FIN 5433: CHAPTER 14

Disposition and Renovation of Income Properties

Why does any asset experience a volutary change ownership?

- Liquidity Needs
- Difference of opinion as to value
  - Most real estate is available for sale at the right price

Disposition Decisions

- Have you hit your target holding period?
  - You should re-evaluate your ownership decision periodically regardless of initial plan
- Has the actual ownership experience deviated from the purchase proforma (which determined why you bought the property)
  - Market rent problems
  - Tax law changes
- Equity build-up
    - Opportunity Cost of not selling the property
    - Reduced interest payments and lower tax deduction if an amortizing loan

Disposition Decisions

- What can the investor net if the property is sold today?
- What is the future expected performance of the property for the current investor if not sold?
- Should the property be sold and the funds invested in one or more alternate properties?
  - Applications of marginal analysis

Disposition Decisions

- Expected cash flows are adjusted for current expectations
  - New rental income growth rate assumptions
  - Original cost and depreciation stay in place
  - Tax rates change to reflect current laws
  - Mortgage and interest stay the same
  - What is the expected future sale price of the property?

Disposition Decisions

- The equity investment you have in your property today, is what you would realize, after expense and taxes, if you sold the property today.
- If the investor will net $100,000 after all taxes and expenses if the property is sold today…
  - Can it be invested and earn a greater return than if the property is not sold?
  - The investor gives up the following cash flow stream by selling the property….

Disposition Decisions

- The future expected net cash flows for a three-year holding period are
  - $ATCF_0$ = ($100,000)
  - $ATCF_1$ = $10,000
  - $ATCF_2$ = $11,000
  - $ATCF_3$ = $12,000
  - $ATCF_3$(sale) = $103,000
  - Compute IRR = 11.82%

Disposition Decisions

- The ATIRR = 11.82% is what the investor gives up by selling the property and taking $100,000 today.
- Is there an equivalent risk investment that can earn a greater ATIRR?
  - If yes, sale is justified
  - If not, property should be kept.

Disposition Decisions

- Return to a New Investor
  - New investor has a new adjusted basis in the property
  - New investor depreciates the property based on current tax law
- What can a new investor earn given the changes?
  - Compute an ATIRR for the new investor
  - The return to the new investor will depend on any changes in tax laws (depreciation schedules), and possibly new financing terms

Disposition Decisions

- Marginal Rate of Return –Property Disposition:
  - Evaluate disposition for a one-year holding period
  - Repeat the evaluation for subsequent one-year holding periods
  - This generates a series of marginal returns based on one-year holding periods

Disposition Decisions

- Marginal Rate of Return
  - Disposition Rule:
    - Sell when MRR falls below assumed reinvestment rate for funds from property sale
    - This determines the optimal holding period
  - Reinvestment Rate:
    - May be constant or changing
    - Should reflect market rates and return on alternative investments
  - However, have to ask, why can it both be optimal for me to sell and for someone else to buy?

Refinancing as an Alternative

- Increase the current LTV ratio by refinancing
  - Provides additional funds to invest elsewhere
  - May provide additional interest write-off
  - Prepayment penalties may make this expensive
- Incremental cost of refinancing
  - What are the additional funds obtained by refinancing?
  - What are the additional cash outflows?
  - Solve for i: can this be earned on borrowed funds?
  - If the new interest rate is higher, the marginal cost of new fund can be very high

Portfolio Considerations

- Via sale or refinance, if equity can be withdrawn, these funds can be used to purchase additional properties and thus benefit from a more diversified portfolio
- An alternate reason for selling an existing property are the portfolio considerations either because the entity has too much real estate, or wishes to redeploy the real estate in a more favorable portfolio

Renovation as an alternative

- What type of skills and goal does the owner have?
- What are economic trends?
  - Is property improvement justified?
    - Enlarged or quality upgraded
  - Should it be converted? (if zoning allows)
    - Alternative use to reflect market changes
- What is the renovation cost?
  - Does it require additional equity (maybe you can finance its entire cost due to equity in the building)?
  - What are available financing sources?
  - Need to asses the incremental gain to this strategy to determine if it is a good investment

Renovation as an alternative

- Calculate the incremental change in the expected future operating cash flows.
- Calculate the incremental change in the future expected selling price of the property.
- Determine the IRR on the additional equity investment.
- The overall return to the property also has to attractive – not just the marginal return
- Compare the IRR to alternative **equivalent risk** investments.

Disposition Decisions

- Additional Considerations
  - Combined renovation and refinancing rather than a separate loan to cover renovations
  - Rehabilitation Investment Tax Credits for older or historic properties
    - Dollar for dollar reduction in taxes
  - Low-income Housing Tax Credit
    - Part of the Tax Reform Act of 1986
    - Goal is to upgrade housing for low income people
    - Requirements for 40-60 percent of occupants to have incomes at and below the median income

Section 1031 Exchanges

- One reason to not sell a property is to delay the taxes due on sale
- One way to delay (defer) capital gains taxes, if one is selling one commercial property but planning to invest in another, is to do a “like kind” or Section 1031 exchange.
- There are numerous rules that one must follow to complete this exchange

Section 1031 Exchanges

- One has 45 days from closing to identify the new property
- One has 180 days to close on the new property
- Because it unlikely that the new property will be purchased for the price of the previous property, there will probably be some cash involved.

Section 1031 Exchanges

- This cash is called the “boot” and will be taxable.
- Must have funds held in escrow with a qualified intermediary, so the investor never receives the funds to create a taxable event, and has no cash generated that could be used to pay taxes

Installment Sale

- If the seller provides financing, the gain will be realized over time as the principal on the loan received will be partly the return of the adjusted basis and partly the capital gain which is taxed. The interest, of course, is taxed as for any loan. The seller is assuming the risk of holding a mortgage
- A structure sale is a special case where the seller essentially purchases an annuity from the sale and then is taxed as the income from the annuity is received (interest, return of capital, and capital gain)