Real Estate Development and Investment: Phase 1 Seminar

I. Real Estate in America – An Enterprising History

The acquisition of land, homeownership, property ownership, developing an area you've decided to buy into something functional, practical, beautiful, for yourself or for others—these are the guarantees entitled to everyone in America, no matter what their background or beliefs. Part of the agreement between the country and its citizens was that property would be protected, land could be purchased at a fair price, and the government would not interfere in the pursuit of individual prosperity.

At first, only the very wealthy owned land in America. While most home ownership in the country was conscribed to farmers or those in rural areas, most everyone else hadn't the ways or the means to own, nor the land or upon which to build a home. The rapid advances in industry in the 19th century however, changed that profoundly. The Industrial Revolution ushered in a period of domestic prosperity that even classical economists couldn't have predicted, though it was the National Banking Acts of 1863 and 1864, the first of the Civil War banking reforms, that helped to guarantee homeownership to working-class people in America.

Mortgages became commonplace. After the federal government took over and stabilized the banking industry (it had been regulated by the states before), by 1865 it slowly began lending money to qualified individuals so they could put money down for a home, a venture on which the state banks had refused to gamble. It proved successful for the prosperity of America. People were now taking great advances toward fulfilling their dreams as property owners, and things advanced quite regularly for a long time.

The Panic of October, 1907, however, forced the government to rethink its banking system. Since 1831, with the expiration of the charter of the Second National Bank, the government had not had a centralized bank to its name. The Wilson administration saw the need for upgrading the federal banking system and, in 1913, Congress passed the Federal Reserve Act. This law stabilized prices for goods and services, safeguarded the economy against inflation and, for the first time, allowed banks to provide mortgage loans for farmers. As a result, more and more American felt reassured and confident that they, too, could be approved for assistance in the form of a mortgage loan.

What followed was a boom in homeownership in America. While home prices had fluctuated for as long as lenders had been offering mortgages, beginning in the mid-1910s they suddenly and sharply began to drop and this, along with new techniques in mass-production, and the ease with which the average American was able to buy a home, began the residential real estate boom that fed into the roaring '20s.

But by 1930, things began to change drastically. Not long after the Great Depression took hold of the economy, money became scarce—be it for lending, borrowing or everyday purchasing. For years, the real estate market stagnated.

One of the many aims of the New Deal, the Roosevelt Administration's herculean effort to stay the indefinite blight of the Depression, was to help American homeowners. The Home Owners' Loan Corporation (1933), the Federal Housing Administration (1934) and the Federal National Mortgage Association (now Fannie Mae, 1938) were all established to stabilize the housing market, stop the housing crash and, eventually, spur homeownership to new heights in the future.

It was in the aftermath of the Second World War, however, which brought by far the greatest opportunity to Americans to take advantage of what the government could offer them. The GI Bill of 1944 provided subsidized mortgages for veterans that changed the housing industry and the face of the American economy itself.

The GI Bill's benefits included low-cost mortgages and low-interest loans to start a business or farm. These subsidies led to not only an escalated demand for housing but, more importantly, the development of the suburbs. An amazing one-fifth of all single-family homes built in the decades after World War II were financed with help from the GI Bill's loan guarantee program, symbolizing the emergence of a new middle class.

As homebuying became more common and, hence, as more red tape became involved, real-estate brokers helped sellers find buyers for their homes. Though the National Association of Real Estate Boards adopted the term Realtor in 1916, the real-estate profession really began to take off during the postwar years. And as demand for housing increased, so did prices. Many began to see the purchase of real estate as perhaps the wisest investment for their future.

But before we talk any further about investment, let's first delve into how any area of surveyed land gets turned into a commercially viable property.

II. Real Estate Development – That Crucial First Step

Perhaps the most satisfying part of the investing in real estate is engaging in what's known as its development. *Development* is simply a term used to describe what happens to raw land after it's been purchased and almost all land, at one point or another, has to be developed. The possibilities that can be achieved are limitless and fueled by the developer's own creative impulses and imagination. However, for efficiency's sake and to maximize profit, they tend to be dictated by several factors: the geographic area in which the land resides, urban demographics, how the land has been zoned, etc. But once you know what you're dealing with as a developer (adhering to all state and federal regulations, of course), you can shape the land in any way you see fit.

The development of any community begins with subdivision of surveyed land, which means dividing any area into two or more lots, parts or parcels for the purpose of selling or building. In the 1920s, the US government formed for the first time an advisory committee to establish two enabling acts for states—legal directives which granted the rights to take steps toward the development of communities. There was the Standard State Zoning Enabling Act in 1926 and the Standard City Planning Enabling Act (SCPEA) in 1928, both of which laid the legal framework for state and municipal laws governing real estate development. The standards put forth in the SCPEA still shape almost all decisions made by city planning commissions today.

Depending on the size of the land and where it happens to be situated—and whether or not it's been adequately parsed prior to purchase—a developer needs to subdivide it into areas the size of which they find suitable to sell to prospective buyers. This subdivision will stand to be perhaps the most vital part of how a community grows in the future, determining such things as its appearance, its mixed land use and how and where roads, drainage systems, water, sewerage, and public utilities will be developed in and around it.

After subdivision is complete, the developer has the choice to either continue with development, or to market the land to a home builder or other end-user for commercial purposes. Offices, retail stores, shopping centers, warehouses and mixed-use properties are all types of products that other developers, great or small, might be eager to break ground on. However, many developers who have engaged in the subdivision of a parcel desire to see their property come to fruition.

It's common knowledge in the industry that developers take the greatest risks in erecting commercial or residential properties on once-empty plots of land. They also reap the greatest rewards. This is a fundamental rule of real estate that's not to be taken lightly.

But those risks can be minimized by not only doing research and making informed, intelligent decisions, but by surrounding yourself with the best group of professionals available to complete your vision. No matter how big or small, developing is almost always undertaken after the formation of a team, brought together from various sectors. These include architects, civil engineers and site planners to address the design of the project; market consultants to determine demand and the project's economic feasibility; attorneys to handle agreements, government approvals and other legal matters; environmental consultants to analyze a site's physical capabilities, limitations and environmental impacts; surveyors and title companies to provide legal descriptions of a property; and lenders to ultimately provide the financing.

In the end, no single path leads to guaranteed success in real estate development. Developers come from a variety of disciplines—construction, urban planning, lending, architecture, law and accounting, and even individuals wishing to break into the field of real estate for the first time with little to no background—and as long the financing, vision and a clear set of goals exist, anyone can find success in real estate in the short or long term.

III. Investing in Real Estate – The Best Avenues to Success

With few exceptions, the average sale price of homes in the U.S. increased each year since the early 1960s (until about 2007, the start of the Great Recession), and so it was that in the 1950s and '60s, financially-able Americans began look into purchasing residential properties in great numbers as the primary way to increase their investment portfolio. However, since then more investment opportunities have emerged, including things like trusts and collectives. Let's take a look at a few

1. **Rental Properties**

For decades, this has been the easiest and most popular way for Americans to start (or build) their investment portfolios. Buying a rental property is in many cases like buying a home, and requires no expert knowledge. However, with a second rental property, you're no longer a homeowner but a landlord, and aside from having a few extra responsibilities, you'll begin to generate income in one of two ways. The first, simply, is by collecting rent from your tenants. The second is through the property's appreciation. If your property appreciates, you'll either be able to profit off its sale, or borrow against the equity to make your next investment. While real estate does tend to appreciate, like in any real estate venture there are no guarantees, so determining how much rent to charge becomes a crucial aspect of your investment.

2. **Flipping Houses**

Since the early 2000s, flipping homes has become an increasingly popular practice among first-time investors. There are two ways to flip a home: repair and update (the more hands-on approach), and hold and resell (the sit-back-and-relax approach). With repairing and updating, you either you make the repairs and updates to the property yourself, or you hire professional contractors to do it for you. With holding and reselling, you simply buy in a rapidly rising market, hold the property for a few months, and sell it when the amount appreciated meets your set goals.

As in being a landlord, fixing up homes and selling them off in short time is a very hands-on, sometimes labor-intensive practice. If that's what you're looking for, great! Many people love the challenge. But for those who would rather be let their money or someone else do most of the work, there are other options.

3. **Real Estate Investment Groups (REIG)**

Many who want to start out investing in real estate, yet lack the initial capital to do so, can band together with others in the same boat to form (or seek out already-established) collectives or companies known as real estate investment groups (REIGs, sometimes called 'real estate investment clubs', too).

REIGs operate like this: A company will buy or build a set of buildings—apartments, say—then allow interested investors to buy into the venture through the company, thus beginning their role as a member. An investor can single-handedly own one or several units of self-contained living space, but the company operating the group manages everything, executing all the functions that a landlord normally would. In exchange for this, the company takes a percentage of the rent, and the investors get the rest.

4. **Real Estate Limited Partnership (RELP)**

An RELP is similar to a real estate investment group. It's an entity formed to buy and hold onto one or an entire portfolio of properties. However, as in most limited partnerships formed in other industries, RELPs exist for a pre-determined amount of time, and then dissolve. Most RELPs have a lifespan of around five to ten years.

An experienced real estate development firm serves as the general partner—the one who does all the work, and on whom all the legal and financial burdens fall. Outside investors are sought to provide financing for the project, in exchange for a share of ownership as a limited partner. Partners can and do receive periodic distributions from the income generated by the project, but the real payoff comes when the properties are ultimately sold.

5. Real Estate Investment Trust (REIT)

An REIT is a corporation (or trust) that is formed using investor money to buy up, maintain, and/or sell properties that generate income. Investors are essentially shareholders, as REITs are bought and sold on major stock exchanges. An added benefit of investing in an REIT is that, in paying out roughly 90% of its taxable profits as dividends, REITs avoid paying corporate income tax, so more money is left to potentially be paid out to its shareholders.

There are three types of REITs: Equity REITs, which own and operate income-producing real estate, making money through rent collection; Mortgage REITs, which lend money to real estate owners or operators either directly (via mortgages and loans) or indirectly (through acquiring mortgage-backed securities), and make their money from interest; and *hybrids*, which are more or less a combination of both.

6. Real Estate Mutual Funds

Real estate mutual funds invest primarily in REITs and other real estate operating companies, though some will directly invest into commercial property, too. And while they generally don't provide the short-term income of REITs, they do offer the ability to gain a diversified exposure to real estate with a relatively small amount of capital.

Like REITs, these funds are highly liquid, which means they can easily be converted to a cash payout in a relatively short amount of time. Another interesting advantage mutual funds provide to investors is analytical and statistical information provided by the fund. This can include details on acquired assets and management's perspective on the performance of specific real estate investments against others that exhibit similar market characteristics.

IV. The Benefits of Investment – Reaping the Rewards

Now after hearing about development in real estate and ways you can invest, let's get to the exciting part: how you stand to benefit from it all in the end. Sure, there's money to be made, but that's just the tip of the iceberg.

First, let's look at what ways real estate investment beats other types of conventional investing. Second, we'll take a look at the benefits to you as an individual investor.

1. Portfolio Diversification and Projection

When stocks are down, real estate is often up. It's a hard and fast reality of the market. Therefore, adding real estate to your portfolio can lower volatility and provide a higher return per amount of risk. The more direct the real estate investment, the better the insurance against volatility. Direct real estate investment also carries less principal-agent conflict, which is a term for how much the interest of the investor depends on the competence or integrity of others involved, like managers, debtors and lenders.

2. Inflation Hedging

There's a lot of stability in real estate. It's true—the ability of real estate to insure against inflation comes from the positive relationship between the growth of national gross domestic product and demand. As local economies expand, the demand for real estate drives rents higher, and this, in turn, translates into higher values. Therefore, real estate tends to maintain the purchasing power of capital, passing some of the inflationary pressure onto tenants through rent increase, and by incorporating some of it in the form of appreciation.

3. Leverage

Normally, if you want to buy a stock, you have to pay the full value of the stock at the time you place the order—unless you have to put up collateral (called a *margin*), and then borrow money from a broker. And even then, the percentage you'll be able to borrow is not as much as with real estate, thanks to bank-lent mortgages. This is what's known, simply, as *leverage*, the fundamental principle behind mortgages.

This means that you can control the whole property and the equity by only paying a fraction of the property's total value up front. Of course, the size of your mortgage affects the amount you actually own, but there's no delay—when the paperwork is complete, the property's yours to take control of.

Now, once you've taken the plunge and put your hard-earned money into commercial property, in what other ways do you, as an investor, stand to benefit?

4. Building equity for your future

As you pay down your mortgage or the home's property value increases, you build up equity, which you can cash in on later. That might mean selling the property for a sizable infusion, tapping the equity in a cash-out refinance or home equity line of credit, or even leveraging it to buy another property and grow your portfolio.

5. A regular income and cash flow

Real estate can also provide consistent, reliable income. If you're still working a day job, that can mean disposable income to use toward vacations and other things like bills, upgrades or just a rainy-day fund. And if you really build out your portfolio, it could equal an entirely new career!

Real estate investments are also a great way to help you during retirement, supplementing Social Security payments and other retirement funds you might already have in place.

6. Positively impacting your community

Depending on where you own or build, you can also help provide much-needed housing, safety and stability for families, increase city tax revenues, support the local economy and more. And the more your property's community flourishes, the more your assets will appreciate in value. It's a positive feedback loop that can really help you build wealth and provide long-term financial security.

7. Valuable tax advantages

Investing in real estate opens the door for innumerable tax benefits. Many investment costs become deductible business expenses; mortgage interest can be written off at tax time; and it's possible you may get to avoid paying self-employment income tax on your rental income, depending on how your business is run.

8. You might get a new home out of it

Ultimately, real estate investing typically gives you some sort of asset. If you invest in a vacation rental property, your family also gets to use that home next time you need a getaway. If you purchase a longer-term rental or fix-and-flip property, you could even find yourself with a new primary residence down the line.

V. Conclusion

According to a Pew Research study, of around the 20 million rental properties in the US, individual investors own around 72.5% of all single-unit residences, with the cutoff at 24 units per property. That's a huge number! And, since 2008, it's only been predicted to increase.

Today, thanks to several factors, the real estate market in many cities is booming. And while there are no guarantees in any investment venture, real estate has historically been one of the most safe, successful and popular areas of investment. As many financially successful individuals will tell you, real estate is not just a great way to dip your toes into the waters of investment for the first time, but it's almost certain to yield consistent and increasingly large returns over time. And, depending on the type of real estate you choose (houses or multi-unit properties, for example), you have a great deal more control in maximizing those returns.

Equity, tax breaks, a steady, passive income, positive impact in your community or others', investment in not just yourself but your family and future generations, even investment in the betterment of America itself—a multitude of reasons exist why real estate is the most trusted and respected form of investment today, and they all revolve around the exciting opportunities waiting for you as an investor!