unit Cost, dated December 1981 and the effective date of valuation.

(2)Local Costs is a multiplier-utilized to reflect local cost conditions such as: Union wages, building conditions, construction volume, etc.

COST VALUATION

Gross Leasable Area (Sq.Ft.) (1)	173,000
Replacement Cost NEW/S.F. (2)	x $32.00
Indicated Cost NEW Before Depreciation	$ 5,536,000
Less Depreciation @ 25% (All Causes) (3)	- 1,384,000
Depreciated Value of Improvements	$ 4,152,000
Add Depreciated Basis On-Site Improvements	+ 325,000
Add Market Derived Land Value @ $1,400/Unit (4)	+ 325,000
Indicated Value by Cost Method	$ 4,802,000
RD to	$ 4,800,000

(1)Gross Leasable Area was calculated from information supplied by the current management. It is assumed to be accurate and representative of the improvements under valuation.
(2)Unit Cost NEW reflects an adjustment for exterior and interior finishes, heating and cooling system type, current and local costs, etc.
(3)The indicated estimate of depreciation was based on an analysis of physical, functional and economic obsolescence accrued to its structure as of the effective date of valuation. Depreciation was based on an age/life method with a lump sum added for deferred maintenance. The effective age is estimated at 8-10 years with a total economic life projection of 40 years. Functional and economic obsolescence were considered, however, not displayed with the subject improvements conforming substantially to other nearby multi-family complexes.
(4)The indicated Land Value estimate was primarily based on a direct sales comparison of multi-family land sales. In the final analysis, an estimated land value of $1,400/unit was selected (233 units x $1,400/unit = $325,000 Rd.).

DIRECT SALES COMPARISON APPROACH

DIRECT SALES COMPARISON METHOD

The appraisers completed an extensive market survey of the subject area. This market analysis is utilized for the purpose of estimating a Direct Sales Value conclusion for the Pines of Anytown Apartments. The significance of this approach is based on the quantity and quality of sales presented, in addition to consideration given to current supply and demand factors, basic rent levels, and overall unit characteristics and occupancy levels (e.g., unit size, unit price per square foot, overall unit price per land and building, gross rent multiplier, etc.).

A diligent search did not reveal sales in the City of Anytown suitable for drawing comparable conclusions. Therefore, the appraisers extended the search on a regional basis in North Carolina. Use of comparables on a regional basis is feasible because of the nature of the market.

The appraisers were able to select five (5) comparable multi-family sales which generally contained the salient characteristics as displayed by the subject property. Each of the selected sales was improved with similar apartments located within the regional area. Additionally, each sale was verified by at least one of the parties involved with the transaction or published sales information.

When appraisers utilized market sales data, it isn't always exactly comparable to the subject property. Therefore, adjustments must be made.

The technique is to layout the subject and sales on a spreadsheet. Then make adjustments to the sale for any differences. If the sale is superior to the subject, a minus adjustment is made. If the sale is inferior, a superior adjustment is made.

The next question is where are the adjustments obtained from? Answer - the market. A technique called paired sales method of analysis is one way of obtaining this information.

Assuming that the subject of the appraisal is a house, the appraiser would first find the sale of a typical house. This would be roughly similar to the subject. This sale then would be compared to other sales until an item of difference was found (one sale had an extra bath). The difference in sales price

would be then attributed to that feature. The appraiser would get additional sales to further support this.

For every feature, the appraiser would go through this iteration. Once having completed this, these adjustments could be utilized for other similar houses in the area.

Although this process has gleaned essential information from the market, that data applies to a particular market. The amount of adjustments may not apply to a new area. Great care must be exercised. The major units of comparison were based on an overall price per unit (Land and Improvements). Additional methods of comparison included monthly rent levels (e.g., per unit or per square foot), gross rent multipliers, and market derived capitalization rates.

A cash equivalency analysis was not considered appropriate in this report with the selected sales reflecting the current interactions of a willing buyer and a willing seller within the local marketplace. The selected sales all were typical of the current market conditions. The sales terms generally consisted of a cash payment and the balance financed. The mortgage terms were at interest rates in the current range with various payout schedules. Financing generally consisted of an underlying first mortgage and either a second mortgage or a wraparound mortgage with the property as security. Since the sales represent the current market transactions, no adjustment for a cash equivalency is indicated. Additionally, most of the sales were acquired by nationally oriented investors and subsequently resold (syndicated) at an increased purchase price.

Following are the individual comparable sales summary sheets, appropriate adjustment analysis, and Market Value conclusion as derived from the Direct Sales Comparison Approach.

DIRECT SALES SUMMARY GRID

SALE NO.	SALE DATE	AGE	PRICE/UNIT	GIM	OAR
1	05/23/84	1979/ 1980	$35,888	8.71	.0759
2	01/19/84	1969/ 1972	$26,039	8.06	.0714
3	10/31/83	1979/ 1980	$36,700	7.70	.0760
4	07/29/83	1976/ 1980	$26,980	6.58	.0915
5	06/23/83	1981	$28,125	7.17	.0893

IMPROVED APARTMENT SALE NO. 1

Project Name:	Forest Oaks
Address:	Old Wake Forest Road Raleigh, North Carolina
Grantor:	The Forest Oaks Apartment Co.
Grantee:	McCombs Properties, VII, Ltd.
Sale Date:	May 23, 1984
Legal Reference:	Book 3133, Page 328
Consideration:	$7,177,660
Terms of Sale:	*$2,100,000 cash, assumed first mortgage of $3,653,099 (30 years @ 10.25%, call in 1996), new second mortgage for $1,046,901, interest only, 10 years
Number of Units:	200
Year of Construction:	1979-1980
Net Rentable Area:	201,180 Square Feet
Average Unit Size:	1,006 Square Feet
Estimated Gross Income:	$824,220 (including 5% vacancy)
Expenses:	$279,486 (34% EGI) $1,397/Unit, $1.39/Square Foot
Net Operating Income:	$544,734
Sale Price/Unit:	$35,888
Sale Price/Sq.Ft.:	$35.68
Gross Income Multiplier:	8.71
Overall Rate:	7.59%

*Total cash and financing equals $6,800,000. The remainder of the purchase price contained a commission of $377,660 to McCombs Realty. The estimated gross income includes an estimated vacancy of 5%. Actual vacancy at the time of sale was 9%, while the complex is currently reported to be at 97% occupancy

UNIT BREAKDOWN

UNIT TYPE	# UNITS	SIZE/SQ.FT.	RENT/SALE
1bed/1bath	50	788	$315-$330
2bed/2bath	110	1,042	$355-$370
3bed/2bath	40	1,179	$400-$415

100 units have fireplaces which command $15/month extra rent

IMPROVED APARTMENT SALE NO. 2

Project Name:	Tar River Estates
Address:	1401 Willow Street Greenville, North Carolina
Grantor:	VREI Corporation
Grantee:	Shelter Properties V
Sale Date:	January 19, 1984
Legal Reference:	Book P-52, Page 196
Cnsideration:	$10,650,000
Terms of Sale:	$3,013,277 cash, $3,000,000 cash in three months, assume existing first mortgage of $4,286,783 @ 9.5%, matures 1/1/2008, PMM for $350,000 @ 11%, interest only, for seven years
Number of Units:	409
Year of Construction:	1970±
Net Rentable Area:	401,700 Square Feet
Average Unit Size:	982 Square Feet
Estimated Gross Income:	$1,321,293
Expenses:	$560,608 (38% EGI) $1,328/Unit, $1.35/Square Foot
Net Operating Income:	$760,685
Sale Price/Unit:	$26,039
Sale Price/Sq.Ft.:	$26.51
Gross Income Multiplier:	8.06
Overall Rate:	7.14%

Comments:

Brick apartment complex built in three phases from 1969 to 1972, containing one, two, and three bedroom units in 59 buildings. Garden and townhouse styles. Some units have washer/dryer connections. The complex is located on 29.17 acres, and includes four laundry rooms and four storage buildings. Amenities include a 140,000 gallon pool and kiddie pool

UNIT BREAKDOWN

UNIT TYPE	# UNITS	SIZE/SQ.FT.	RENT/SALE
1bed/1 bath/Garden	152	700	$240
2bed/1.5bath/TH	60	1,067	270
2bed/1.5bath/TH	66	1,067	280
2bed/1.5bath/TH	74	1,067	290
3bed/1.5bath/TH	15	1,200	320
3bed/2.5bath/TH	33	1,500	355
3bed/2.5bath/TH	8	1,550	395
3bed/2.5bath/TH	1	2,000	450

IMPROVED APARTMENT SALE NO. 3

Project Name:	Courtney Square
Address:	4600 Dansey Drive Raleigh, North Carolina
Grantor:	Millbrook Associates, Ltd.
Grantee:	Jacques-Miller Realty Partners
Sale Date:	October 31, 1983
Legal Reference:	Book 3211, Page 276
Consideration:	$7,340,000
Terms of Sale:	$3,390,000 cash, assumed first mortgage at 9-7/8% with balance of $3,650,000, second mortgage for $300,000 at no interest for eight years
Number of Units:	200
Year of Construction:	1979-1980
Net Rentable Area:	204,400 Square Feet
Average Unit Size:	1,022 Square Feet
Estimated Gross Income:	$953,000
Expenses:	$395,000 (41% EGI) $1,975/Unit, $1.93/Square Foot
Net Operating Income:	$558,000
Sale Price/Unit:	$36,700
Sale Price/Sq.Ft.:	$35.91
Gross Income Multiplier:	7.70
Overall Rate:	7.60%

Comments:

Townhouse apartment complex just off Highway 401. Property is of contemporary style, and features cedar siding, thermopane windows and heat pump. Extensive landscaping. Amenities include a swimming pool. No tennis court or clubhouse

UNIT BREAKDOWN

UNIT SIZE	# UNITS	SIZE/SQ.FT.	RENT/SALE
1bed/1 bath	40	700	$330
1bed/1 bath/FP	40	700	340
2bed/1.5bath	20	1,100	405
2bed/1.5bath/FP	20	1,100	415
2bed/2.5bath	20	1,200	415
2bed/2.5bath	20	1,200	425
3bed/1.5bath/FP	20	1,320	460
3bed/2.5bath/FP	20	1,500	490

IMPROVED APARTMENT SALE NO. 4

Project Name:	Spring Forest
Address:	Spring Forest Road Raleigh, North Carolina
Grantor:	Cecil D. Hylton
Grantee:	Raleigh Spring Forest Apt. Association
Sale Date:	July 29, 1983
Legal Reference:	Book 3151, Pages 466-470
Consideration:	$10,900,000
Terms of Sale:	$3,122,077 cash, assumed existing mortgages with remaining balance of $6,877,923. New mortgage of $900,000. Total annual debt service of $907,080
Number of Units:	404
Year of Construction:	1976-1980
Net Rentable Area:	407,742 Square Feet
Average Unit Size:	1,009 Square Feet
Estimated Gross Income:	$1,657,594 (5% vacancy)
Expenses:	$660,000 (40% EGI) $1,634/Unit, $1.62/Square Foot
Net Operating Income:	$997,594
Sale Price/Unit:	$26,980
Sale Price/Sq.Ft.:	$26.73
Gross Income Multiplier:	6.58
Overall Rate:	9.15%

Comments: Garden apartment complex of two and three story buildings. Constructed in two phases (1976 and 1980). All masonry construction. Some units are heated with natural gas, while others have heat pumps. Complex is sparsely landscaped, and appeal is inferior to subject. At the time of sale, many areas of deferred maintenance were evident

UNIT BREAKDOWN

UNIT TYPE	# UNITS	SIZE/SQ.FT.	MO.RENT	RENT/SQ.FT.
1bed/1bath	92	672	$300	$0.45
1bed/1bath	92	672	315	0.47
1bed/1bath	92	672	310	0.46
1bed/1bath	92	779	335	0.43
1bed/1bath	92	779	330	0.42
1bed/1bath	92	942	355	0.36
1bed/1bath	92	942	350	0.37
1bed/1bath	92	878	340	0.39
2bed/1bath	264	844	355	0.42
2bed/1bath	264	844	340	0.40
2bed/1bath	264	844	366	0.43
2bed/1bath	264	844	350	0.41
2bed/1bath	264	909	360	0.40
2bed/1bath	264	844*	309	0.37
2bed/1bath	264	844*	319	0.38
2bed/2bath	264	1,188	381	0.32
2bed/2bath	264	1,188	386	0.32
2bed/2bath	264	1,188	391	0.33
2bed/2bath	264	1,188	345	0.29
2bed/2bath	264	1,188	371	0.31
2bed/2bath	264	1,188	376	0.32
2bed/2bath	264	1,188	381	0.32
2bed/2bath	264	1,294	386	0.30
2bed/2bath	264	1,294	391	0.30
2bed/2bath	264	1,294	381	0.29
2bed/2bath	264	1,188	371	0.31
2bed/2bath	264	1,188	376	0.32
3bed/2bath	48	1,231	448	0.36

*Handicap units

Comments: These are all garden units. One and two bedroom units have a variety of

features which affect rents. These include fireplaces, dens, wet bars, and sitting rooms

IMPROVED APARTMENT SALE NO. 5

Project Name:	Green Meadows Apartments
Address:	Green Road at Brockton Drive Raleigh, North Carolina
Grantor:	Westminster Company
Grantee:	Fidelity Equities Corporation
Sale Date:	June 23, 1983
Legal Reference:	Book 3135, Page 814
Consideration:	$2,700,000
Terms of Sale:	*All cash to seller, with buyer obtaining new mortgage at 12% with 30 year amortization, 8 year call, interest only, 5 years (see comments)
Number of Units:	96
Year of Construction:	1981
Net Rentable Area:	74,304 Square Feet
Average Unit Size:	774 Square Feet
Estimated Gross Income:	$376,314 (including 5% vacancy)
Expenses:	$135,260 (36% EGI) $1,409/Unit, $1.82/Square Foot
Net Operating Income:	$241,054
Sale Price/Unit:	$28,125
Sale Price/Sq.Ft.:	$36.34
Gross Income Multiplier:	7.17
Overall Rate:	8.93%

*New financing (obtained by purchaser) in amount of $1,850,000 represents 69% of purchase price

Comments: Garden apartment complex constructed in 1981. Construction features masonry and frame materials. Washer/dryer connections are located in all units. No fireplaces available

UNIT BREAKDOWN

UNIT SIZE	# UNITS	SIZE/SQ.FT.	RENT/SALE
1bed/1 bath/Garden	43	643	$320
1bed/1 bath/Garden	5	643	250*
2bed/1.5bath/Garden	48	905	375

*Special rent handicapped unit

DIRECT SALES COMPARISON METHOD
CORRELATION AND CONCLUSIONS

Based on the sampling of sales presented, the appraisers have selected the price per unit method as the primary valuation indicator. This method of comparison was based on an analysis of five (5) multi-family improved sales. Each of the improved sales is located in the subject regional market area in North Carolina, is of recent date, and was verified by deed reference/or assessor's records.

In comparing each sale to the subject property, a series of market derived adjustments were necessary. These adjustments considered such factors as date of sale, locational features, property and/or unit size, age and construction characteristics, and overall site amenities. The sale price per unit before adjustments ranged from $26,039 to $36,700. The adjusted comparable sales ranged from $22,393 to $27,892 per unit.

After analyzing each of the improved multi-family sales, the following findings are indicated:

SALE NO.	UNIT PRICE BEFORE ADJUSTMENT	ADJUSTED PRICE/UNIT
1	$35,858	$ 24,383
2	$26,039	$ 22,394
3	$36,700	$ 27,892
4	$26,980	$ 22,393
5	$28,125	$ 26,438

The adjusted sales resulted in a narrow per unit value range of $22,000 to $27,000. In the final analysis, the appraisers have selected a Direct Sales value of $22,500 per unit. The following Direct Sales Comparison conclusion is indicated:

SUBJECT'S # OF UNITS		ESTIMATED MARKET PRICE/UNIT		DIRECT SALES VALUE CONCLUSION(1)
233	x	$22,500	=	$ 5,250,000(RD)

(1)The indicated Direct Sales Value Conclusion of $5,250,000 equates into a square foot cost of $30.35/GLA.

The average adjusted selling price of the selected sales calculates into a per unit value estimate of $24,700. Based on the foregoing, it is the appraisers' opinion that the Direct Sales Comparison Method provided a reliable basis of valuation analysis.

Each of the selected sales are further utilized in the Direct Sales Capitalization and Gross Income Multiplier Sections of this report.