Real Estate Investment Analysis

Fall 2011

Midterm Exam 2 – Version A – Solutions

Dr. Stanley D. Longhofer
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 $250,000 next year, and this figure is expected to grow by 3 percent per year for the foreseeable future. The proposed purchase price is $2.5 million, and HP will incur $100,000 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 1.30 minimum debt-coverage ratio (DCR), and will charge 3 points in conjunction with this loan.

   The tax assessor currently values the property at $2 million, $1.8 million of which is attributable to the building. A recent private appraisal valued the property at $2.5 million, $2 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. $1,211,439
B. $1,050,000
C. $1,453,727
D. $1,009,532
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 GREATER THAN THE CAP RATE.
B. The mortgage constant is less than the cap rate.
C. The property has too much debt.
D. The cash-on-cash return is greater than the cap rate.
E. ADDITIONAL DEBT WILL LOWER THE INVESTOR'S CASH-ON-CASH RETURN.
F. Additional debt will raise the investor's cash-on-cash return.
G. THE MORTGAGE CONSTANT IS GREATER THAN THE 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:

Year 1	Year 2	Year 3	Year 4	Year 5
$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. $7,000
B. $3,500
C. $3,500 tax credit
D. <u>$0</u>
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. $10,500
B. $15,750
C. <u>$7,000</u>
D. $0
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. 90,909
B. <u>71,970</u>
C. 50,748
D. 75,758
E. None of the above; the correct answer is _______________.

______ 7. How much is the depreciation allowance in this property during the second year?

A. <u>90,909</u>
B. 71,970
C. 50,748
D. 64,103
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.