REAL ESTATE MANAGEMENT

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Real Estate Management
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Chapter 5

Owner Relation and Record Keeping

Part-I

Principles of
Real Estate Management
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REAL ESTATE MANAGEMENT

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INTRODUCTION - 1/2

- Anyone technically can manage property, but, in the real estate industry, property management refers to have someone other than owner supervises a property's operation according to owner's objectives.
- There is a direct and explicit business relationship between property's manager and its owner.
- The relationship is one of an *agent* and a *principal*, in which the property manager (agent) enters into a legal, fiduciary, and confidential arrangement with the owner (principal).
- This chapter will focus on real estate as in income-producing asset and those who own it for the benefits it offers as an investment.

INTRODUCTION - 2/2

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- Investors give different reason for placing their money in real estate.
  - It provides Tax shelters.
  - As a steady flow of cash.
  - As a hedge against inflation.
- Yet , in the final analysis, all want to maximize their income.
- To be an effective real estate investment's manager, must be keenly a ware of the nature of the property's ownership and its reason for investing in real estate and must understand the role of client relations.

PRINCIPAL FORMS OF INCOME-PROPERTY OWNERSHIP 1/2

- Real property in nation's early years was owned almost exclusively by individuals, either alone or with partners, joint tenants, or tenants in common.
- So great was the fear that land ownership might follow the pattern of Europe, where large landholdings were common and restricted to wealthy, that it was impossible for corporations to own property.
- As the nation developed and affluent society emerged, this fear gradually diminished.

PRINCIPAL FORMS OF INCOME-PROPERTY OWNERSHIP 2/2

- As a result of real estate marketing in projects, affordable only to very rich individuals and excluding investors of less means; alternative forms of ownership been explored. Shared ownership was the only solution.
- Although some real estate is owned by individual investors, new and revitalized forms of shared ownership have grown in popularity such as
  - Corporation
  - Limited Partnership
  - Real Estate Investment Trust (REIT)
  - Individual investor

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1- Corporation 1/5

- The depression of 1929-1933 created great changes in income-property ownership in United States.
- In the prosperous 1920s, real estate totaling millions of dollars were sold in dominations as low as $ 100 to small investors desiring the high yields these securities offered.
- Each holding represented a portion of major mortgages placed on larger developments of this period.
- All went well until these projects defaulted during the depression and bondholders became unwilling owners of real estate.
- As a solution, they agreed to share in the ownership of the properties acquired for foreclosure.
- Liquidating corporation were created which held title to the real estate until satisfactory sales could be arranged.

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1- Corporation 2/5

- The advantages of corporate ownership of real estate are numerous:
  - A stockholder in a corporation has no individual liability (only the stockholder's capital contribution is at risk)
  - The corporation is an entity in itself.
  - Entirely apart from its stockholders
  - Stock in a corporation can be sold or otherwise disposed of at will
  - Additional capital can be raised by issuing new securities or by borrowing
- However, there are several disadvantages to corporate ownership of real estate. Tax issue is the most important.

1- Corporation 3/5

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- Three kinds of taxes affect corporate-owned real estate.
  1. Tax levied against property (ad valorem tax)
  2. Federal tax levied against corporation (corporate tax)
  3. Tax levied against individual's stockholders share of corporate profits withdrawn in the from of dividends (individual income tax)
- The effect of the last two types of taxation that are corporation's earning are subject to double taxation; at the corporate and individual levels.
- Because of the tax liability incurred in transferring a property's cash flow to investors, individual usually consider it impractical to form a corporation as a vehicle for owning real estate.

1- Corporation 4/5

REAL ESTATE MANAGEMENT

- The exception would be if the investors are extremely high tax brackets, in which case using a corporation might result in a lower cumulative tax liability
- The corporate form of ownership is used most commonly and successfully by institutional investors involve in long-term business activities
- These corporate owners of investment real estate are of two major types:
  1. Corporations that own and have responsibility for income properties but are not large enough to supervise these properties. These corporations usually engage the services of professional property managers.
  2. Bulk users of space (commercial) who construct buildings primary for their own business use. Whether for prestige or for future expansion, often these corporations built structure too large for their own space requirements.

1- Corporation 5/5

- As a result, regular administration is necessary, and periodic leasing too.
- Some of those corporation hire managers on their own payroll to administer the properties.
- Others, the majority, engage professional management firms for this work.

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2- Limited Partnership 1/7

- The limited partnership was designed to provide the benefits that corporate ownership did not offer.
- It too, developed during depression when thousands of properties defaulted to banks, insurance companies, trust companies and other lenders.
- In most cases, these agencies came under pressure to liquidate the foreclosed real estate.
- As a result, the market was flooded at a time when funds were limited and investors were skeptical.
- With cash in short supply, many large properties were sold under terms requiring minimal down payments often as low as 10% and always much less than had been acceptable previously.

2- Limited Partnership 2/7

- **Yet, despite the nation's depressed economy, many people considered income real estate are attractive investment, especially when the terms became more favorable to the buyer.**
- **These potential investors would not speculate al their capital in such investment, but they were willing to risk a small percentage in a combined ownership plan.**
- **Such a combination was called a *syndicate* and was, in effect, an early type of *limited partnership* formed to buy, own , and operate a specific piece of property.**

2- Limited Partnership 3/7

- **Astute property managers recognized in this trend a unique opportunity:**
  1. **First, as a broker, a manger could earn a commission through a sale of property and organization of the syndicate to become the buyer.**
  2. **Second, if the manager applied the commission to purchase a part of the syndicate, he would be a partner in the ownership of the property and then could control its management.**
- **Syndicate, therefore, presented a threefold income opportunity to the manager: a brokerage commission, a management fee, and a potential cash flow from the investment.**

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2- Limited Partnership 4/7

- ❖ **Although the special investment opportunities of the early recovery period gradually disappeared because of higher prices and greater market activities, other factors brought new buyers into the field.**
- ❖ **Rising prices that stimulate the purchase of real estate as an inflation hedge and earlier success of syndicate members attracted prospective investors.**
- ❖ **More importantly, by using limited partnership interest to divide the equity in a property, the double taxation that applied to corporate ownership of real estate was avoided.**
- ❖ **Real estate ownership through limited partnership became a significant factor in the property's manager operations.**

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2- Limited Partnership 5/7

- ❖ **In forming a limited partnership, several investors pool their capital, enabling them to acquire larger, more expensive properties.**
- ❖ **In this way, the limited partnership represents an opportunity to invest in real estate that otherwise out of reach of each individual investors.**
- ❖ **The limited partnership can buy real estate to hold for a brief period before selling it; or, it may invest in income property and hold it for the ongoing income and tax shelter it will produce**

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2- Limited Partnership 6/7

- Under limited partnership agreement, one or more *general partners* manage the partnership and its investments and have unlimited liability for all claims against it.
- The property manager involved in a limited partnership usually acts as the general manager, providing the management of the syndicate real estate.
- The limited partners supply the capital but are prevented by low from management activity.
- In return, their liability is restricted to their investment, and they are given the tax advantages of the partnership form of organization
- For tax purposes, the limited partnership act as a conduit and passes through to limited partners the tax deduction and losses generated by the property.

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2- Limited Partnership 7/7

- For this reason, the limited partnership usually outlines the corporation as a form of real estate ownership.
- There are two types of limited partnership:
  1. The tradition *private limited partnership*
  2. The *public limited partnership*
- The public limited partnership has a large number of limited partnership as many as 20,000 to 25,000 and must be registered under federal and state securities laws, a costly and time-consuming process.
- The private partnership is designed for modest-sized project that do not attract major capital sources, even though the real estate may be quite desirable.
- The private limited partnership has less than 35 investors and ordinary does not require registration under federal or state securities laws.

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3- Real Estate Investment Trust 1/3

- Another ownership from that broadens participation in income real estate is the ***Real Estate Investment Trust*** (REIT), a type of trust established by the Real Estate Investment Trust Act of 1960.
- Qualified REITs obtain special tax treatment: if REIT distributes at least 95% of its ordinary taxable income to investors as dividends, corporate-level taxation is avoided.
- A REIT, then, is a single-tax entity that enables small investors to take part in large real estate investment.

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3- Real Estate Investment Trust 2/3

- If conservative procedures had been followed, the REITs would have been a desirable investment, but the promoters underwriters of many of these trusts overestimated their capacity to produce return for their investors.
- After several years of phenomenal growth following the passage of 1960 act, REITs accounted for a major percentage of all construction loans in the United States.
- But the situation changed as credit tightened, and many trusts sold their assets or field for bankruptcy.
- Several factors caused the REITs to fail, but the main reasons were that they had too much money to invest too quickly, and they made unsound investments.

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3- Real Estate Investment Trust 3/3

- **The fact that REITs borrowed heavily on a short-term basis so they could obtain more funds added to their.**
- **When shorter-terms rates rose to 13% in 1974, the REITs were obligated to instruments that could not generate returns sufficient to meet commitments.**
- **There is nothing essentially wrong with the REIT concept, except the judgment of certain promoters who often had little or no real estate experience.**
- **The REITs are regaining favor among smaller investors, although, their outcome remain uncerain.**

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4- Individual Investor 1/2

- **Although individual ownership of investment real estate is usually limited to small-scale enterprises, the property manager should be familiar with it as well.**
- **Since individual owners often have their own businesses and consider income properties strictly as investment, they cannot assume the responsibilities of management nor do they wish to collect rents, handle rental inquiries, and service complaints, and supervise maintenance.**
- **Also, there are many absent landlord who neither work nor live near the properties they own and almost always require the services of local property manager.**

4- Individual Investor 2/2

REAL ESTATE MANAGEMENT

- The advantage to individual property ownership is that income and profits are taxed only once.
- A property's financial operations are listed on the owner's individual tax return
- If the property sustains a taxable loss, this loss can be a tax shelter and reduce other taxable income.

MANAGEMENT AGREEMENT - 1/5

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- Regardless of the form of real estate ownership or the type of property, the duties and responsibilities assumed by the property manager for the owner and the owner's obligations to the manager are sufficiently important to require a written contract.
- A *management agreement*, agreed to and signed by both parties, is the first place in creating a satisfied client, which is the primary objective of the property manager.
- In a management agreement, the property owner contacts the management of the building to an individual property manager or management firm.

MANAGEMENT AGREEMENT - 2/5

- The document should be an in-depth and complete statement of the building to the terms and conditions of the understanding, including the fees involved and the duties, responsibilities, and limitations of the signatories.
- To ensure its validity, the agreement should be prepared, or at least approved, by large counsel.
- A sample agreement, formed by Institute of real Estate Management, is included in the appendix. It is not necessary that this particular form be used, but it is essential that all management relationships be covered by a written contract that include:

MANAGEMENT AGREEMENT - 3/5

1. An adequate description of the property to be managed.
2. The exact names of the owner and the manger.
3. The fee to be paid for the management service.
4. The clear statement of the responsibility and authority of the property manager and any limitations placed on the operation of the property.
5. Provision of adequate protection for both parties for any risk incurred.
6. The term of the agreement and termination provisions.

- Within this framework, the management agreement must stipulate those activities that the property manger can assume freely versus those that must be referred to the owner for approval. When is the property manager free to execute leases with tenants? Who pays for advertising? What about major repair? What about insurance and bank arrangement?

MANAGEMENT AGREEMENT - 4/5

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- While it is essential that a written management agreement be contracted by and between property's owner and the manger, it need not be for long-term period.
- There are advantages and disadvantages in a long-term management contract for both the owner and the manger.
- If special services are to be performed and adequate compensation will not be received in a short period, the manager may be justified in seeking a long-term agreement.
- For example, in assuming the management of a new office building, the manger may be involved in pre-leasing activity and operational planning several months before the building is ready for occupancy and management fees are earned.

MANAGEMENT AGREEMENT - 5/5

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- The management agreement should be of sufficient duration to guarantee the manger adequate reimbursement for time spent without compensation.
- In all cases, the manger should realize that a satisfied client is far more important for long-term business than contractual ties alone.
- Even when long-term arrangement exist, the wise manger treats all clients as though the contracts had to be renewed monthly.

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Thank You