Real Estate Values and Inflation: The Value of Real Estate Versus the Value of Money

by Walter R. Kuehnle, C.R.E.

Market value is usually defined by appraisers as the price in money at which a fully-informed seller and a fully-informed buyer, ready, willing and able to deal, will agree. At the present time a problem stems from the word "money."

As appraisers we express opinions of the value of real estate in terms of our own country's currencies: pesos, cruzeros, bolivars, dollars (U.S. and Canadian), and so forth. In arriving at our value conclusions we usually think of the price which would be paid by prospective buyers in our own respective countries. According to such a market approach to value, a study of sales of comparable properties demonstrates—through the action of buyers and sellers—the probable price that typical buyers would pay for a certain property. In other words, contemporary or past action of buyers in the market indicates the present value of the future benefits of ownership.

However, now comes the complicating factor that challenges the comparative sales approach to value. As a result of accelerating rates of inflation, investors—from the buyers of houses to the buyers of investment real estate—are uneasy with the purchasing power of currency and attempt to exchange it for real estate which they believe will increase rather than erode in money value. Using the same philosophy sellers raise their asking prices which purchasers may pay in the hope of reselling at even a higher

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price. Accordingly, inflation is making it difficult for the appraiser to estimate the value of real estate in current money.

INTERNATIONAL INVESTMENT

There is another current influence in the real estate market, especially on large investment properties. International investors in countries with strong currencies are attracted to real estate investments in other countries where stable real estate is available in weaker currencies. Here is an opportunity to make bargain acquisitions of inflation-hedging investments and get rid of surplus foreign money. Buying competition from abroad is further encouraged by the foreign dollar powers holding "Euro" dollars. However, there is little evidence that the limited number of purchases to date by "offshore buyers" have had any broad effect on current real estate prices in the United States.

Nevertheless, this existing reserve of foreign held dollars was highlighted by the Deutsche Bank of Frankfurt's recent proposal to purchase the 110-story Twin Tower World Trade Center in New York City. Countries with stable governments and economic policies, but currently weak currencies, have attracted foreign buyers to invest in such real estate as shopping centers, office buildings, hotels, farms, forests, and fisheries.

Prospective investors, both national and foreign, tend to regard current informed opinions concerning proper rates of interest on investment and resulting valuation of experienced local appraisers as not reflecting true value potential. To them a substantially higher price in the local currency is still a bargain compared to investment opportunities currently available in their own countries.

All of this means that, as inflation gains momentum past sales of real estate tend to lose credibility as indications of actual value, a situation that has been occurring in certain Western Hemisphere countries. In those countries most recently affected, many national real estate investors have been reluctant to accept the full implication of an inflationary trend. While long-term interest rates continue to rise, insurance companies still make long-term loan commitments, but at ever increasing interest rates. After all, they are responsible to their policyholders only in currency, regardless of its purchasing power. In some countries with very rapid inflation, lenders require repayment of the amount borrowed, plus the inflation index in addition to interest.

GENERAL CONCERN WITH INFLATION

While inflation is causing great anxiety, we hope for solution by miracle. We are confused by financial writers' and government officials' daily press discussion of causes and solution proposals which keep this hope alive. However, the public does not presently support the theory that reversal of the inflation trend may be achieved only by balanced personal and government budgets. Government does understand that such a program would be generally unacceptable.

REVERSAL—CONTROLLING INFLATION

Therefore, it does not appear logical to expect a successful attempt to wring out the inflation that has been gaining momentum for ten years and reached 9% for 1978. Currently publicized solutions only suggest controlling inflation, which is reaching alarming rates in other countries. Brazil for example, reports a 12-month rate of 42.7% and lenders there may demand indexed repayment of principal (original loan, plus inflation). If I understand the current consensus of economists, such rates need not occur in the United States due to the strength of the economy. It would appear, therefore, that the degree of inflation in future years will depend on decisions made by government, business, and financial institutions and a better understanding by those who influence these decisions.

PROSPECTIVE TREND IN REAL ESTATE PRICES

Given these circumstances, increased inflation is expected, with an attendant upward increase in construction costs and the value of well-selected real estate and other tangibles. No economic trend is universal, however, so the term "well-selected real estate" has a special emphasis. Under influencing pressures certain real estate will escalate in value, some will remain constant, while other parcels will decline. The increases will likely take place on well-located commercial property with percentage clauses and the probability of escalating rents. Value decreases may include property under long-term lease with no revaluation clause and limited prospects for residual value at the end of the lease term, downtown retail business streets with poor prospects for increasing sales volume growth, and, in general, properties in second-class locations.

In other words, the properties that should perform best under an inflationary pressure are those with good locations and a prospect of income which will increase with the inflation rate.

An understanding of current conditions and trends is the stock-in-trade of the real estate appraiser and counselor, and a basis for action by the investor. If we are to be effective real estate practitioners, we must understand what is happening in our country and in others as well. Events taking place elsewhere today may happen at home tomorrow.