The real estate cycle - Part 2: The 4 phases of the physical cycle

Understanding is crucial to forecasting rental income and vital to avoiding costly losses.

Septmeber 29, 2015 BY IAN IPPOLITO

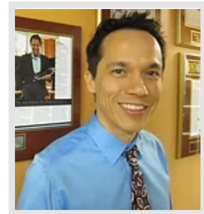
In part 1 of this article, we talked about the long-term commercial real estate financial cycle which affects. However, looking at **pricing isn't enough**. **Rental income** is also an important part of almost every real estate investment return. And that is affected by **rising and falling rental prices and vacancies**. Those **changes** are called the **physical cycle**. If you don't take the physical cycle into account, you can end up crippling your investments. In this article, **we'll talk about the physical cycle** and its four phases.

- Part 1: The long commercial real estate financial cycle that drives prices.
- Part 2: The shorter physical cycle that drives rental income via vacancies and rent prices.
- Part 3: Warning signs that a recession is about to hit.
- Part 4: Where are we in the local real estate cycle?

What is the physical cycle?

The **physical cycle** drives the rental income of your investment (based on rental price and vacancies). Unlike the financial pricing cycle, it is entirely

About Ian Ippolito



Ian Ippolito is an investor and serial entrepreneur. He has been interviewed by the Wall Street Journal, Business Week, Forbes, TIME, Fast Company, TechCrunch, CBS News, FOX News and more.

Ian was impressed by the potential of real estate crowdfunding, but frustrated by the lack of quality site reviews and investment analysis. He created The Real Estate Crowdfunding Review to fill that gap.

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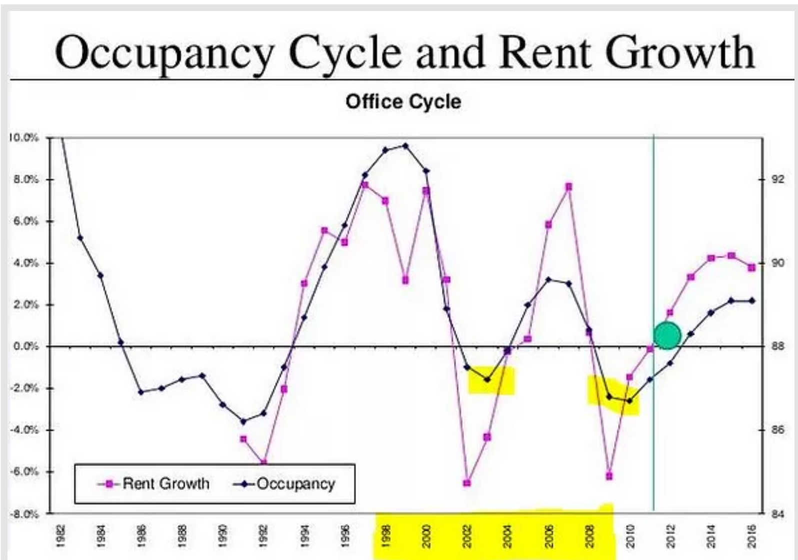
driven by the **local market**. It's also a much **shorter** cycle.

It's **supply-side** is driven by **construction**. It's **demand-side** is driven by **occupancy** (or its opposite metric, **vacancy**). This in turn is driven by several things, including **employment** (or unemployment) in the local area. that in turn is driven by the **local and national economy**.

What does it look like?

Below is a graph of **commercial office real estate rental growth** since 1982. Notice how in the **17-18 year financial/pricing cycle** from 1990 to 2008 (highlighted in yellow at the bottom of the graph), **two**



Since **these smaller physical cycles occur more often**, they are what most people are talking about when they simply say **"the real estate cycle".** As you can see above, **most of the time that's probably okay**.

But when the huge financial cycle bust comes (which on average drops prices 35%+ and take several years to recover), it's **important to see the forest** (financial cycle) in addition to the **trees** (physical cycle). Only by keeping an eye on both cycles can you truly protect your investments.

What causes physical cycles?

But back to the physical cycle. It does deserve close attention, since it's shorter cycle means it's the one most likely to affect your investment. What causes that?

The main reason is: "lag". Development and construction of real estate takes time. Because of this there is always a **lag between demand** for the real estate **and the supply** of it. Back in 1876, Henry George noticed that this **dynamic caused** a continually **repeating pattern of booms and busts,** which he called the real estate cycle.

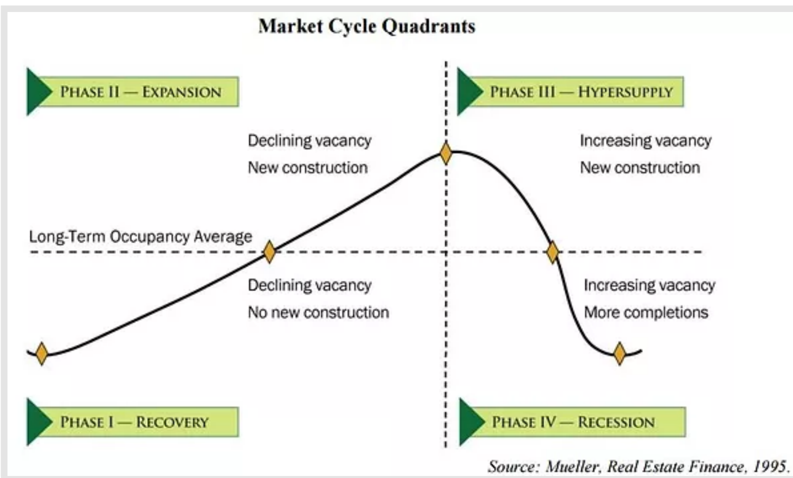
Since then, the theory has been studied, **refined and modernized** by many others, including most recently by Dr. Glenn Mueller of the University of

Denver.

2/9/2020: Editor's note: After interviewing and questionin Dr. Mueller a few years ago about the details of his forecasting system, I personally do not have much confidence in the accuracy of it as a forecasting tool for the timing of future downturns (as he has to make "guesses" about things that I personally think are ultimately "unknowable" and can lead to error). And he himself has acknowledged he has been off on some forecasts. However I'm including this section here because I think the framework he came up with is still very useful for understanding the past and what will happen in the future, even if it is not useful for knowing the exact timing of when.

The physical cycle pattern is caused by the four phases that it goes through:

- Recovery
- Expansion
- Hyper supply
- Recession



And here's **why they happen, what they entail, and the key moments** to watch for.

Recovery

Before this phase starts, there is an oversupply of inventory from previous new construction and/or negative demand growth.

Recovery begins at the key bottom point of the cycle. This **occurs when the excess construction** from the previous cycle finally **stops**.

Demand growth slowly absorbs the existing oversupply, while new construction is nonexistent or very low.

Over time, vacancy rates fall allowing rental to rates stabilize and even start to increase. As recovery continues, landlords can increase rates at a slow pace (at or below inflation). Often, the Federal Reserve assists by decreasing interest rates to stimulate the economy. This makes properties more profitable.

Eventually, the market reaches its long-term occupancy average where rental growth is equal to inflation, and the market moves to the next phase.

Expansion

In this phase, **demand growth increases**, creating a need for additional space. Due to the tight supply, **rapid rent growth** (sometimes called "rent spikes") can occur.

Eventually rents rise high enough, and the market reaches the key point where new construction is cost feasible.

As long as demand grows higher than supply, vacancy rates continue to fall and the expansion continues. **Many historical expansion cycles were slow, long-term, uphill climbs** over long expansionary periods.

Eventually, rent growth accelerates faster and faster, and the market reaches another key point. Before this, sellers price land at its current value. After this, sellers price land at its current value plus a premium in anticipation of what it will be worth in the future. **This is the birth of the real estate bubble**, as prices and rent growth accelerate further.

However, at some point, supply finally catches up with demand. This key point is called equilibrium, and marks the end of the expansion phase. **Unfortunately, since occupancy rates are at their highest possible levels, most real estate participants don't recognize when this occurs.**

Hyper supply

During this phase, the **supply of new construction continues to come in, while demand falls.** This causes occupancy rates to fall, and rental growth to slow. Different suppliers of new construction begin to compete heavily for tenants.

Eventually, **market participants recognize the downturn** and commitments to new construction **should theoretically slow or stop.** If they do so soon enough, the market can avoid a severe downturn or even stay in this phase for a while (or even regress to the previous phase).

However, due to the lagged nature of construction, **this doesn't always happen.** If new construction continues to come in faster than demand and occupancy drops below its long-term average, then **the market falls into the final phase: recession.**

Recession

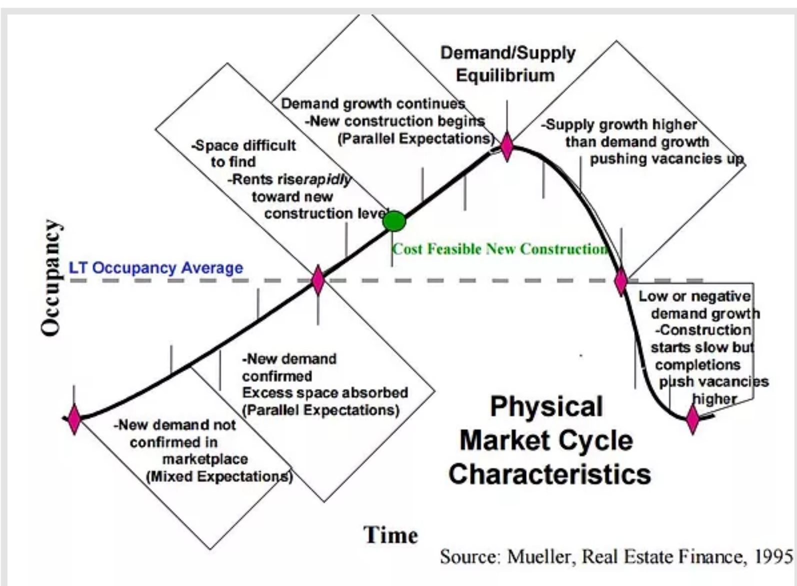
In this phase, **massive oversupply**, along with negative demand growth, cause **rents to be lowered**, and **losses to occur.**

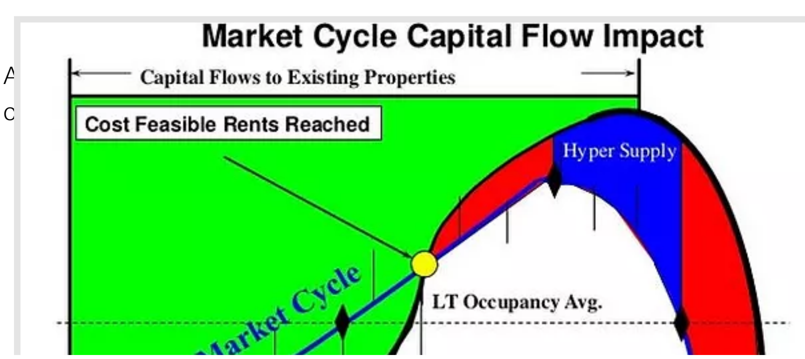
Additionally, the price increases caused by hyper supply often force the Federal Reserve to raise interest rates. This has the positive effect of slowing new construction, but also increases financing costs on existing properties. If **interest rates** are **raised high** enough, this can cause **potentially painful losses.**

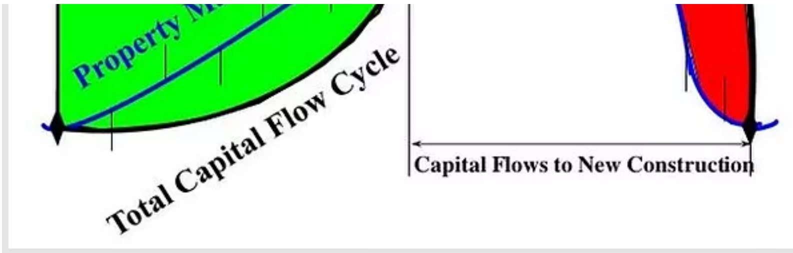
As the bid ask spread in property prices becomes too wide, **market liquidity can become low or nonexistent**, preventing landlords from cutting their losses easily by selling. Property owners stuck in this situation either **need deep pockets** to ride out the recession, or **forced to make a distress sale** and take catastrophic losses.

And since real estate is a large part of the overall economy, **the entire economy suffers**, which accelerates the real estate recession dynamics. **Foreclosures begin to occur,** and may even begin to accelerate. At this stage, Foldvary (2007) felt: *"shrewd investors pick up real estate bargains."*

The **market bottom** doesn't occur until new constructions and completion cease, or demand grows higher than the new supply being added.







Exceptions

It's important to understand that a market doesn't necessarily have to move forward along the cycle. **Sometimes the market stands still**, and occasionally **even moves backwards.**

But **generally progress moves forward**.

So where are we today?

So now that you understand the cycle, you're probably asking, "Where are we in the cycle right now and when will the next recession come"?

We'll answer that in <u>The real estate cycle – Part 3: Warning signs that a recession is about to hit.</u>

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