Chapter 8: Understanding Real Estate Markets

Market - the mechanism or arrangements through which goods and services are traded between market participants

Real Estate Space Markets – mechanism or arrangements for trading the rights to use land and buildings
  o people, firms, and other entities are willing to pay various prices for the use of space for consumption or production purposes (demand)
  o owners of space are willing to sell the rights to use such space to the users for various prices (supply)
  o Space markets are segmented by location and type of use
    ▪ Office space markets
      • Class A
      • Class B
      • Class C
      • Class D
    ▪ Retail space markets
      • Freestanding retail
      • Neighborhood center
      • Community center
      • Regional center
      • Superregional center
    ▪ Industrial space markets
      • Warehouse
      • Manufacturing/production
      • Materials processing
    ▪ Agricultural space markets
      • Annual (seasonal) cropland
      • Perennial cropland
      • Livestock grazing and facilities
    ▪ Lodging space market
      • Highway motels
      • Convention/business hotels
      • Luxury hotels
      • Resort (destination) hotels
      • Extended stay hotels/motels
    ▪ Residential space market
      • Single-family detached homes
      • Single-family attached homes (condos, co-ops, townhouses, etc.)
      • Manufactured homes
      • Multifamily apartments
Price movements in real estate space markets
- The demand curve in real estate markets is downward sloping.
- See Figure 8.2 on page 157.
- The supply curve in most real estate markets is vertical at the current quantity of space and horizontal at higher quantities.
- In a typical market, therefore, demand increases are unlikely to result in long-term price increases. Demand decreases, however, may lead to dramatic price decreases.
- See Figure 8.3 on page 158.
- Of course, each market has particular circumstances that determine the impact of supply and demand changes on equilibrium prices. The text discusses the luxury, ocean-accessible housing market in Fort Lauderdale, Florida, as an example.

Real Estate Asset Markets – mechanism or arrangements for trading the rights to cash flows generated by land and buildings
- the real estate asset market is part of the larger capital market, which includes
  o publicly traded equity assets (stocks, mutual funds, real estate investment trusts)
  o privately traded equity assets (real property, private companies, oil and gas partnerships)
  o publicly traded debt assets (bonds, mortgage-backed securities, money instruments)
  o privately traded debt assets (bank loans, whole mortgages, venture debt)
- prices in real estate asset markets are determined by:
  o opportunity cost of capital
  o growth expectations
  o risk

The Real Estate System – consists of real estate space markets, the real estate asset market, and the development industry
- See Figure 8.6, page 164.
- Prevailing economic conditions influence both the capital markets and individual space markets.
- Landlords and tenants in space markets negotiate and determining rents, which produces cash flows that are of primary concern to participants in the real estate asset market.
- If the cash flows are attractive in the real estate asset market relative to other capital asset categories, the development industry is persuaded to add new space to the market, thus completing the system.

Market Analysis – examination of the supply and demand sides of a real estate space market and the balance (equilibrium) between them

Inputs to market analysis
- Vacancy rate – higher vacancy rate indicates less demand relative to supply and vice versa
- Rent or price level – trends in rents and prices indicate changes in the balance between supply and demand
- Quantity of new construction started – indicates new supply that will be coming into the market
- Quantity of new construction completed – indicates new supply that is just arriving into the market
- Absorption of new space – indicates the rate at which new supply is becoming occupied in the market

Using “Months Supply” to look forward in a real estate market analysis
- Months supply = (vacant space + space in construction)/net absorption per month
- If months supply is much greater than construction time for new projects, then the new project will likely hit the market at a time when supply exceeds demand
- If months supply is equal to or less than construction time for new projects, then a new project will likely be well received by the market.

Key Drivers for real estate space markets
- Office: employment in office occupations
- Lodging: air passenger volume, highway traffic counts, tourism receipts, number of visitors
- Retail: per capital income, aggregate income, wealth measures
- Industrial: manufacturing employment, transportation employment, shipping volume
- Apartments: population, household formation, local housing affordability, employment growth (blue and white collar)
- Owner-occupied residential: population, household formation, interest rates, employment growth, income growth