



MASTERING REAL ESTATE PRINCIPLES

EIGHTH EDITION

GERALD R. CORTESI

Dearborn™
Real Estate Education

SAMPLE

MASTERING
REAL ESTATE
PRINCIPLES

EIGHTH EDITION

Gerald R. Cortesi

Dearborn[™]
Real Estate Education

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MASTERING REAL ESTATE PRINCIPLES EIGHTH EDITION
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Contents

About the Author	viii
Preface	ix
Introduction	x

PART I INTRODUCTION TO REAL ESTATE

UNIT 1	
Introduction to Real Estate	3
The Real Estate Business	4
Classes and Characteristics of Real Estate	7
The Real Estate Market	11
UNIT 2	
Real Estate Concepts	17
Basic Concepts and Background of Real Estate Law	18
Real and Personal Property	21
Part I: Introduction to Real Estate Diagnostic Test	28

PART II REAL ESTATE LAW

UNIT 3	
Government Powers	35
Police Powers	36
Other Government Powers	42
Environmental Considerations Affecting Real Estate	43
UNIT 4	
Encumbrances	53
General Notes on Encumbrances and Easements	54
Types of Easements	59
UNIT 5	
Encumbrances: Liens	65
General Notes on Liens	66
Real Estate Tax Liens	69
Liens Other than Real Estate Taxes	75

UNIT 6

Legal Descriptions 81
Metes-and-Bounds Method 82
Rectangular Survey System 85
Plat-of-Survey Method and Measuring Elevations 91

Part II: Real Estate Law Diagnostic Test 97

PART III

REAL ESTATE OWNERSHIP

UNIT 7

Freehold Interests in Real Estate 105
Fee Simple and Defeasible Freehold Estates 106
Life Estates 109
Water Rights 113

UNIT 8

Leasehold Estates in Real Estate 119
Types of Leasehold Estates 120
Types of Lease Agreements 122
Lease Characteristics 126

UNIT 9

Forms of Ownership 133
Severalty and Co-Ownership 134
Forms Commonly Used in Business 139
Other Forms of Ownership 142

Part III: Real Estate Ownership Diagnostic Test 151

PART IV

TRANSFERRING REAL ESTATE

UNIT 10

Transferring Title 159
Methods of Transferring Title to Real Estate 160
Types of Deeds 165
Parts of a Deed 170

UNIT 11

Recording Title 177
Public Records and Recording 178
Evidences of Title 182
Title Insurance 184

UNIT 12

Real Estate Closings 189
The Closing Process, TRID Rule, and RESPA 190

The Closing Statement and Prorations	198
The Closing Disclosure Form	204
Part IV: Transferring Real Estate Diagnostic Test	215

PART V REAL ESTATE BROKERAGE

UNIT 13	
Agency and Real Estate Brokerage	223
Defining Agency Relationships	224
Principal and Agent Duties	229
The Broker-Principal Relationship	240
UNIT 14	
Real Estate Contracts	249
General Contract Concepts	250
The Required Elements of a Contract	257
Ending the Contract	261
UNIT 15	
Client Representation Agreements	267
Types of Listing Agreements	268
Creating and Terminating Listings	273
UNIT 16	
Real Estate Licensing Laws	279
Administration of Licensing Laws	280
Licensing Requirements	283
UNIT 17	
Fair Housing Laws	289
Illegal Practices and Fair Housing Acts	290
The Fair Housing Act of 1968	293
Enforcement of the Fair Housing Laws	300
Part V: Real Estate Brokerage Diagnostic Test	305

PART VI REAL ESTATE VALUATION

UNIT 18	
The Appraisal Process	315
The Concept of Value	316
Principles of Value	318
Appraisal Procedures	322

UNIT 19

Methods of Estimating Value	331
The Sales Comparison Approach	332
The Cost Approach	337
The Income Approach	342
Gross Rent and Gross Income Multipliers	345
Part VI: Real Estate Valuation Diagnostic Test	351

PART VII REAL ESTATE FINANCE

UNIT 20

Lending Laws and Government Activities	359
Government Activities	360
Laws Affecting Lending	363
Bank Reporting Acts	376

UNIT 21

Loan Instruments	381
Financing Instruments	382
The Mortgage Agreement	385

UNIT 22

Lending Practices	389
The Loan Process	390
Providers of Mortgage Money	397
Foreclosure and Redemption	402

UNIT 23

Types of Real Estate Loans	411
Mortgage Plans	412
Government Insured and Guaranteed Loans	422
Part VII: Real Estate Finance Diagnostic Test	429

PART VIII SPECIALTY TOPICS

UNIT 24

Property Management	437
Property Management Objectives and Activities	438
The Property Management Agreement and Professional Organizations	443
Homeowners Insurance Policies	446

UNIT 25

Tax Advantages of Home Ownership	453
Income Tax: Homeowner Deductions	443
Income Tax: Excluding Capital Gain and Home Sale	456

UNIT 26

Real Estate Investments	461
Terminology, Advantages, and Disadvantages of Real Estate Investments	462
Tax Rules and Real Estate Investments	465
Investment Types	470

Part VIII: Specialty Topics Diagnostic Test	475
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STUDY TOOL KIT

List of Real Estate Abbreviations	479
Real Estate Designations	482
Summary of Laws Affecting Real Estate	484
Real Estate Internet Sites	492
Construction Basics	498
Real Estate Math Review	511
Math Review Practice Exercises	527
Solutions for Math Review Exercises	530
Comprehensive Practice Examinations	533
Answer Keys and Diagnostic Worksheets	553
Glossary	590
Index	609

About the Author

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EDITORIAL REVIEW BOARD

The author and the publisher wish to acknowledge the assistance of the following reviewers, whose comments and suggestions have had a profound impact on the development of this book:

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Preface

Mastering Real Estate Principles continues to assist thousands of real estate students in their quest to become licensed, as well as many other readers seeking to expand their knowledge of real estate and make informed decisions regarding buying, selling, or leasing real estate.

Now in its eighth edition, *Mastering Real Estate Principles* is an alternative to the traditional real estate textbook format. This title has established itself as one of the most popular and successful real estate teaching tools available.

As always, the new edition continues the tradition of explaining complex real estate topics using everyday language in a user-friendly format by offering clear, real-life examples and frequent exercises that continually reinforce key concepts and ideas.

This new edition features a format to enhance readability and comprehension, and the material, examples, and questions have been updated throughout the text to reflect changes in the real estate environment since the seventh edition.

I hope you enjoy using the book, find it useful, and are successful in all your future real estate endeavors.

Gerald R. Cortesi

2021

Introduction

IMPORTANT!

Please Read the Introduction Before Using the Book!

This introduction is an important part of the book; it should be read to understand the design, organization, and formatting techniques incorporated into the book. The introduction also includes suggestions on how best to use *Mastering Real Estate Principles*.

WELCOME

Congratulations on your interest in the fascinating world of real estate. Hopefully, this book will start you on a new adventure and perhaps fun and profit in real estate. The concept, design, and format of this book are intended to provide an effective learning tool for the reader.

OBJECTIVE

The primary purpose of this book is to provide a practical learning tool to use in real estate licensing courses. The content includes all the topics necessary to prepare for the real estate licensing exam; however, unlike traditional real estate textbooks, the format is designed to “instruct” rather than “present” information. While the book focuses on the real estate topics necessary to become a licensed real estate professional, it can also be used by those seeking information on real estate basics for their personal knowledge.

FORMAT

The format of this book is not quite like most other texts. The narrative is combined with examples, exercises, and solutions. Using this format, a topic is explained and illustrated, and the reader is asked to immediately practice applying the information and is given the answers with explanations to provide feedback. This is repeated for each section in the unit so that the book interacts with the reader in a format similar to instruction in a classroom setting.

The book uses a variety of format techniques to provide helpful “signposts” to guide you through the material. These techniques also provide the emphasis an instructor would use in a classroom environment.

Boxed text in the margins of the book serves three key purposes:

- Providing tips to explain or help students remember terms or concepts
- Highlighting common mistakes made by students
- Adding additional information that will enhance students’ understanding of the topics

EXAMPLES More than 300 examples have been included to illustrate each concept taught in the book. Both positive and negative examples are used. These illustrate “what it is” and “what it is not,” to present an overall understanding of the concept and how it is applied.

Boldface lettering: Mastering real estate terminology is critical to understanding real estate principles. All key real estate terms are printed in **boldface lettering** to highlight them.

Italics: Italics are used to provide *emphasis* in the print. Italics are also used when listing subparts of a topic.

ORGANIZATION

Text Organization

The overall structure of the book includes the components listed as follows:

The book is divided into two segments. The first segment is the core of the book and comprises 26 units that contain the basic information for all the topics. It also includes Diagnostic Tests, which are used to practice applying the real estate concepts presented in the units and measure your comprehension of the material. The second segment of the book is the **Study Tool Kit**, which provides tools that can be used as a quick reference and for review. These include two Comprehensive Tests and answers with explanations for both the Diagnostic and Comprehensive Tests.

Hint

The book includes an extensive glossary of real estate terms. Terminology of real estate is very important to understanding the concepts and is one of the obstacles students new to real estate have difficulty with. Refer to the glossary frequently as you read and study the material so that you become familiar with the language of real estate.

Part

Unit

Section

Part Diagnostic Test

Parts

There are eight parts in the book. Each part contains several units that group similar topics (e.g., Real Estate Law, Real Estate Brokerage). A Diagnostic Test follows each part and includes questions on the topics in that part.

Units

Each unit in the book addresses a specific topic. Each unit begins with a short description of the topic and why it is important to the reader, the learning objectives of the unit, and key terms. The content of each unit is divided into sections.

Sections

Each section in a unit presents a specific part of the unit topic. Section exercises provide practice and reinforce real estate concepts. Solutions are given at the end of the unit so that you can evaluate progress in understanding the section content.

STUDY TOOL KIT

The kit has helpful tools for reviewing and studying the material in the book. Use these tools as you progress through the unit sections or when preparing for state licensing exams.

The contents of the Study Tool Kit are described as follows:

- List of Real Estate Abbreviations
- Real Estate Designations
- Summary of Laws Affecting Real Estate—a brief description of each law
- Real Estate Internet Sites
- Construction Basics—basic construction terminology and illustrations
- Real Estate Math Review—various real estate math problems with examples and solutions
- Comprehensive Practice Examinations—two tests include all the topics used in the book; answer keys are also provided
- Solutions to the Diagnostic Tests and the Comprehensive Practice Exams
- Glossary of common real estate terms

TOPIC SEQUENCE

A great deal of thought has been put into the organization and presentation of the topics. The sequence of the topics is designed to first lay a foundation of the basic real estate “principles” (Parts I–IV). Then, building on that foundation, the text presents the topics related to the “practice” of real estate (Parts V–VIII). Figure 1 in this introduction depicts the sequence of topics.

OVERVIEW OF A REAL ESTATE TRANSACTION

The topics in this book are used in real estate transactions every day. Figure 2 illustrates the steps in a typical real estate transaction. This overview shows how the steps are related to one another and to the topics in the book. The numbers listed in the steps are the units in the book that contain related information.

HOW TO USE THIS BOOK

The content, presentation of topics, and format of the book have been carefully developed to provide the reader with a learning tool for mastering the principles of real estate. To derive the greatest benefit from this book, please read this section carefully. Listed on these pages are the suggested approach and hints on using the book.

1. Start with Part I. This introductory part includes units that cover basic terms and principles of real estate. Many of these terms and concepts appear in later units, so it is recommended that these be completed first. After covering the units in Part I, other parts can be used in any order; however, we do recommend doing them in the order they appear.

2. Do the units in each part in the order in which they appear. The unit topics are arranged progressively, so that each unit builds on the one that precedes it.
3. Complete the review exercises for each section in the unit, and review your answers before starting the next section. Unit sections cover specific subtopics and should be understood before proceeding to the next section.
4. Track your progress by checking off the Learning Objectives and Key Terms included at the beginning of each unit.
5. After completing the units in a part, complete the Part Diagnostic Test. These tests will provide you with important feedback on your progress in understanding and applying real estate principles.
6. After completing all the parts, try taking the Comprehensive Exam.

Remember

The Study Tool Kit is available for your use and assistance while you cover the topics in the book. Become familiar with the information included in the tool kit, and it will become a valuable assistant.

FIGURE 1: Topic Sequence

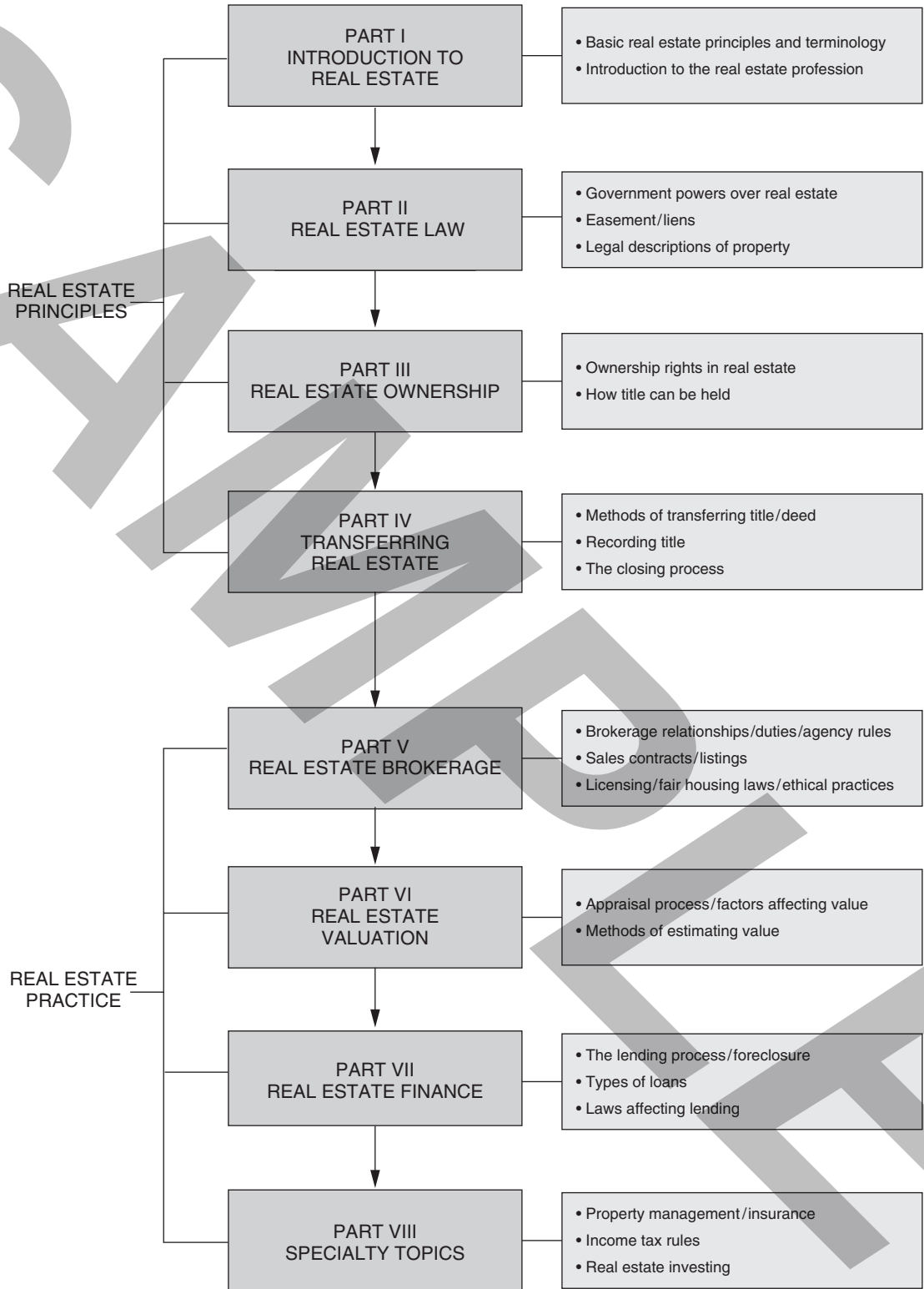


FIGURE 2: Real Estate Transaction Overview and Related Topics in the Text

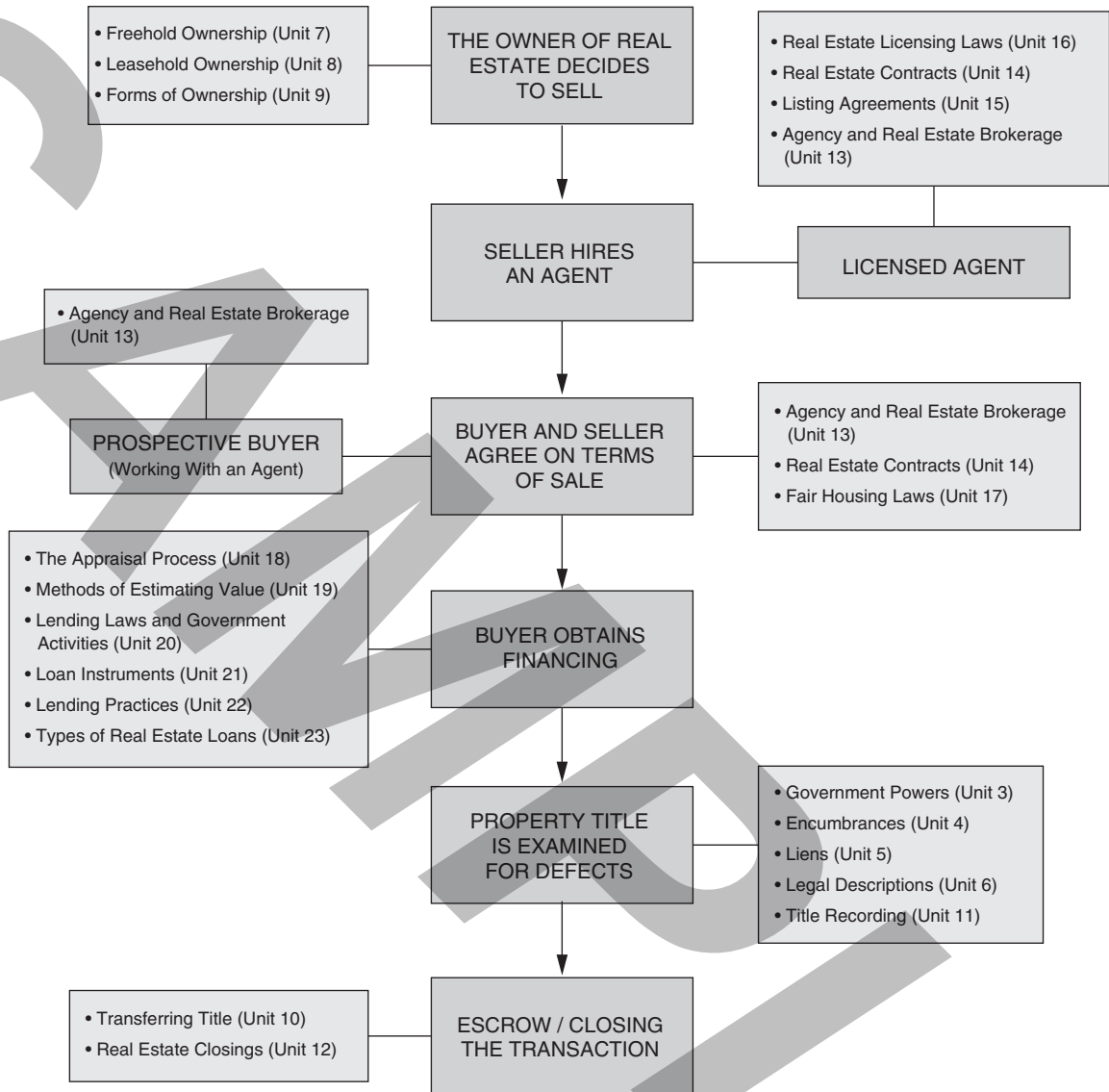
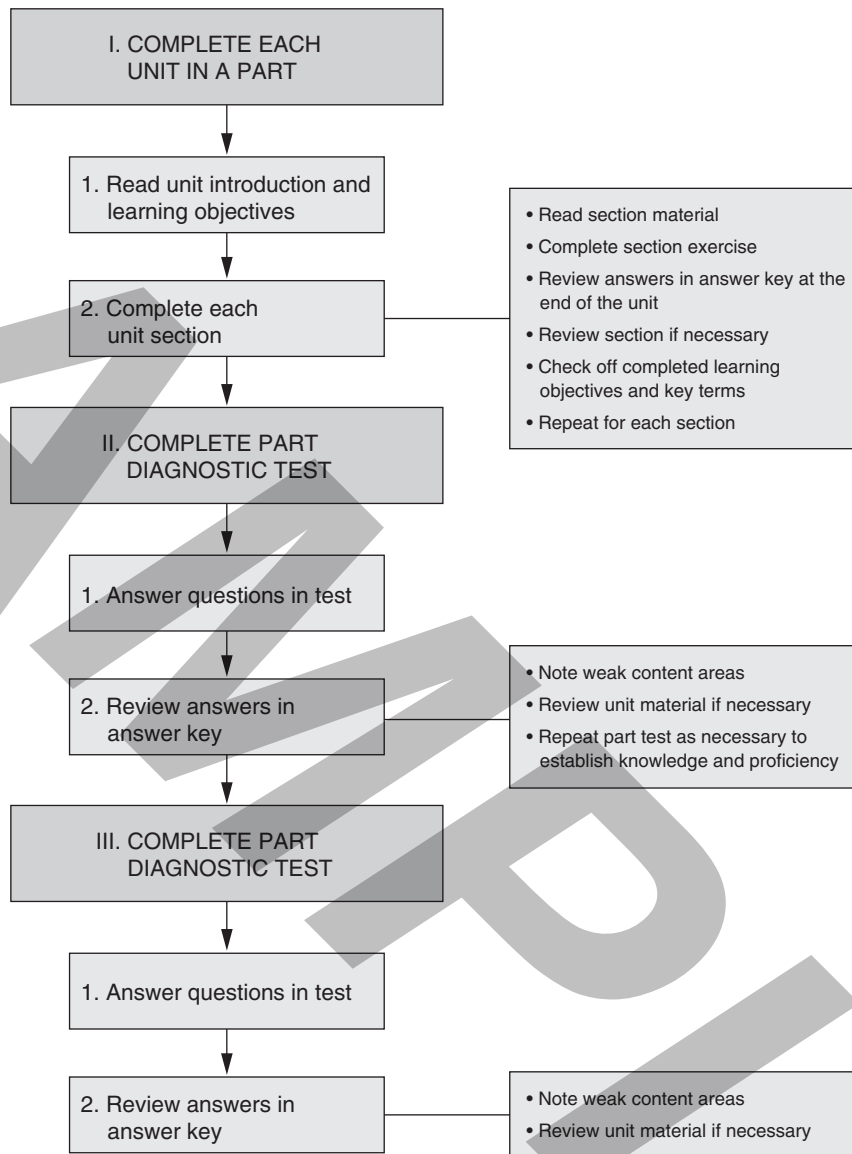


FIGURE 3: Summary of Steps for Using This Book



P A R T

INTRODUCTION TO REAL ESTATE

Unit 1: Introduction to Real Estate

Unit 2: Real Estate Concepts

SAMPLE



Introduction to Real Estate

Tip

If you have not done so, please read “How to Use This Book” in the Introduction to this book. The format of this book is different from most texts, and by following the suggested approach, you will derive greater benefits from your efforts.

Real estate is a huge business and plays an important part in the country’s economy. This unit presents an introduction to real estate and the real estate business. *Section 1* introduces services provided by the real estate industry and classes of real estate. *Section 2* describes the physical and economic characteristics of real estate. *Section 3* describes the real estate market and factors that affect the supply and demand for real estate. Remember to use the Study Tool Kit at the end of the book to reference key information.

■ LEARNING OBJECTIVES

Track your progress as you work through the unit by checking each learning objective when you complete it.

- ___ **List** the various services provided by the real estate business and some of the professional real estate organizations.
- ___ **Name** the five classes of real estate and give examples of each.
- ___ **Describe** the physical and economic characteristics of real estate.
- ___ **Describe** factors affecting the supply and demand for real estate and the effect on values due to changes in the supply or demand.

■ **KEY TERMS AND PHRASES** *Track your progress as you work through the unit by checking each term when you understand its meaning.*

- | | | |
|---|--|--|
| <input type="checkbox"/> Agricultural real estate | <input type="checkbox"/> Industrial real estate | <input type="checkbox"/> Residential real estate |
| <input type="checkbox"/> Appraisal | <input type="checkbox"/> Market segmentation | <input type="checkbox"/> Scarcity |
| <input type="checkbox"/> Brokerage | <input type="checkbox"/> Modification | <input type="checkbox"/> Situs |
| <input type="checkbox"/> Commercial real estate | <input type="checkbox"/> National Association of REALTORS® (NAR) | <input type="checkbox"/> Special-purpose real estate |
| <input type="checkbox"/> Demographics | <input type="checkbox"/> Nonhomogeneity | <input type="checkbox"/> Vacancy levels |
| <input type="checkbox"/> Fixity | <input type="checkbox"/> REALTOR® | |
| <input type="checkbox"/> Immobility | | |
| <input type="checkbox"/> Indestructibility | | |

SECTION 1

The Real Estate Business

Each year in the United States, millions of real estate transactions worth billions of dollars are completed, and most involve real estate professionals. Real estate is a significant part of the country's economy, and on a personal level, almost all people will be involved in a real estate transaction sometime during their life. People are involved in the real estate process as buyers, sellers, landlords, tenants, developers, or investors. For most buyers and sellers, a real estate transaction is the largest financial transaction in their lives.

SERVICES PROVIDED BY THE REAL ESTATE INDUSTRY

Most people think that real estate is only selling houses. While selling residential property is a major sector of real estate activity, many other services are provided by the real estate profession. These services provide numerous career opportunities in real estate.

Brokerage

Real estate **brokerage** is bringing together parties (the buyer and the seller or the landlord and the tenant) in a real estate transaction. The sponsoring broker (or a sales associate working for the broker) usually acts as an agent on behalf of the party or parties in negotiating the sale, purchase, or rental of the property. This is the most visible activity performed by real estate professionals, and most people who hold real estate sales or broker licenses are engaged in this type of service. Part V covers activities and topics related to real estate brokerage.

Appraisal

Appraisal is the process of estimating the market value of real estate. Appraisals are needed for many types of real estate activities, including lending, tax assessments, and insurance adjusting. Some appraisers are employed by lenders and government agencies; others work as independent appraisers. Appraisers now need to be licensed or certified to perform appraisals for federally related property transactions. Part VI covers real estate appraisal.

Counseling

Real estate counselors provide independent advice to individuals and firms regarding the purchase and use of real estate investments. Counselors need an extensive knowledge of real estate, tax laws, and investing. Part VIII covers tax and investment topics.

Education

Real estate education includes instruction for both real estate practitioners and the general public. Instruction may take the form of courses or seminars and can be held at universities, community colleges, private schools, and business organizations.

Financing

Most real estate transactions require financing. A number of real estate brokers are also mortgage brokers and may assist in finding real estate financing for buyers. Federal law requires mortgage loan originators to qualify for the Nationwide Multistate Licensing System and registry (NMLS), found at <https://nationwidelicensing.org>. Part VII covers real estate finance.

Property Subdivision and Development

Subdivision involves dividing larger parcels of land and development is the construction of improvements such as roads and utilities. Buildings constructed by developers can range from single-family homes to large shopping centers or office complexes. A variety of real estate principles used by developers are included throughout the book.

Property Management

Many investors in larger income-producing properties such as large apartment buildings and shopping centers may not have the time, interest, or expertise to take care of the daily operation of these buildings. They hire property managers to run the property for them and maximize the income flow while maintaining the property value. Property managers are typically responsible for finding tenants, collecting rents, and ensuring that the property is maintained. Some real estate firms specialize in property management, and larger firms may have separate property management departments. The Building Owners and Managers Association (BOMA) International, www.boma.org, is a resource for owners and managers. Unit 24 covers property management.

Rental Finding Services

Rental finding services help tenants find rental units and landlords find tenants. These services typically compile lists of available rental units and sell the information to prospective tenants.

Urban Planning

Urban planning is an area of specialization in real estate services. Urban planners usually work with local governments making recommendations regarding new schools, parks, utilities, streets, and highways.

Property Inspection

Professional property inspectors (also referred to as home inspectors) conduct a thorough survey of a commercial or residential property's structure; its mechanical, plumbing, and electrical systems; and site conditions. A report is prepared providing valuable information on the property's physical condition. Often a property inspection results in a recommendation for additional examination of a property condition, such as evidence of mold damage or insect infestation. There is an increased reliance by residential purchasers on inspection reports in making purchase decisions. Recognizing the importance of a well-trained inspector, many states have created home inspector licensing requirements that include education, examinations, training, and ongoing coursework. Real estate sales contracts are usually contingent on the inspector's report. The American Society of Home Inspectors (ASHI), www.homeinspector.org, and the National Association of Home Inspectors (NAHI), www.nahiassociation.org, are trade groups for property inspectors.

PROFESSIONAL ORGANIZATIONS

There are numerous professional organizations in real estate. These organizations reflect the various services offered by the real estate industry and the cultural diversity of real estate professionals. Many offer professional designations awarded after applicants complete educational, testing, and experience requirements. A list of real estate organizations and designations is included in the Study Tool Kit at the back of the textbook.

The **National Association of REALTORS® (NAR)** (www.realtor.org) is the largest and best-known professional association in the real estate industry. Founded in 1908, it has worked to promote high standards of professionalism in the real estate industry.

Note

Not everyone who holds a real estate sales or broker license is a REALTOR®. A licensee must join a REALTOR® board to use its designation and logo.

The term **REALTORS®** is a registered trademark of the NAR and may be used only by its members. Most real estate professionals belong to state, regional, and local NAR associations. The NAR performs many important functions, three of which are discussed here. First, it sponsors several affiliated institutions and societies that offer educational and training programs in specialized areas of real estate, such as property management and appraisal. Many of these training programs lead to professional designations. Second, it takes positions on legislation affecting real estate and provides testimony to Congress and to government and regulatory agencies on important real estate issues. Third, it has established a code of ethics designed to protect the public and serve as a behavior model for real estate professionals.

Before reading the next section, complete the Section 1 review exercises and compare your answers with the solutions at the end of the unit.

SECTION 1 REVIEW EXERCISES

1. Name the service provided by the real estate profession that *BEST* fits each description.
 - a. _____ Providing instruction to both the general public and real estate professionals

- b. _____ Operating a property for the owner
- c. _____ Bringing buyers and sellers together
- d. _____ Assisting buyers in securing a loan
- e. _____ Estimating the value of real estate
- f. _____ Dividing larger tracts of land and building homes
- g. _____ Providing advice on such topics as real estate investments

Are the following statements true (T) or false (F)?

2. ___ The term REALTOR® includes anyone who is licensed in real estate.
3. ___ More real estate licensees perform brokerage services than any other real estate service.

Supply the term that BEST matches each description.

- | | |
|--------------------------------------|--|
| a. Brokerage | 4. ___ service that typically includes finding tenants, collecting rents, and maintaining the property |
| b. Appraisal | 5. ___ The service of bringing buyers and sellers together |
| c. Property management | 6. ___ A large professional organization for the real estate industry |
| d. National Association of REALTORS® | 7. ___ Estimating the market value of real estate |

SECTION 2

Classes and Characteristics of Real Estate

CLASSES OF REAL ESTATE

Note

While it is possible for a real estate company to be involved with all classes of property and provide all the real estate services, this is impractical and seldom done. Companies and licensed individuals usually specialize in the type of service they provide, as well as in the class of property they handle. For example, a company may specialize in brokerage services for residential property or a property manager may manage only commercial property.

Real estate can be divided into five classes, based on the use of the property. Because it is difficult to become an expert in all types of real estate, brokers tend to specialize in one or two types of property.

1. **Residential**—includes single-family residences, condos, cooperatives, apartments, duplexes and triplexes, townhomes, and mobile homes. It also includes dwellings used for vacation homes and retirement housing.
2. **Commercial**—used for business and includes retail stores and shopping malls, office buildings, theaters, and parking lots.
3. **Industrial**—includes factories, warehouses, and research and development facilities.
4. **Agricultural**—includes farms, orchards, timberland, ranches, and hatcheries.
5. **Special-purpose**—all other types of property that do not fit the previous classes, including churches, cemeteries, government land, hospitals, and schools.

CHARACTERISTICS OF REAL ESTATE

Real estate has *physical* and *economic* characteristics that make it distinct from other commodities. (See Figure 1.1) These characteristics affect real estate value and the real estate market. Physical characteristics describe the physical attributes of the land. Economic characteristics affect the value of real estate. This section discusses the physical and economic characteristics of real estate and some consequences of the characteristics. Some of the consequences pertain to real estate topics discussed in later units.

FIGURE 1.1: Characteristics of Real Estate

Physical	Economic
Immobility	Scarcity
Indestructibility	Modification (improvement)
Nonhomogeneity (uniqueness)	Permanence of investment (fixity)
	Area preference (situs or location)

Physical Characteristics of Real Estate

Three physical characteristics of real estate are immobility, indestructibility, and nonhomogeneity.

Immobility An important and unique characteristic of real estate is **immobility**. Real estate includes the land's surface and beneath to the earth's center, as well as things permanently attached. Even though a property's minerals, topsoil, and other substances can be moved, the geographical location of the property always remains the same.

Because the location for real estate is fixed, the following consequences occur:

- The *location* of real estate is an important factor in determining its value.
- Real estate markets are local, and real estate professionals need to be familiar with the market in their area.
- Land is easily regulated and taxed by local governments.
- The value of real estate is heavily influenced, either favorably or unfavorably, by changes in the surrounding area.
- An exact legal description of the property's location, including definite reference points, is required when title to property is transferred.

Indestructibility The characteristic of **indestructibility** is also called *durability*. Land cannot be destroyed or worn out. Its appearance may be altered, but it continues to exist. Also, improvements to land, such as buildings, usually have a long life. Because land is indestructible, the following effects occur:

- Real estate investments are relatively stable and long term.
- Land cannot be depreciated because it does not wear out.
- Land is not insured by property insurance because it cannot be destroyed.

Nonhomogeneity **Nonhomogeneity** means that no parcels of real estate are exactly alike. Differences between parcels of real estate include the type of buildings located on the property, the size and shape of the property, the type of minerals or soil on the property, and so on. Even if two parcels of real estate look exactly alike, they always will be different because of their unique locations. Another way of expressing this characteristic is *uniqueness* or *heterogeneity*.

- Because of this lack of standardization, real estate professionals must work very hard to match a property to a buyer's needs.
- Because each property is different, it takes buyers longer to select and purchase real estate.
- Another consequence of nonhomogeneity is in contract remedies. If a seller breaches a real estate sales contract with the buyer, the courts may not allow the seller to substitute money or another parcel of land. Another term to describe the concept that real estate is nonsubstitutable is *nonfungible*.

Economic Characteristics of Real Estate

Four economic characteristics of real estate are scarcity, modifications, permanence of investment, and area preference.

Scarcity Scarcity means that the supply of real estate is limited. There is no shortage of land for use; however, there frequently is not enough in certain popular areas to meet demand. A term used by economists to describe a commodity with a *fixed supply*, such as real estate, is *inelastic*.

A consequence of this characteristic is that a strong demand in an area will increase property values.

Modification Modification (also called *improvements*) states that changes in a parcel of land affect its value. The effect may be either *favorable* or *unfavorable*.

EXAMPLE An apartment building owner has the grounds around the building landscaped. This change (modification) to the property probably will increase its value.

Permanence of investment Permanence of investment (also called *fixity*) means that investments in real estate are long term. This is primarily due to the physical characteristics of *immobility* and *indestructibility*. Because land is immobile, investment in property becomes fixed; it cannot be moved if the market becomes more favorable elsewhere. Also, because real estate transactions are complex and involve large amounts of money, they are not made as frequently as other transactions and require more time to consummate. Therefore, real estate investment decisions should be viewed as *long-term* investment decisions.

Area preference Area preference, also called *situs* or location, refers to people's preference for certain areas. Area preference, and therefore the property's location, is considered the most important economic characteristic of real estate.

There are two main consequences of this characteristic:

1. Prospective purchasers of property will attach great importance to the surrounding area when making their decision and determining the amount they are willing to pay.
2. The preference for certain areas that meet the needs of prospective purchasers will affect the amount they are willing to pay and therefore the value of the property.

EXAMPLE A family looking for a house finds an area that has good schools, a low crime rate, and other favorable factors. They will be agreeable to making a higher offer to the seller of a house in this area.

Before reading the next section, complete the Section 2 review exercises and compare your answers with the solutions at the end of the unit.

SECTION 2 REVIEW EXERCISES

1. List the physical characteristic of land that *BEST* fits each description.
 - a. _____ Land is not standardized.
 - b. _____ Location of land cannot be changed.
 - c. _____ Land is durable and does not wear out.
2. List the economic characteristic of land that *BEST* fits each description.
 - a. _____ Investments in land are long term.
 - b. _____ Changes in land will affect its value.
 - c. _____ Buyers prefer some locations over others.
 - d. _____ The supply of land is fixed.
3. Name the class of real property that *BEST* fits each description.
 - a. _____ Store
 - b. _____ Apartment building
 - c. _____ Farm
 - d. _____ Church
 - e. _____ Warehouse

Are the following statements true (T) or false (F)?

4. ___ Land's indestructibility makes it easily regulated by local government.
5. ___ Scarcity means that we may not have enough land to satisfy demand.
6. ___ The characteristic of modification means that the changes will always increase a property's value.
7. ___ Brokers tend to specialize in one or two types of real estate.

List the term that *BEST* matches each description.

- | | |
|---|--|
| <ol style="list-style-type: none"> a. Immobility b. Permanence of investment, or fixity c. Nonhomogeneity d. Indestructibility e. Situs f. Scarcity g. Modification h. Commercial real estate i. Residential real estate | <ol style="list-style-type: none"> 8. ___ The physical characteristic of real estate that land cannot be destroyed 9. ___ The economic characteristic of real estate that changes in land may affect its value as well as the value of surrounding properties 10. ___ The physical characteristic of real estate that land cannot be moved 11. ___ The economic characteristic of real estate that refers to the limited supply of land 12. ___ The physical characteristic of real estate that no two parcels of real estate are alike 13. ___ Investments in real estate being for the long term 14. ___ Refers to people's preference for some areas over others 15. ___ Property used for housing 16. ___ Property used for business, such as stores and office buildings |
|---|--|

SECTION 3

The Real Estate Market

Real estate can be bought and sold like other types of commodities. The real estate market is the mechanism whereby real estate is bought and sold, prices can fluctuate up or down, and the supply and demand for the product are always changing. To be effective in real estate, it is important to understand the characteristics of the real estate market and the forces that affect the supply and demand for real estate.

CHARACTERISTICS OF THE REAL ESTATE MARKET

Hint

Price changes usually go the same way as demand changes. Price changes usually go the opposite way to supply changes.

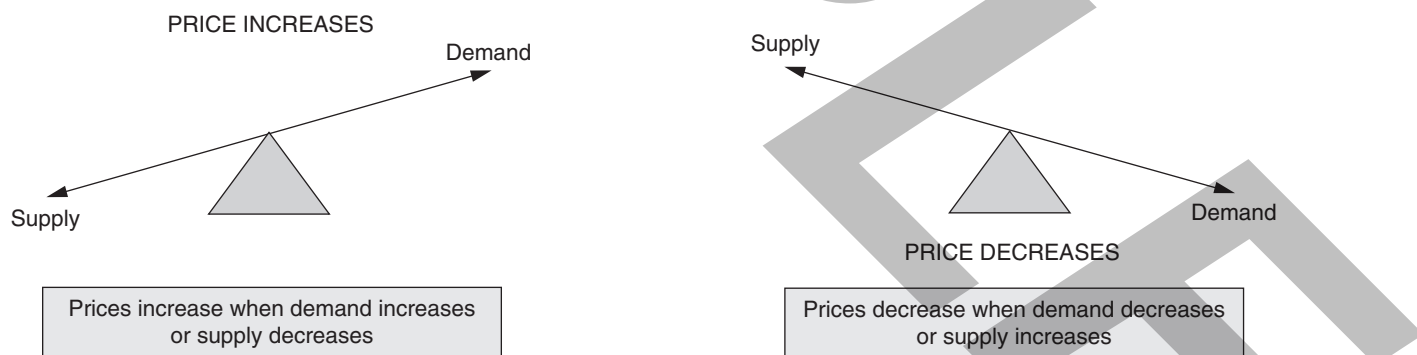
Supply/Demand and Price

In the real estate market, supply and demand interact to affect property prices. As in any market, supply and demand are continually adjusting, and this causes changes in the price of property.

- Prices increase when demand increases or supply decreases. This is called a *seller's market*.
- Prices decrease when demand decreases or supply increases. This is called a *buyer's market*.

A goal of real estate professionals is to be aware of market changes to better serve their clients. Figure 1.2 illustrates the relationship between supply and demand.

FIGURE 1.2: Relationship Between Supply, Demand, and Price



Local Market

One of the physical characteristics of real estate is *immobility*. Because property cannot be moved around to satisfy demand in different areas, the real estate market is very *local* in character. Markets may differ among cities or even among different sections of the same city. Because of this, each local market must be considered separately.

Market Segmentation

In addition to being localized, the real estate market may be *segmented*; that is, several different markets may operate in the same area. **Market segmentation** may occur in several different ways, including the type of property and the price range for property.

EXAMPLE The market for houses priced from \$150,000 to \$300,000 may be different from the market for houses priced above \$300,000.

EXAMPLE The market for residential property in a city may be different from the market for office buildings.

Market Adjustments

As the forces of supply and demand change, the speed at which prices respond is determined by the *standardization* and *mobility* of the product. Because real estate is *nonmobile* and *nonstandard*, the price of real estate is slow to adjust. Also, the construction of improvements to real estate takes longer to complete, slowing increases in supply.

Even when supply and demand can be forecast with some accuracy, natural disasters such as hurricanes and earthquakes can disrupt market trends. Similarly, a sudden change in the national financial market, a local event such as a business closure, or a regional disruption caused by storm damage can dramatically disrupt a seemingly stable market.

FIGURE 1.3: Factors Affecting Supply and Demand

Supply	Demand
Labor supply	Population
Government controls	Demographics
Government financial policies	Employment and wage levels

FACTORS AFFECTING THE SUPPLY OF REAL ESTATE

Note

While the supply of real estate may be slow to adjust, the demand for real estate may change quickly. For instance, if mortgage rates were to drop suddenly, more people could afford a home, and the demand for real estate might increase quickly as homebuyers rushed to buy homes and lock in the lower rates.

The Supply of Labor and Construction Materials

It takes significant amounts of labor and materials to construct a building. Many skilled laborers, such as carpenters, masons, plumbers, et cetera are required for the construction. The availability of skilled labor and materials will affect the supply of buildings that can be built.

EXAMPLE A shortage of lumber may delay construction of homes.

Government Controls

The federal government and its many agencies affect the supply of real estate through regulatory controls. These controls can affect the amount of money available for real estate construction loans, which are critical for building new structures.

EXAMPLE Changes to real estate taxation can affect the desirability of investing in real estate. A city may offer tax incentives in a depressed area, thereby increasing the availability of investment funds to build new commercial buildings.

Local government controls real estate through zoning and building ordinances. These also influence the supply of housing.

EXAMPLE A suburb changes its zoning rules to require larger lot sizes for houses. In this case, fewer houses can be built.

EXAMPLE A town designates an enterprise zone with low real estate taxes to attract commercial developers. This will increase the supply of commercial buildings.

Government Financial Policy

The large dollar amounts in real estate transactions require the availability of mortgage money at a reasonable cost. Therefore, the supply and cost of financing (the interest rate) are important factors in determining the quantity and timing of new additions to real estate supply. These are significantly affected by government economic and financial policy. Construction of additional housing (supply of real estate) diminishes when the cost of financing is high.

EXAMPLE The government could increase spending programs such as aid for low-income housing. This might increase the supply of housing.

EXAMPLE Increased government spending could raise interest rates because the government needs to borrow money. This in turn might decrease the affordability of loans and the ability of people to purchase housing.

FACTORS AFFECTING THE DEMAND FOR REAL ESTATE

While the factors that affect the demand for real estate are the same as those that affect the demand for most other commodities, real estate markets are generally local (because of the characteristic of immobility). Because of this, local demand factors will influence the market.

Population and Demographics

It should be obvious that if the population increases, so will the demand for housing. Other than the number of people, another major factor is the **demographics** of the population. The term *demographics* refers to the characteristics of the population: age distribution, family size, and population movements. Demographics affect not only the total demand for real estate but also the type of housing demanded.

EXAMPLE As children of the baby boom generation reached adulthood, the demand for apartments increased. As they grew older and had families of their own, the demand for single-family housing increased.

EXAMPLE The movement of people to the western and southern states created a greater demand for housing in those areas.

Employment and Wage Levels

Employment and wage levels directly affect people’s ability to pay for real estate. This is especially important for a durable commodity such as real estate because people have the option of deferring the purchase to a later time if they are fearful of losing their jobs.

EXAMPLE People may decide to rent and put off purchasing a house until their income rises or they are more certain of employment.

Vacancy Levels

A vacancy rate is the percentage of all units that are not occupied. While not a factor in creating demand, **vacancy levels** are an indication of the demand for property in an area, and there may be several rates based on the type of property.

EXAMPLE A town may have a vacancy rate of 5% for apartment units, 20% for retail space, and 20% for office space.

EXAMPLE If the vacancy rate for apartment units has recently fallen from 6% to 3%, there is increasing demand in this section of the market.

Complete the Section 3 review exercises and compare your answers with the solutions at the end of the unit.

SECTION 3 REVIEW EXERCISES

1. Name the factor affecting the supply of or demand for real estate that *BEST* fits each description.
 - a. _____ A measure for the number of units that are not occupied
 - b. _____ The availability of carpenters and other workers
 - c. _____ The number of people in an area
 - d. _____ Zoning laws regulating the type of real estate construction
 - e. _____ The number of people without jobs
 - f. _____ Setting interest rates for the country’s money supply

Are the following statements true (T) or false (F)?

2. ___ The real estate market is relatively quick to adjust to the forces of supply and demand.
3. ___ Most real estate professionals do not try to advise clients regarding property outside the local real estate market in which they are actively engaged.
4. ___ If the demand for real estate decreases and the supply increases, prices will increase.
5. ___ If the supply of real estate decreases and the demand increases, prices will increase.

Supply the term that BEST matches each description.

- | | |
|--|--|
| <ol style="list-style-type: none"> a. Supply of real estate b. Market segmentation c. Vacancy levels d. Local e. Demographics | <ol style="list-style-type: none"> 6. ___ Divides real estate markets into submarkets 7. ___ Details the characteristics of the population 8. ___ The percentage of building units that are not occupied 9. ___ The quantity of housing available for sale 10. ___ Characteristic of the real estate market |
|--|--|

SOLUTIONS FOR SECTION REVIEW EXERCISES

Section 1

1.
 - a. Education
 - b. Property management
 - c. Brokerage
 - d. Financing
 - e. Appraisal
 - f. Property development
 - g. Counseling
2. FALSE Only members of the National Association of REALTORS® may use the term REALTORS®.
3. TRUE
4. c. Property management
5. a. Brokerage
6. d. National Association of REALTORS® or NAR
7. b. Appraisal

Section 2

1.
 - a. Nonhomogeneity
 - b. Immobility
 - c. Indestructibility
2.
 - a. Permanence of investment, or fixity
 - b. Modifications
 - c. Situs
 - d. Scarcity
3.
 - a. Commercial
 - b. Residential
 - c. Agriculture
 - d. Special purpose
 - e. Industrial
4. FALSE Land's *immobility*, not its indestructibility, makes it easily regulated by local government.
5. TRUE
6. FALSE The characteristic of modification means that changes may either increase or decrease the property's value.
7. TRUE
8. d. Indestructibility
9. g. Modification

10. a. Immobility
11. f. Scarcity
12. c. Nonhomogeneity
13. b. Permanence of investment, or fixity
14. e. Situs
15. i. Residential real estate
16. h. Commercial real estate

Section 3

1.
 - a. Vacancy rate
 - b. Supply of labor
 - c. Population
 - d. Government controls
 - e. Employment levels
 - f. Government financial policy
2. FALSE The real estate market is relatively slow to adjust to the forces of supply and demand.
3. TRUE
4. FALSE Prices will decrease because there will be an oversupply of real estate.
5. TRUE
6. b. Market segmentation
7. e. Demographics
8. c. Vacancy levels
9. a. Supply of real estate
10. d. Local

MASTERING REAL ESTATE PRINCIPLES

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