FOCUS ON RESEARCH

Real Estate Value Cycles - Critical Knowledge for the 21st Century

by Peter F. Korpacz

As radical as the changes in the real estate market have been over the last 10 years, the timelessness of real estate remains intact.

The real estate recession of the early '90s wreaked financial havoc on investments saddled with the enormous overbuilding of the 1980s without the corresponding effective demand. Later in the decade, however, it gave way to a startling recovery with vastly improved occupancies and double-digit market rent increases. In the process, the public markets (REITs and CMBS) emerged as the catalyst for disciplined and adequate real estate investment dollars.

And yet, what else is new? Haven't we been there before? For some of us, more than once in our careers? Some of the same suspects and a few new ones, only a different time? The one constant through it all, peaks and valleys, is the cycle of real estate performance. Market cycles are timeless, and the process is unlikely to change.

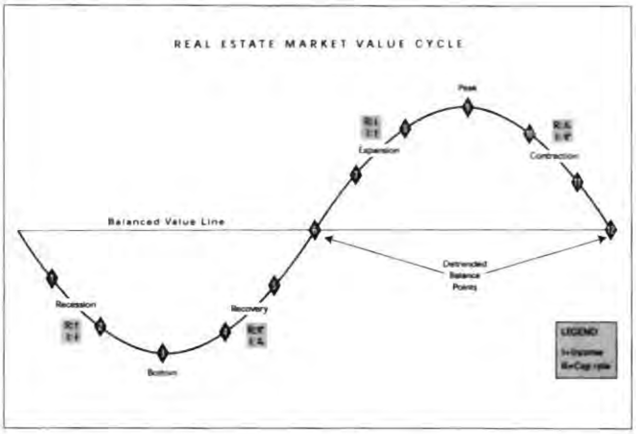
The notion that real estate markets are cyclical is not new. What is new and significant is the recognition by informed decision-makers of the importance of research on the cyclical nature of real estate markets with regard to real estate values.

The real estate value cycle methodology employed by the Global Strategic Real Estate Group of PricewaterhouseCoopers incorporates both the physical and capital market real estate cycles through a simple concept. The physical real estate cycle addresses real estate economics – the interaction between supply and demand, in other words, real estate that impacts vacancy rates and rental rates. The capital market real estate cycle addresses the redistribution of real estate assets from sellers to buyers – the creation of real estate value through new construction.

The combination of the physical and capital market real estate cycles occurs in the formula known to many in the real estate industry: $V = I/R$, wherein V equals value, I equals income, and R equals the cap rate. The physical real estate cycle directly impacts the income (I) or real estate assets. If vacancy rates increase and occupancy declines, rental rates decrease. The multiplication of occupancy and rent theoretically equals income. The capital market real estate cycle impacts cap rates (R), which respond to changes in vacancy rates and changes in income. Real estate cycles impact the bid-ask between sellers and buyers and new construction by developers and owners.

Computer modeling adds immeasurably to the efficient and accurate placement of each real estate market by property type and geography in the proper phase of the full cycle – recession, recovery, expansion, and contraction. Alternatively, the investor can analyze both the characteristics and trends in I (income) and R (cap rate) in any given property market to determine where the market is in the value cycle *(Exhibit 1)*.

Exhibit 1



Once the hard work of determining the cycle position of the markets under study is completed, the user can utilize the results as a management tool for timing strategies, asset management and valuation, portfolio risk assessment, and short- versus long-term lease decisions, among others. Every real estate investment needs a strategy for a profitable venture to include timing and an exit notion. Cycle modeling and analysis provides a tool for such a strategy.

Changes in the real estate markets are inevitable. Some will bring back memories of times past; some may be new wrinkles on old themes. Investors, eager to avoid a repeat of past mistakes, continue to seek out advance warnings of future risks to real estate investments. The good news is that more timely information on real estate markets is available in the 21st Century. And, real estate research provides the modeling capability in the form of real estate value cycle analysis that provides a powerful tool to anchor investment strategy.REI

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Peter F. Korpacz, MAI, *Bethesda, Maryland, is currently the director and global head of the strategic real estate research group of PricewaterhouseCoopers, LLP. With over 35 years of experience in real estate appraisal, counseling, and research fields, he is sought after as a qualified expert witness in various state and federal courts involving real estate disputes, and is nationally recognized as an appraiser and arbitrator in real estate tax assessment disputes. He was formerly the president of Peter F. Korpacz & Associates, Inc., wherein the* Korpacz Real Estate Investor Survey *was first published in 1988 and now marks its 12th year in publication under the PricewaterhouseCoopers' banner. Beginning in 2000, PricewaterhouseCoopers launched* Real Estate Value Cycles, *a semi-annual publication of real estate cycle information on the position of office, warehouse, retail, apartment, and hotel sectors in 58 major U.S. markets.*