Seldin On Change
NEW RATIOS: WHAT ARE THEY TELLING US?

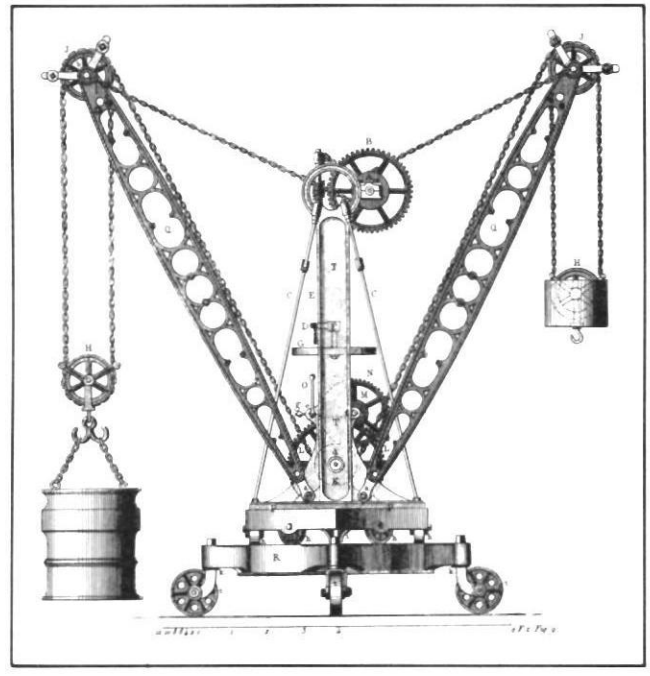
by Maury Seldin, CRE

Consider a few facts on land values:

- For the typical single-family house, the ratio of land value to the value of land and building doubled in the last quarter century. It had been cut in half in the previous quarter century, and is now about the same as it was in the late 1920s,[1] as shown in Figure 1.
- Residential land prices as measured by the Homer Hoyt Institute Land Price Index turned down in late 1981 after a decade of sharp increases.[2] The price increases were greater than inflation rates but less than housing price increases.[3]
- Governmental regulations and excessive zoning requirements are, aside from inflation, the two main reasons for the high cost of land.[4]

Now take a look at the changes in inflation rates (using GNP deflator):

- In the 1950s the inflation rate averaged about 2½ percent per year. It dropped to about 1½ percent in the early '60s and then started a sharp upward movement.



- In the late '60s it was 3½ percent; in the early '70s, 5 percent; and in the late '70s, 7½ percent.
- More recently it has been running about 9 percent, as reflected in Figure 2.

Interest rates and capitalization rates are listed in Figure 3. For most of the '70s, prime property mortgage interest rates ranged around 9 percent. Capitalization rates were about ½ percent higher than interest rates for this same time period. The gap disappeared in 1979. Since then, interest rates have been higher than capitalization rates.

Prices show that the average cost per square foot of office space in 1981 was $73 (based on sample data from SREA

This article is the third in a series which focuses on the problem of change in the real estate industry.

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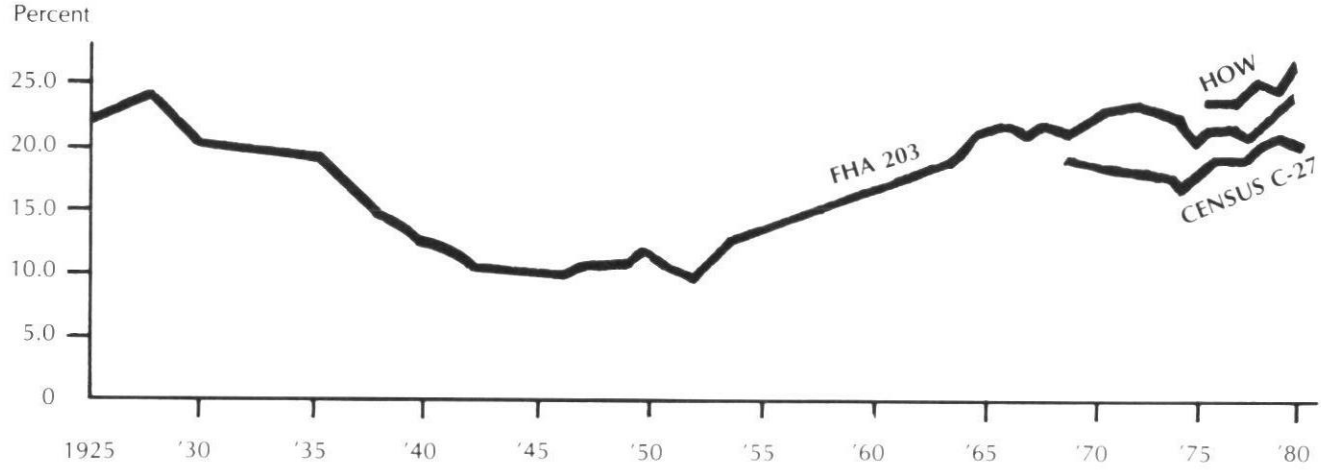
FIGURE 1

Ratio of Land to Home Prices of Single Family Detached Homes
1925-1980



Source: Homer Hoyt Institute, "The Relationship of Land Costs to House Prices, 1925-1980," *Land Review* (September 1981), 6-7.

Market Data Center as reported in *Land Review*, January 1982). The ratio of net income to price was 7.6 percent in California and 10.15 percent in all other states.[5] The average cost per square foot of shopping space (also based on SREA data as analyzed by *Land Review*, was $57 in California and $49 elsewhere. The ratio of net income to price was 8.2 percent in California and 7.4 percent elsewhere.

At these prices, a number of things seem to be happening:

- Office condos are in bloom in some areas.
- Price-per-square-foot pressures are causing tenants to seek economies in amount of space and location, with some shift to lower-priced suburban areas for back-room activities.
- The pace of building construction looks out of line with long-run requirements, although some structural changes are occurring in local markets.
- Condo development of shopping centers is showing early signs of a trend.
- Prices have hurt many retail operations, resulting in greater economies and turnover in space.
- Competition has hit some shopping centers hard.

In regards to financing, long-term fixed rate mortgages are basically out; 100 percent financing with equity participation is in, as well as pension funds and foreign money with heavy or all-cash investments.

Changes Seen As Cyclical And Structural

The ratio of debt to equity has changed, interest rates have changed and capitalization rates have changed. The price per square foot has changed for residential, retail, office and especially for land. It is not just change over time, but changes in structural relationships. The old rules-of-thumb don't help much.

Much of the discussion these days is of boom or bust: the Great Depression Syndrome. Are we going to get it again — or worse, are we already there?

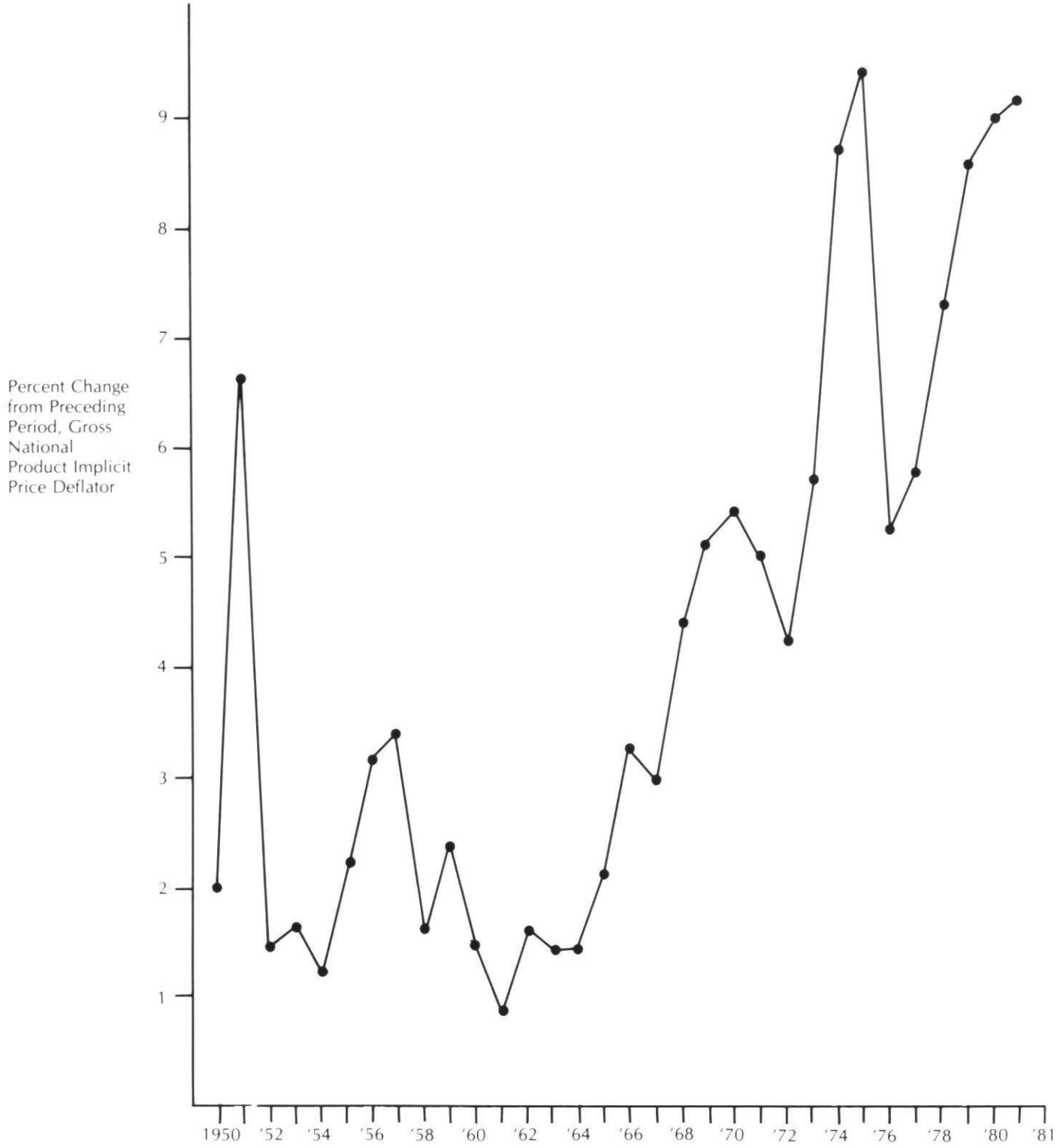
A look at any of the markets will show cyclical activity. In general, amplitudes have increased, and we are getting wider swings in the cycles and maybe different time spans for the cycles.

Then there are the structural changes. Long-run structural changes are occurring in the economy. This does not mean that we necessarily have a Great Depression on our hands, but that rather the relationships are different. The national economy is producing different products. Our international position has changed economically. We may be going through an adjustment process different from anything we have previously experienced.

We are manufacturing different products and services at different locations and changing our real estate requirements. We are financing the real estate differently. Real estate investment has become riskier. What concerns me is that the decision makers may see only the short trends and extrapolate them. There is no more certain recipe for disaster.

FIGURE 2

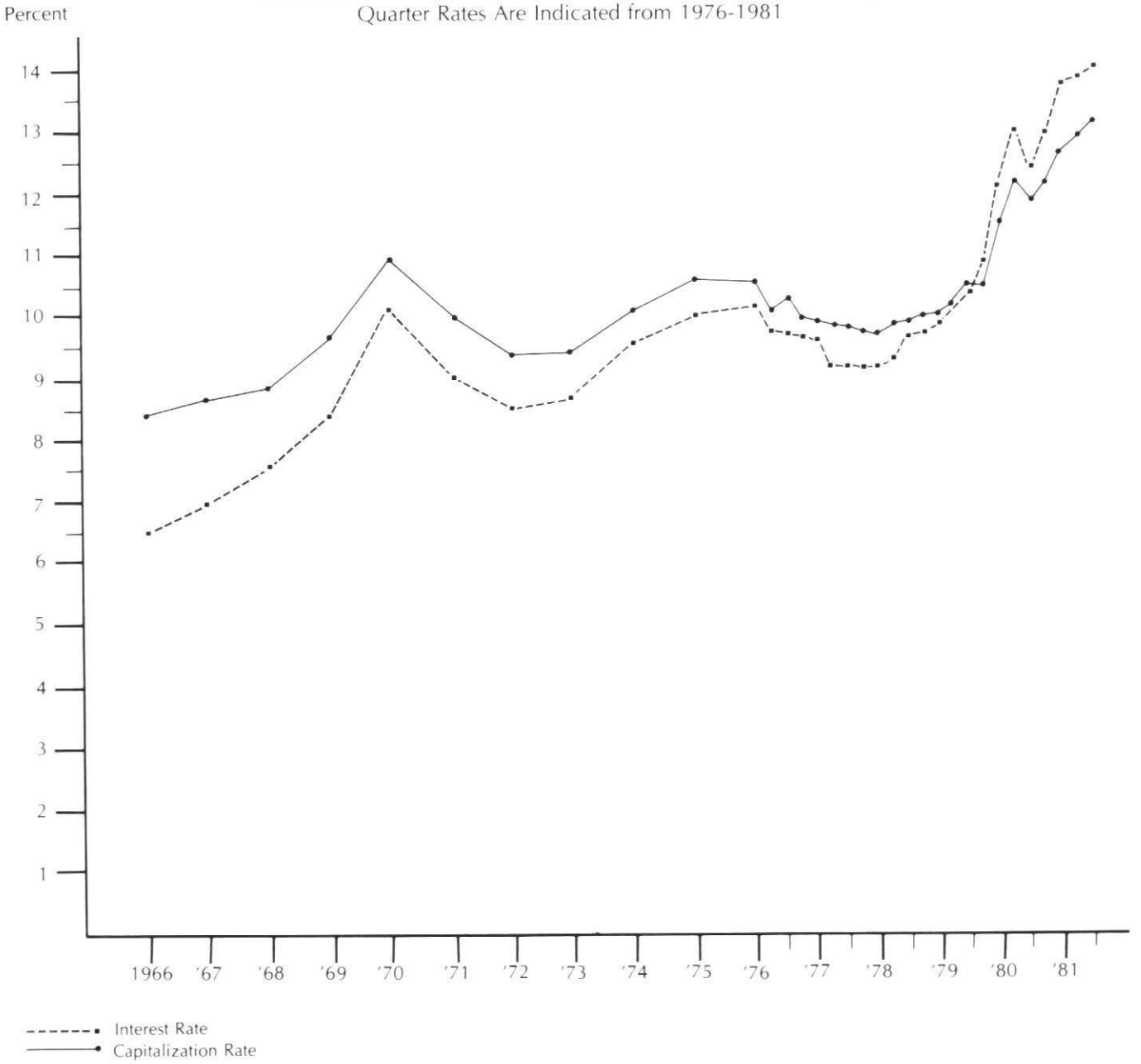
Inflation as Measured by Gross National Product Deflator, 1950-1981



Source: Department of Commerce, Bureau of Economic Analysis, as shown in *Economic Report of the President* (February 1982), 237.

FIGURE 3

Interest and Capitalization Rates of Office Building Mortgage Commitments by Selected Life Insurance Companies 1966-1981; Quarter Rates Are Indicated from 1976-1981



Source: American Council of Life Insurance, *Investment Bulletin* (Table L, various issues).

NOTES

1. Homer Hoyt Institute, "The Relationship of Land Costs to House Prices, 1925-1980," *Land Review* (September 1981), 6-7.
2. Homer Hoyt Institute, "Land Price Index Declines," *Land Review* (November 1981), 8.
3. Homer Hoyt Institute, "Land Costs Outpace Inflation, But Not Housing Prices," *Land Review* (August 1981), 5
4. Homer Hoyt Institute, "Regulations, Zoning Are Main Culprits of High Land Cost," *Land Review* (November 1981), 6.
5. Homer Hoyt Institute, "Recent Sales of Shopping Centers and Office Buildings," *Land Review* (January 1982), 5.

Look for the next Seldin On Change *article in the Fall/Winter 1982 edition of* REI.