UNDERSTANDING REAL ESTATE ECONOMICS 2020 (WITH EXHIBITS)

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1. INTRODUCTION

A lot has changed in this world since this article was first written. The pandemic has had an enormous effect on commercial real estate, but its long-term impact may not be known for years. Although the pandemic has accelerated change, it has not affected the basic economic indicators and analysis for commercial real estate.

An attorney or other advisor for commercial real estate must have some familiarity and understanding of the fundamental economic analysis of a specific property in order to make judgments about that real property. The purpose of this article is to review some of the concepts and the methodologies for measuring commercial real estate returns and compare and contrast them. In addition, it looks at some mistakes often made in projecting the returns of a specific real estate property as an investment, including the possible pitfalls that confront an investor when the investor pushes the numbers to justify an expensive purchase price.

As an investment, commercial real estate is an asset. The return to an investor is tied to two basic economic components:

- The annual income it produces over the term of ownership; plus
- The proceeds of any capital transaction, such as a refinancing or sale.

Unlike stocks or bonds, real estate also has a tax-shield component. Real estate also has inherent emotional attachments, such as the view from a property overlooking the ocean or the status accruing to the owner of some other kind of "trophy" property. No one acquires stock in a company because the stock certificate is a work of art or because of exciting graphics in the annual report. But the emotional attachments of real estate can definitely influence an investor.

Real estate, as an investment, competes with stocks, bonds, and, other assets. A common misconception in investment analysis is that bonds represent a fixed-income investment that is easy to understand, that individual stocks are difficult if not impossible to correctly predict, and that real estate is a relatively messy investment, but easy to decipher with a proper set of spreadsheets. It was also almost an axiom of investment that the safest investments were in bonds or gold. In his book, Stocks for the Long Run,[1] Jeremy Siegel tracked the real returns[2] from 1802 until 1997 and concluded that one dollar invested in each category of stocks, bonds, and gold in 1802 would have been worth, in constant dollars in 1997, \$558,945 for stocks, \$803 for bonds and 84 cents for gold.