FINANCIAL ADVISORY

Real Estate Principles: What Creates Value in Real Estate?

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A lot of us have been successful in real estate because we bought property and worked hard. Over the decades, the value of our properties and our income from them have grown dramatically. Real estate is simple, right? I've spent a lot of years in school studying real estate and can tell you that there is really a whole science behind our field. You can probably become successful without this knowledge; but learning it certainly can't hurt. A more thorough knowledge of the philosophy behind real estate may even lead you to greater successes. After all: Attendance at golf lessons isn't a requirement to win The Masters, but there probably aren't many Green Jacket owners who haven't taken them. This month, we will review several concepts concerning the value of real estate.

ECONOMIC CONCEPTS OF VALUE

These economic concepts are referred to as the principles of appraisal valuation and are used by professionals who estimate the value of real estate: appraisers. I spent some time in my youth doing commercial real estate appraisals, and I like to think that this served as an excellent "base" for my understanding of how property is valued. As investors, we always want to buy something that is "cheap" relative to other properties and sell it when it is more expensive. An understanding of these concepts will help us to know when these times are.

Principle of Supply and Demand: Like all other commercial goods, the value of real estate is affected by the laws of supply and demand. When demand for a product rises, so too does the cost of that product. How much will hand sanitizer and a face mask cost you today versus this time last year? This is why I always advocate buying apartment properties in growing metropolitan areas. Without a rising population, and rising demand, it is harder to create growth.

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Principle of Conformity: This principle states that value in a neighborhood is maintained when the similarity of improvements in the neighborhood is maximized. Some will disparage the existence of tract home communities, but this principle suggests that they result in higher values for homeowners. This principle supports the existence of zoning laws, and homeowners' associations.

The Principle of Regression asserts that the value of the best property in the neighborhood will regress down towards those of lower valued properties in the neighborhood. This is best explained by someone who builds a $2 million, 7,000 sf, home in a neighborhood of $500,000, 1,300 sf, homes. Upon sale, he'll likely receive a lower price when compared with a similar house surrounded by other mansions.

Principle of Progression: This idea is the opposite of the principle of regression. Progression declares that a smaller and lesser-maintained property in a nicer neighborhood gets a boost in value from the nicer, larger and more desirable neighboring houses.

Principle of Contribution: The value of one component or improvement of a property is measured in terms of its contribution to the value of the whole property rather than its cost. You can spend $2 million placing an elaborate swimming pool in your backyard, but it won't necessarily add $2 million to the value of your house. Incidentally, the county tax assessor added the cost of a pool to the assessed value of my house – in excess of the house's market value and in violation of this principle. My pool didn't cost anywhere close to $2 million, but that was my exact argument when I challenged my re-assessment. I was unsuccessful – because the assessor's office is not at all concerned about value. (probably a topic for a future article.)

Principle of Substitution: This principle forms the basis of real estate appraisal. It says that if two properties were exactly the same, then a buyer would never pay more for one than the other. Imagine that five 4-unit properties next door to one another were listed for sale, and imagine that they are all 100% vacant and all identical to one another in every way. If one was priced $100,000 more than all the others, it will absolutely be the last one to sell.

Principle of Change: Lastly, we will talk about the principle of change. This states that real estate is constantly in a state of change, and that its life cycle has four stages: development, stability, decline and renewal. This life cycle typically covers a long amount of time. Think about, for example, an apartment property that was built in the 1950's. In this neighborhood, over the decades, older competing properties have been demolished and replaced with newer, more attractive and more desirable properties that command higher rent. It is possible to keep an older property at "stability" through periodic renovations. If this hasn't been done; the property could then be in decline and the principle of regression, as discussed earlier, proclaims that its value will therefore suffer compared to the surrounding market. To remedy this, the property could then undergo renewal with an extensive renovation or demolition and redevelopment, and be back at the stability phase.

This review of some factors that affect the value of real estate should be a good foundation to help you determine value in your own investments. If you have any questions, please call my office at (877) 313-1868.

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- Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- Potential for foreclosure – All financed real estate investments have potential for foreclosure;
- Illiquidity – Because 1031 Exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions;
- Impact of fees/expenses – Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits

Scenarios provided herein are provided merely to illustrate mathematical principals and are not a guarantee of performance.