

Real Estate Investment Analysis **Fall 2011**

Midterm Exam 2 – Version A – Solutions

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TTh 11:00-12:15

- 1) (80 points) Hensler Properties (HP) is deciding whether to purchase a warehouse property in Dallas, TX. The property is expected to generate NOI of \$200,000 next year, and this figure is expected to grow by 2.5 percent per year for the foreseeable future. The proposed purchase price is \$1.75 million, and HP will incur \$50,000 in due diligence (acquisition) costs if it purchases this property. If HI purchases this property, it will put it into service on January 1 next year. After 5 years (December 31 sale date), HI expects to sell the property at a 10 percent cap rate; it will incur sale costs equal to 5 percent of the sale price at that time.

Financing is available with a 7-year balloon loan at 6 percent interest amortized over 25 years. The lender requires a 75 percent maximum loan-to-value (LTV) ratio and a 1.25 minimum debt-coverage ratio (DCR), and will charge 3 points in conjunction with this loan.

The tax assessor currently values the property at \$1.25 million, \$1 million of which is attributable to the building. A recent private appraisal valued the property at \$2 million, \$1.8 million of which is attributable to the building.

HI is in the 40 percent tax bracket for ordinary income; the long-term capital gains tax rate is 15 percent and the depreciation recapture rate is 25 percent. HI requires an 18 percent after-tax return on its investments.

Assuming the after-tax cash flows from operations will be \$80,000 in years 2 through 5, calculate the internal rate of return and net present value of this investment over a five year holding period and indicate whether this is a good investment for HI; explain your reasoning. You must show and clearly label your work for full credit.

Multiple Choice Questions (2 points each)

- _____ 1. Kung-McIntyre Enterprises is purchasing an office building for \$1.4 million. Expected first-year NOI is \$100,000. Far East Mortgage will provide 20-year financing at 5.5 percent interest; Far East requires a 75 percent loan-to-value ratio and a 1.20 debt-coverage ratio (DCR). Based on this information, what is the largest loan Far East will provide?
- A. \$1,050,000
 - B. \$1,009,532**
 - C. \$1,211,439
 - D. \$1,453,727
 - E. None of the above; the correct answer is _____.
- _____ 2. Which of the following statements is true for a property that exhibits negative financial leverage? More than one answer may be correct; write down all correct answers.
- A. The mortgage constant is less than the cap rate.
 - B. THE MORTGAGE CONSTANT IS GREATER THAN THE CAP RATE.**
 - C. The cash-on-cash return is greater than the cap rate.
 - D. THE MORTGAGE CONSTANT IS GREATER THAN THE CASH-ON-CASH RETURN.**
 - E. The property has too much debt.
 - F. ADDITIONAL DEBT WILL LOWER THE INVESTOR'S CASH-ON-CASH RETURN.**
 - G. Additional debt will raise the investor's cash-on-cash return.
- _____ 3. Which of the following statements about 1031 exchanges is most correct?
- A. 1031 exchanges allow investors to completely avoid paying capital gains taxes on real estate investments in most circumstances.
 - B. 1031 exchanges allow you to defer your capital gains taxes when you exchange a real estate investment for another asset such as stock market investments.
 - C. To execute a 1031 exchange, you must sell your current asset and buy your new asset at the same time.
 - D. NONE OF THE ABOVE STATEMENTS IS CORRECT.**
 - E. All of the above statements are correct.

Use the following information to answer the next two questions:

Jim has a real estate investment with the following expected taxable income over the next five years:

<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
\$10,000	(\$20,000)	\$10,000	(\$15,000)	\$45,000

Jim has no other passive investments, and his current marginal tax rate is 35 percent.

- _____ 4. How much tax will Jim be required to pay on his real estate investments in YEAR 3?
- A. \$0
 - B. \$7,000
 - C. \$3,500
 - D. \$3,500 tax credit
 - E. None of the above; the correct answer is _____.
- _____ 5. How much tax will Jim be required to pay on his real estate investments in YEAR 5?
- A. \$0
 - B. \$10,500
 - C. \$15,750
 - D. \$7,000
 - E. None of the above; the correct answer is _____.
- _____ 6. You have purchased an apartment property with a depreciable basis of \$2.5 million. This property was placed into service on March 1 of this year. How much is your depreciation allowance this year?
- A. 71,970
 - B. 90,909
 - C. 75,758
 - D. 50,748
 - E. None of the above; the correct answer is _____.
- _____ 7. How much is the depreciation allowance in this property during the second year?
- A. 71,970
 - B. 90,909
 - C. 64,103
 - D. 50,748
 - E. None of the above; the correct answer is _____.

- _____ 8. True or **FALSE**: If I sell a real estate investment today but the buyer makes payments to me over several years, all of my capital gains taxes from the sale are due this year.
- _____ 9. **TRUE** or False: Commercial banks tend to require recourse on commercial real estate loans, while institutional lenders like life insurance companies do not.
- _____ 10. (Bonus) **TRUE** or False: Was it just me, or did I see a lot of zombie accountant costumes this Halloween? Oh, wait...those were real accountants, they just look and act like zombies. Easy mistake.