UNIT

15

THE REAL ESTATE MARKET AND ANALYSIS

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Describe the physical and economic characteristics of real estate.
- Identify the factors that influence supply and demand for real estate.
- Distinguish among ways of interpreting market conditions and demonstrate understanding of the different market indicators.

KEY TERMS

buyer's market	seller's market	supply
demand	situs	vacancy rate
household		

INTRODUCTION

The word *market* has many meanings, depending on usage. It can mean a place where farmers and tradespeople display their produce and products for buyers. It can mean a place where securities are exchanged, such as the commodities market or the stock market. Regardless of difference in form, the basic principles of market operation hold true for all. A market can function only when sellers and buyers interact. Many markets use intermediaries to facilitate activity between seller and buyer, and the real estate market is one such market.

15.1 PHYSICAL AND ECONOMIC CHARACTERISTICS OF REAL ESTATE

There are physical and economic characteristics of the real estate market that set it apart from other markets.

Physical Characteristics of Real Estate

Immobility of Real Estate. The geographic location of real estate is fixed. Because of the immobility of real estate, location largely influences the value of real estate. Real estate value is heavily influenced by changes in the surrounding area.

Land Is Indestructible (Durable). Land's indestructibility refers to the durability of the land and its fixed location. Land cannot be destroyed. An appraiser, when applying the cost approach to valuation, does not depreciate the land; only the structure. The physical structures (improvements) on the land are relatively stable and long term; however, over time the improvements can become obsolete and deteriorate.

Land's indestructibility is the reason property insurance protects the owner's buildings and other man-made improvements; property insurance does not cover the land value—even in times of catastrophe the land will survive. Flood insurance is issued on the contents and the structure, not the land. Investments in real estate tend to be long term, primarily due to the immobility and indestructibility of the land.

Real Estate Is Unique. No two tracts of land are identical. Real estate is not standardized. Real estate, therefore, is unique or *nonhomogeneous* because even two lots side by side have different geographic locations.

Economic Characteristics of Real Estate

Government Controls Influence the Market. Government controls influence the market through zoning, building codes, taxes, monetary policy, and so forth.

Relationship Between Supply, Demand, and Price. In the real estate market, supply and demand interact to affect property prices. In any marketplace, supply and demand are continually adjusting; this causes changes in the price of real estate. When the supply increases relative to demand, prices go down. When demand increases relative to supply, prices go up.

The Market Is Slow to Respond to Change in Supply and Demand. Design, land acquisition, site preparation, and construction phases of real estate are time-consuming. For this reason, when the equilibrium between supply and demand is upset, it can be years before the imbalance is corrected.

Area Preference. **Situs** refers to prospective buyers' preference for certain area. Area preference, and therefore the property's location, is considered the most important economic characteristic of real estate. One of the top considerations of families with K–12 age children is school zones. Subdivisions in preferred school zones demand higher prices compared with other subdivisions. So goes the saying: location, location, location!

Practice Questions

1. List the physical characteristics of real estate.
    1. Land is ______________________________
    2. Land is ______________________________
    3. Land is ______________________________
2. When the supply increases relative to demand, prices go ______________.
3. When demand increases relative to supply, prices go ______________.
4. The premium paid for location preference is ______________.

15.2 SUPPLY AND DEMAND FACTORS

A study of markets and their operations reveals several factors that influence supply and demand.

Supply

Supply is the amount and type of real estate available for sale or rent at differing price levels in a given real estate market. The variables that influence supply are listed in the following text box.

VARIABLES THAT INFLUENCE SUPPLY

- Availability of skilled labor
- Availability of construction loans and financing
- Availability of land
- Availability of materials

Availability of Skilled Labor. Numerous skilled laborers, such as carpenters, roofers, and electricians, are required for construction. The availability and cost of labor depend on such things as unemployment rates, skill levels required, and the influence of foreign labor. When an area is growing rapidly, the growth usually is characterized by much construction with resulting high employment in the construction industry. These conditions cause competition for labor and its cost increases.

Availability of Construction Loans and Financing. New construction is directly related to the availability of construction loans and short-term financing. As money becomes more available and less expensive, more speculative homes will be built, increasing the available supply of housing. The same is true for commercial development.

Availability of Land. Although land seems physically plentiful, the supply of the type and location of land most in demand is always scarce. Two factors influence the availability of land: (1) the scarcity of readily usable land and (2) the regulations affecting its use and cost of development.

Availability of Materials. The availability of construction materials influences the supply of new housing. In the late 1970s and early 1980s, the construction industry nationwide was severely crippled by a shortage of drywall. Drywall couldn't be found anywhere. New construction was stalled, and construction costs spiraled.

Demand

Demand is the desire and ability to purchase or rent goods and services. In real estate, demand is the amount and type of real estate desired for purchase or rent in a given market at a given period of time. The variables that influence demand are listed in the text box that follows.

VARIABLES THAT INFLUENCE DEMAND

- Price of real estate
- Population numbers and household composition
- Income of consumers
- Availability of mortgage credit
- Consumer taste or preferences

Price of Real Estate. There is an inverse relationship between price and the demand for real estate. When prices rise, demand goes down. When prices decrease, demand goes up.

Population Numbers and Household Composition. The demand for dwelling space depends on both the population and composition of households in every market area. Mere population size does not provide sufficient information for accurately estimating the demand for dwelling space, nor does a count of households.

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Modern lifestyles, changes in economic conditions, and reduced family size have caused the household to become the basis for most population analysis. A **household**, as defined by the U.S. Census Bureau, is any person or group of persons occupying a separate housing space. Thus, a household may be a single person living in a rented apartment, a married couple with four children living in their own home in the suburbs, or two unmarried adults living in a condominium near the city center. Each constitutes a household.

Just before the end of the 19th century, 100 dwelling units housed 490 people, due to the average size of households at that time (4.9 persons). The most recent census reveals that the decreased size of the average household (about 2.58 people per household) requires approximately 190 dwelling units to house 490 people. The change in average household size alone has therefore caused a 90% increase in demand. Those who study population trends believe that a further reduction in average household size will occur. This again will change the demand for housing, not only in numbers of units but also in size of dwellings. *Demographics* refers to the characteristics of the population: age distribution, family size, and population movements. Demographics affect not only the total demand for real estate but also the type of housing demanded.

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The 2020 U.S. Census is available at https://www.census.gov/programs-surveys/decennial-census/decade.2020.html.

For valuable information on economic indicators, visit https://www.census.gov/economic-indicators/. Data concerning construction spending, new home sales, and housing starts are updated regularly.

Income of Consumers. Whereas change in price is inversely related to change in demand, income is directly related to demand. As individual income increases, so does demand for dwelling space. Any change in local employment numbers or salary-wage levels causes a change in demand for dwelling space and related loan considerations.

Availability of Mortgage Credit. The availability and cost of mortgage credit has been called the barometer of the real estate market. Because the typical purchase of residential property involves two or three times the buyer's annual net income, it is easy to understand why a large number of homebuyers use credit to arrange the purchase. If a potential homebuyer can afford the monthly mortgage payments (principal and interest), plus property taxes and hazard insurance, the total cost of the house is of secondary importance.

The amortized (principal) portion of a monthly payment can be increased or decreased by (1) the amount of the down payment made on the property and (2) the term of the loan. Both of these have a direct bearing on demand for housing.

When a *tight money market* develops and interest rates rise, a corresponding drop is reflected in housing demand because the amount of money needed to make monthly mortgage payments increases. For example, a $90,000 mortgage loan at 7% interest for a period of 30 years requires a monthly payment of $598.77, not including taxes and insurance. The same amount of money for the same period of time but at 9% interest requires a monthly payment of $724.16, an additional $125.39 per month. An increase in mortgage interest rates of even 1% causes a definite drop in demand for housing.

Consumer Tastes or Preferences. Another factor related to demand concerns changing consumer tastes or preferences. Different architectural designs are sometimes introduced into the residential market and may enjoy brief periods of popularity. Generally speaking, however, enduring changes in consumer tastes occur slowly, over extended time periods. In recent years, the "green movement" has consumers preferring energy-efficient homes. Whatever style and type of house the buying public prefers at a given time is the type of dwelling that will be built more often than others, until a new demand creates a new preference.

Changes in demand for condominiums or second homes for vacation purposes also reflect changes in consumer preferences. For years, *empty nesters* (those parents whose children are grown and have moved away) continued to live in the same house where they had reared their children, although it was then entirely too large for their needs as a couple. The numerous chores of the homeowner related to maintenance, repairs, and grounds upkeep were often a joy but sometimes too physically demanding. The advent of condominiums and other forms of smaller, maintenance-free housing units offered a solution to these empty nesters and other small families.

Practice Questions

5. _______________ is the amount and type of real estate available for sale or rent at differing price levels in a given real estate market.

6. _______________ is the desire and ability to purchase or rent goods and services.

15.3 INTERPRETING MARKET CONDITIONS

Price Levels. The changes in price levels of home sales is an indicator of new housing supply and demand for certain price ranges.

Price and supply are inversely (oppositely) related. When supply goes down, prices go up (more buyers competing for fewer homes). The supply and demand equilibrium is upset by excess demand (more buyers than supply) and a **seller's market** develops.

When supply goes up, prices go down (fewer buyers are competing for a bigger supply of homes for sale). The supply and demand equilibrium is upset by excess supply (more houses for sale than potential buyers), and a **buyer's market** develops.

Market Indicators

Price Levels and Building Permits. Changes in price levels of home sales and the number of building permits issued for a given period of time are indicators of new housing supply and demand for certain price ranges.

Vacancy Rates. A **vacancy rate** is the percentage of rental units that are not occupied. Vacancy rates are one indicator of demand for housing in a certain market area. An increase in vacancy rates in rental housing indicates a surplus of housing space. A 5% vacancy rate (95% occupancy rate) is usually considered indicative of a healthy housing market. As the occupancy rate increases, rental rates tend to increase, and apartment dwellers who have been waiting to buy homes of their own start looking at houses for sale and moving out of apartments. This causes increased apartment vacancies and eventually a drop in rents, as well as a halt in construction of new apartments. One of the first indications of a revived real estate market is an increase in rental occupancies that cannot be attributed to reduced rents or giveaway programs. High occupancy rates lead to increased rents. Increased rents lead to new construction and a revived real estate market.

Sales Volume. Sales associates can collect information on the number and prices of homes sold during the recent past. Data on the number of houses sold and the sale price of each are available from county public records. From MLS data, licensees can extract information on how many sales occurred, the approximate sale prices, where the properties sold were located, and the types of houses.

A database system arranged by subdivision, by streets, or alphabetically can be of great value in building a current sales data file. A large-scale map of a town or those areas of a city where interest is high can become a valuable tool to pinpoint areas of greatest activity and to forecast direction of growth. When a sale is reported in a publication, a color-coded "pin" can be placed on the map in the database to indicate price range and location of property. A glance at such a map shows where most sales are occurring and the general price ranges. Direction and rate of growth also can be estimated from a sales data map.

Calculating Occupancy and Vacancy Rates

To calculate the occupancy rate, divide the number of occupied units by the total number of units in the building.

Formula: Occupancy Rate

occupied units ÷ total units = occupancy rate

EXAMPLE: Assume that 200 apartments are rented in a 250-unit apartment building. What is the building's occupancy rate?

200 rented units ÷ 250 total units = .80 or 80% occupancy rate

To calculate the vacancy rate, divide the number of vacant units by the total number of units in the building.

Formula: Vacancy Rate

vacant units ÷ total units = vacancy rate

EXAMPLE: What is the building's vacancy rate if 225 units are rented in a 300-unit apartment building?

300 total units – 225 rented units = 75 vacant units

75 vacant units ÷ 300 total units = .25 or 25% vacancy rate

Practice Questions

7. A ______________ market exists when demand exceeds supply.

8. Price and demand are ______________ related.

9. A 400-unit apartment building currently has 350 units occupied. What is the building's vacancy rate?

10. There are 180 apartments rented in a 225-unit apartment building. What is the building's occupancy rate?

15.4 SUMMARY OF IMPORTANT POINTS

- Physical characteristics of the real estate market are that (1) real estate is immobile; (2) land is indestructible (durable); and (3) real estate is unique (nonhomogeneous).
- Economic characteristics of real estate include (1) government controls influencing the market through zoning, building codes, and taxes; (2) the market's slow response to change in supply and demand; (3) area preference (situs) influencing the price buyers are willing to pay; and (4) supply and demand interacting to affect property prices.
- *Supply* is the amount and type of real estate available for sale or rent at differing price levels in a given real estate market. Variables that influence supply are availability of labor, availability of construction loans and financing, availability of land, and availability of materials.
- *Demand* is the desire and ability to purchase or rent goods and services. Variables that influence demand are price of real estate, population numbers and household composition, income of consumers, availability of mortgage credit, and consumer taste or preferences.
- *Situs* refers to prospective buyers' preference for a certain area.
- A buyer's market occurs when the supply and demand equilibrium is upset by excess supply (supply exceeds demand).
- A seller's market occurs when the supply and demand equilibrium is upset with excess demand (demand exceeds supply).
- A vacancy rate is the percentage of unoccupied rental units.

UNIT 15 EXAM

1. The economic characteristic that refers to preference for a certain location owing to various factors such as climate, employment outlook, public schools, and so forth is called
   a. highest and best use.
   b. vacancy rates.
   c. sales volume.
   d. situs.
2. Which characteristic does NOT describe the real estate market?
   a. Land is indestructible.
   b. The market is quick to respond to changes in supply and demand.
   c. Real estate is heterogeneous.
   d. Real estate is immobile.
3. Which statement is FALSE regarding the relationship between price and demand?
   a. An increase in price causes a decrease in demand.
   b. A decrease in price causes an increase in demand.
   c. There is an inverse relationship between price and demand.
   d. An increase in price causes an increase in demand.
4. Some 280 apartments are rented in a 350-unit apartment building. What is the building's occupancy rate?
   a. .20
   b. .70
   c. .80
   d. .85
5. Which statement is NOT associated with the economic concept of demand?
   a. Demand is the desire and ability to purchase or lease goods and services.
   b. Changes in price cause an inverse change in demand.
   c. Consumer preferences influence demand.
   d. The availability of building materials influences demand.
6. When the equilibrium of the real estate market is upset by an excess supply,
   a. builder activity increases in response to the need.
   b. a seller's market exists.
   c. a buyer's market exists.
   d. demand decreases.
7. One person or a group of persons occupying a separate housing space is technically defined as a
   a. unit.
   b. household.
   c. family.
   d. multiple ownership unit.
8. The uniqueness of real estate is also called land's
   a. immobility.
   b. nonhomogeneity.
   c. indestructibility.
   d. fixed location.
9. The durability of land refers to land's
   a. immobility.
   b. homogeneity.
   c. indestructibility.
   d. situs.
10. Factors affecting the supply side of the real estate market do NOT include the availability of
    a. land.
    b. skilled labor.
    c. material.
    d. mortgage credit.