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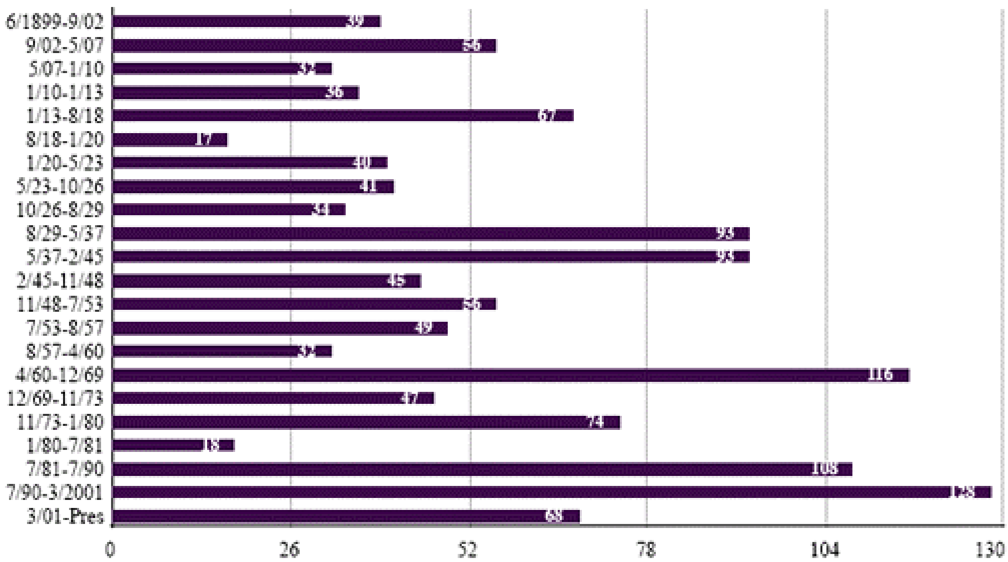
Market Cycles and Income-producing Real Estate

The psyche of investors versus the reality of investing is sometimes a wide gorge. Ask a group of investors during a strong market if there is a recession on the horizon and the answers are generally “No” or “We’ve learned to anticipate and correct” or “The causes of a recession are fixed and under control.” Ask a group of investors during a recession if we will recover from the current recession and most will be skeptical, show-me types who don’t see getting out of the recession.

Our economy has always had recessions and has always gotten out of them. Our economy is made up of actions and reactions. We live in free markets that buy, manufacture, invest, liquidate, hire, fire, etc. Because it is impossible to achieve economic balance between all of these activities, our economy will always be out of balance and therefore always cyclical. We are either going up, down, or sideways. Following is a look back at these cycles and guidelines for real estate investment.

Number Of Months From Peak-To-Peak of Each Business Cycle Since 1900



Information Source: Nat’l Bureau of Economic Research, Inc.

An investor needs three pieces of information for developing a reasonable investment strategy and the chart provides this information: (1) The average length of time from peak-to-peak for the prior twenty-one cycles is 58 months. (2) The current business peak was reached in March 2001. (3) We are presently 68 months into the current cycle. What have we concluded so far?

- Given the country’s current economic model, the economy is cyclical.
- Bull markets don’t last forever.
- Recessions don’t last forever.
- The average cycle for the past 100 years from peak-to-peak is 58 months.
- The peak for the current cycle was March 2001.
- We are 68 months into the current cycle.

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This information gives an investor the next possible peak and the length of time needed for the subsequent peak. The average is 58 months. The shortest peak-to-peak business cycle is 17 months and the longest is 128 months. Given those conclusions, the real estate investor has to follow a sound investment strategy which includes techniques that insure staying power.

The following techniques support a strategy of staying power and apply to the purchase of income-producing real estate.

Leases

- Setup a schedule of lease expirations.
- Are the current lease payments consistent with market rents?
- On lease expiration, factor in market rent adjustments, the costs for leasing commissions, tenant improvements, common area maintenance changes, advertising, and vacancy.

Re-leasing at lower rents plus the additional costs of leasing have a negative affect on a property's value, cash flow, and financing. These factors should be reflected in the purchase price and terms of the potential transaction.

The lease is a legal contract between the lessee and lessor. When buying property the new owner is substituted as the new lessor and therefore assumes all of the obligations of the prior lessor. This is another good reason to review all residential and commercial leases. For commercial properties, you should get an estoppel certificate from each lessee. An estoppel certificate states that there are no agreements other than the lease.

Lessee Profile

As current leases expire, is it reasonable to assume that the profile for current lessees will remain in tact? If not, what will be the new profile, and what affect will it have on the property?

Expenses

Review each line item expense for at least the past three years. Look for possible increases. Look for continuity. Certain operating expenses have a way of disappearing during the year of a sale.

Capital Improvements

Get the property's history of capital improvements. Determine why they were done and what remains to be done. Find out if any vendor's guarantees or warrantees still exist. Have a careful structural analysis done. Surprises in this area can be catastrophic to an investment. All the information gathered on capital improvements needs to be factored into the price.

Environmental Issues

The importance of identifying environmental issues through inspections and due diligence cannot be overstated. It's important for potential real estate buyers to know that even though an environmental problem may have been caused by a prior owner, the costs to resolve it usually belong to the property's current owner. The current owner may seek redress from the past owner who caused the problem, but they still have to defend or pay for resolving the problem.

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Financing

- Don’t buy real estate supported by artificial interest rates.
- Don’t allow initial interest rate inducements to be the reason for buying.
- Avoid lock-ins.
- Avoid high prepayment penalties. Some prepayment penalties are obvious (such as points), and some are not as obvious (maintenance yields).
- Avoid variable loans unless the index used to determine interest rates and the annual maximum caps and loan cap are acceptable.
- Follow the treasurer’s rule: Fix interest rates as low as possible and push the maturity date out as far as possible.

Investment Criteria

Make price comparisons on all of the following:

- Price per square foot
- Income per square foot
- Capitalization rate
- Replacement costs
- Usage
- Parking, amenities, age, location, structure, and convenience of egress and ingress
- And last and least important, the gross rent multiplier

Cash flow starts at close-of-escrow and is real. Do not buy income-producing real estate based on artificial cash flow (seller guarantee). Every successful real estate investment has an economic anchor(s) that is conveniently located in the area. Identify that anchor(s), analyze it, and determine its prospects for the future.

The Wednesday edition (real estate section) of the Wall Street Journal lists hundreds of properties for sale. Obviously not all of those listings are going to become successful investments. You have to cull out the ones that fit your criteria and are going to be successful. There is no such thing as the last good deal. There will always be another good deal.

Summary

We are 68 months into the current business cycle. Looking at the past 100 years, we know that the shortest business cycle from peak-to-peak was 17 months, the longest was 128 months, and the average length was 58 months. This means we could be at the peak of the current cycle or very close to it. The result of the timing of any current income property purchase is that the new investor could be facing a downturn, a bottom, and an upturn during the next 68 months. In other words, it may be 68 months before the current peak and market values are reached again. The area and type of real estate will determine the extent of the downturn, bottom and upturn. To insure the highest probability of success, any strategy for the acquisition of income-producing real estate must include the safety checklist described here. In summary, given the right investment strategy, it is a good time to acquire income-producing real estate.