



# Investment Value in Property Investment and Debt Financing

This presentation explores the advanced concepts of investment value and debt financing in real estate. We'll examine how sophisticated investors can leverage unique market positions and tax advantages to create positive NPV opportunities.

# Market Value vs. Investment Value

## Market Value (MV)

The expected price at which an asset would sell in the current property market without pressure or distress.

Reflects opportunity cost of the investment.

## Investment Value (IV)

A property's value to a particular owner who plans to operate the asset long-term.

Can differ between investors for the same asset.



# Key Differences: MV vs. IV

## Market Value

Objective value exogenous to any one party.

Same for a given asset for all investors at a given point in time.

## Investment Value

Private or subjective valuation of a specific party.

Based on unique investor circumstances and capabilities.

## Relationship

When  $IV > MV$ , buying makes sense.

When  $IV < MV$ , selling makes sense.

# When IV Exceeds MV: Examples



## Expansion Needs

A retailer values adjacent lots higher than market for expansion space and to block competitors.



## Market Power

An investor owning most apartments in an area values additional properties higher to strengthen market position.



## Synergy Effects

A property owner sees unique synergies between existing and potential new properties.



## Entrepreneurial Innovation

An investor develops a new property concept that meets latent market demand.



# Measuring Investment Value

1

## Use Multiperiod DCF

Project long-term cash flows specific to the particular owner/user.

2

## Include Synergy Effects

Account for spillover benefits with owner's other assets and operations.

3

## Apply Market Discount Rates

Use opportunity cost of capital based on capital markets.

4

## Focus on Cash Flow Numerators

Differences in IV typically come from cash flow projections, not discount rates.



# Boston Real Estate Example

1

## Current Situation

BRE owns apartment complex (Plot A) generating \$100,000 yearly.

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2

## Opportunity

Adjacent Plot B available with two development options: apartment or retail.

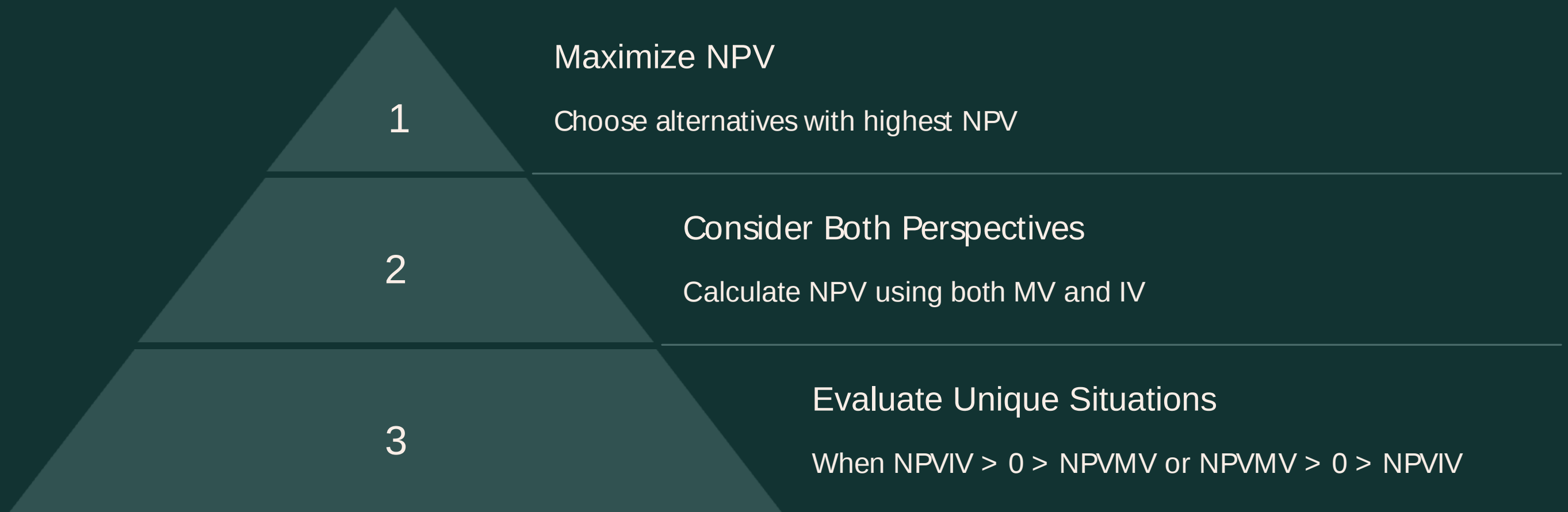
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3

## Synergy Effect

Retail on Plot B would increase Plot A's value by \$400,000 through spillover benefits.

# Decision Making with IV and MV



# Negotiation Philosophies

## Conservative Philosophy

Never pay more than MV for something, even if your IV is higher.

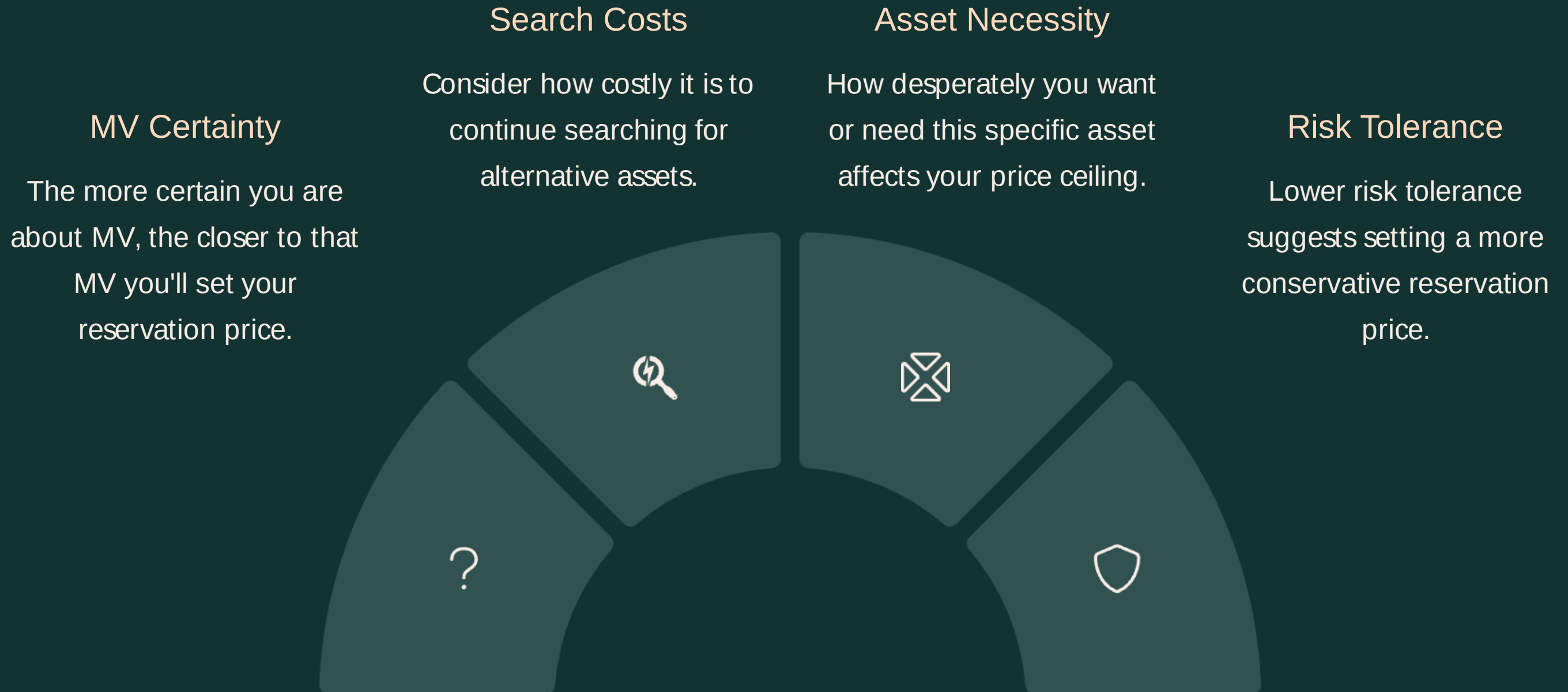
Bargain seller down to MV or walk away from the deal.

## Liberal Philosophy

Make the deal as long as it meets investment criteria on NPVIV basis.

Bargain for best price, but accept positive NPV from your IV perspective.

# Setting Your Reservation Price



# Understanding Market Equilibrium



## Marginal vs. Intramarginal Investors

### Marginal Investors

Those for whom  $IV = MV$ , indifferent between buying and selling at market price.

### Intramarginal Investors

Those for whom  $IV \neq MV$ , can achieve positive NPV deals by trading at market prices.

### Market Equilibrium

MV is determined by the IV of marginal participants in the asset market.

# Investment Value Through Debt Financing



# After-Tax Valuation of Debt Example

4%

Market Mortgage  
Rate

Prevailing interest  
for typical mortgage  
loans

3%

Tax-Exempt Rate

Municipal bond rate  
for tax-free  
investments

25%

Implied Tax Rate

Marginal tax rate of  
typical debt market  
investors

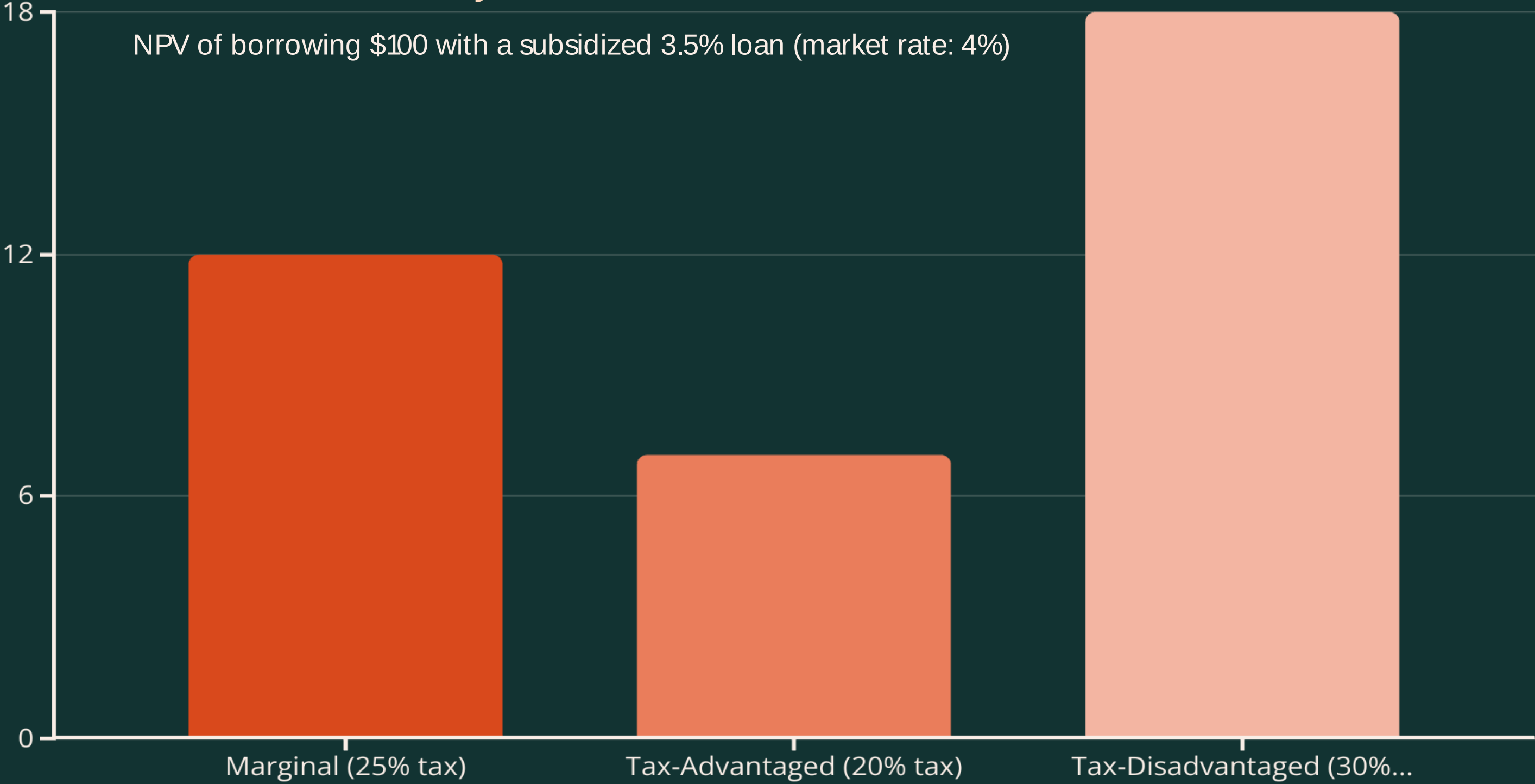


# Investor Tax Scenarios

| Investor Type                | Tax Rate | Debt NPV Impact |
|------------------------------|----------|-----------------|
| Marginal (Mary)              | 25%      | Zero NPV        |
| Tax-Advantaged (Abner)       | 20%      | Negative NPV    |
| Tax-Disadvantaged (Clarence) | 30%      | Positive NPV    |



# Subsidized Loan Analysis



# Debt and Taxes in Property Market

1

Higher Tax Investors

Gain positive NPV from borrowing

2

Market Competition

Drives property prices higher

3

Equilibrium Reached

When  $APV = 0$  for marginal investors

4

Price Premium

Property prices include tax advantage value

## REAL ESTATE INVESTMENTS



# Apartment Property Example



## Property Details

Market value: \$937,000

NOI: \$77,250 in year 1



## Financing

Loan amount: \$702,670

Interest rate: 5%



## Tax Situation

Investor tax rate: 35%

Debt market marginal tax rate: 15%

# Valuation by Components



Calculate After-Tax OCC of Debt

$$(1 - 0.15) \times 5\% = 4.25\%$$



Discount Loan Cash Flows

Present value of loan obligation: \$649,767



Calculate NPV(Financing)

$$\$702,670 - \$649,767 = +\$52,903$$



Determine NPV(Property)

$$\text{For APV} = 0, \text{NPV(Property)} = -\$52,903$$





# Corporate Real Estate: Own vs. Rent

## Key Principles

Discount after-tax cash flows at after-tax discount rates.

Include both corporate and personal taxation levels.

Discount cash flow components at risk-appropriate OCC rates.

## Typical Outcome

For profitable taxed corporations, leasing often makes more sense from a tax perspective.

Value impact is typically small when considering debt capacity effects.

## Other Considerations

Duration of space usage, depreciation allowances, price/rent multiples, and expected capital gains.

Non-financial factors may outweigh tax considerations.

# Key Takeaways: Investment Value



## IV vs. MV Framework

Understanding both perspectives enables better investment decisions.

## Tax Advantages

Debt financing can create positive NPV for high-tax-bracket investors.



# Next Steps for Sophisticated Investors



## Identify Unique Advantages

Look for situations where your IV exceeds MV due to synergies or capabilities.



## Analyze Tax Situation

Understand how your tax position affects debt financing value.



## Apply APV Framework

Evaluate investments by separating property and financing components.



## Develop Negotiation Strategy

Set reservation prices based on your IV and market knowledge.