

Where is the Real Estate Market Going?

By Chris Miller, MBA

This is a question I hear often. While nobody knows exactly what will happen, (if they are being honest with themselves), investors can position themselves in the right place to take advantage of a change.

The difference between residential and commercial markets

First, there is a clear difference between the *commercial* and the *residential* real estate markets. Commercial real estate is bought and sold based on the cash flow the property produces. Big cash flow equals a big value. Low cash flow equals a low value. Adjustments are made for the length of the lease or the quality of the tenant (“*safety adjustments*”) but that’s the basic concept.

Residential real estate on the other hand, is sold based on the laws of supply and demand, not the potential income the property can generate. A more desirable location, set of features (a pool, granite counters, etc.), or size will drive a residential property’s value. Note that residential properties with 4 units or more tend to trade more in line with commercial values than with single family homes.

The point of this comparison is that these two separate markets are not necessarily correlated. A decrease in the residential real estate market won’t necessarily affect the commercial market – if you buy commercial properties in a good geographic market.

The Residential (Single-Family Home) Market

As mentioned before, single family home values are not based on income potential. If it was, after all, residential prices would never have climbed as high as they did. Have you tried pricing California single family residences as investments recently? Good luck putting as much as 50% down, and getting *zero* cash flow. High demand for housing, spurred by the country’s employment growth and low interest rates, has driven demand, and therefore prices, higher.

According to USA Today, single family homes in the Los Angeles area appreciated at an average rate of 28.5% annually between 2001 and 2006. Where is the residential market going next? This is open to debate, but we can all probably agree that this growth can not continue. Dr. Dolores Conway, director of the Casden Real Estate Economics Forecast at USC, forecasts a “soft landing” with single family home values remaining at a “plateau” for several years. At worst, in her opinion, a 10 to 20 % downturn in values is possible. Dr. Conway is known for her “bullish,” or optimistic outlook on the housing market.

Dr. Christopher Thornburg, former senior economist of the UCLA Anderson School of Business, famous for his bearish predictions on the housing market, sees a “hard landing:” flat prices over the next five years as a best case scenario, with a drop of 30-40% as a worst-case scenario.

These experts, although their opinions on housing prices are opposites, don’t sound very different at all. So, who to believe? We don’t really need to pick one or the other. If we accept that prices will not continue to rise, then we agree with both Dr.s Conway and

Thornburg – we think they will either “plateau” or fall. So, if we believe this, what can we do to profit from it?

One answer is to sell California real estate and exchange into out of state markets with lower prices and higher cash flow. The current lofty state of residential prices in California (some may call it a bubble) is actually present throughout the country, so low (single family) residential prices can't be found anywhere – Alabama, for example, had the same low interest rates that California did, with the same relaxed lending standards, and ended up with the same result – high prices. Good buys can be found, however, in the commercial real estate market.

The Commercial Market

As mentioned previously, a commercial property's value is entirely based on the cash flow it produces. Commercial buyers think less about buying property, and more about buying cash flow. They look at the cash flow a building produces – how much is it now, how much will it rise in the future, what is the risk that it will stop? – and price the assets accordingly. As an experienced real estate buyer once told me, “Real estate is worth nothing to me – I buy cash flow. The only real estate worth anything is the last California State landmark where someone was hung.” This colorful expression helped me remember this crucial point.

So, how are commercial properties valued?

A commercial property's sale price is estimated using a multiple of cash flow – the CAP Rate. A CAP Rate will tell you what a property will return if it is purchased for all cash, (not subject to a loan) without taking capital expenses into account. For example, a \$1,000,000 apartment complex purchased at a CAP Rate of 5% will yield a net income (before taxes), of \$50,000 annually – without taking into account loan payments or the \$7,500 per year you are saving for the new roof. Without raising rents, if you sold the property at a 2.5% CAP Rate, you would receive \$2 million. At a 10% CAP Rate, the price is \$500,000. This shows what a large effect CAP Rates have on value and prices.

CAP Rates loosely follow interest rates in the marketplace. While commercial CAP Rates and the 10-year treasury rate are not directly correlated, they serve as a good basis for comparison. For example, if the 10-year treasury bond is paying 5%, an investor may be willing to pay a 6% CAP Rate for real estate. An investor expects real estate to appreciate (while the bond's value is deflated by inflation), so is willing to take an extra 1% of income, and this appreciation as compensation for additional risk.

As real estate must compete with other investment options for dollars, these CAP Rates will adjust. In the example above, if the 10-year treasury rate rose to, say 7.5%, the investor may not want to accept a 6% return and the risk that goes along with real estate when he can earn 7.5% risk-free. This CAP Rate this investor would pay may look more like 8%. Since interest rates seem likely to rise in the future – this could lead to upward pressure on CAP Rates (and downward pressure on value.)

Here in Orange County, we saw some amazingly low CAP Rates, particularly in apartment houses. Some apartment buildings locally were trading for CAP Rates as low as 3 or 4 percent; this means that owners were buying them with negative leverage –

borrowing money at 6 or 7 percent to fund a property paying 3 or 4 means a lower return for the investor – perhaps even a zero return. Investors were paying these higher prices for expected appreciation. With CAP Rates likely to rise in the future, however, this appreciation may be hard to come by. For instance, if an investor purchased a property at a 3% CAP Rate, and sold at a 6% CAP three years from now, he would lose 50% of his value. To keep the same value, his net income on the property would have to double. This would mean doubling rents, and hoping that expenses stayed the same. Although lower affordability for single family homes mean that the chances of apartment rents rising over the next several years is good, it is not likely they would double. Even if they did, that is a lot of work to just “stay even.” A smarter alternative is to be a seller at 4% CAPs, and to buy in other markets at, perhaps 7% CAPs.

If CAP Rates are rising, how can we find appreciating property?

Property Value Estimate X CAP Rate = Net Operating Income (NOI)

The formula above illustrates how the CAP Rate calculation is done. The only variable that we, as investors, have control over is the Net Operating Income. Our solution is to buy properties with NOI's that we believe will rise faster than CAP Rates. We do this by seeking out properties in growing markets with good rent growth potential. Since buying at a high CAP Rate gives a lower price, the motto regarding CAP Rates is “buy high, sell low.” In today's low CAP Rate environment, expecting to sell at a lower CAP rate may not be feasible. In fact, many would call that an aggressive resale assumption. By finding properties with rising cash flows, it is possible to buy at a low rate today, and sell at a higher rate, and still make a good profit. If we are wrong, and CAP Rates are lower in the future, our conservative underwriting will make the deal that much better. (We'll get even higher returns.)

Where can we find these properties?

Areas like Texas, for example, are attracting more office users with more business-friendly laws, and no state income taxes. Since construction has mostly focused on housing developments over the past several years, this has led to a shortage of office space in many areas. Also, since construction prices have risen along with home prices, many commercial buildings today can be purchased for *below replacement cost*. This is important because it keeps away competition for a few years; if one could buy a high-rise office building for \$150 per square foot (sf), why would an investor build a new one next door for \$225 per sf? Pockets of growth exist in many places all over the country – look for areas of the country with strong population growth, and watch for large companies expanding their presence. (Such as a new Honda plant under construction.)

What Do I Look For? –

Location, Location, Location?

This oft-repeated mantra of the real estate investor is, unfortunately for very many, completely wrong. The three things you should really look for are-

- Location
- Price

- Timing

If any one of these is wrong, your profitability will suffer.

Location is self-explanatory; your property needs to be near those who will use it. A mall must be near suitable pockets of disposable income, a single-family housing development needs to be where people want to live, and an office building must be near homes of the employees, or cheap enough to warrant the commute.

Price - Many experts believe “you make your money on the purchase, not the sale.” Paying too much for a property will cut into your profits when it is time to sell. This may become painfully true for buyers of 3% CAP apartments soon. Japanese investors learned this all too well in the 1980’s, and continue to sell properties at a loss - even today.

Timing is also a crucial factor. This is not trying to “time” the market and buy at the very bottom, or sell at the peak; timing means buying in the right set of circumstances. For example, buying in Raleigh, North Carolina as the market there is continuing to expand is preferable to buying an interest in a GM assembly plant, as the automaker is continuing to experience problems.

How Can I Buy Out of State Commercial Property?

Owners looking for hands-on management can find deals throughout the country that are attractive. On-site property managers can be hired as well. This describes “minor league” real estate that is commonly owned by individual investors.

“Major-league” deals, the kind that institutional investors buy, are now available to individual investors as TIC investments. A TIC investment gives investors the opportunity to buy an interest in a 30, 40 or 100 million dollar property, and get a trophy asset with credit rated tenants. Best of all, the sponsor that performs the due diligence and buys the property for you will stay on as the asset manager – to guide the property through its’ business plan. Such an arrangement, through less management work, can result in fewer headaches for you. A “turnkey” arrangement like a TIC is the answer that many of my clients were looking for – a way to sell their real estate and management duties, while avoiding capital gain taxes, and maintaining (in many cases, increasing) their income.

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