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Analyzing New Property Development

By Wayne E. Etter

Many, but not all, local real estate markets have emerged from the effects of overbuilding during the 1980s. Properties purchased by investors during the latter 1980s and early 1990s at prices less than their original construction cost are now providing their owners with positive cash flows and satisfactory rates of return. In some markets, rising occupancy and rental rates promise even better financial performance.

Until recently, moreover, many investors believed they had little chance to be competing with newly constructed properties at any time soon. Their complacency was supported by both economic theory and financial feasibility analysis: market rental rates, while sufficient to provide the owners of older properties a satisfactory return, were considered inadequate to support new construction. A rational investor would not build a new property unless anticipating profit. Yet, construction is occurring in some markets. How can this be explained?

Relating Rental Rates to Costs

Using economic theory, market rental rates can be graphically related to costs as shown in the figure. The market rental rate (P) is established in the market by the forces of supply and demand. As long as the market rental rate received from supplying an additional unit, *i.e.*, the marginal revenue, is larger than the cost of supplying an additional unit, *i.e.*, the marginal cost, the unit will be supplied. The owner's cost includes all fixed and variable costs (including management compensation).

The figure reveals that the market rental rate is sufficient to provide the owner of an existing property (purchased, perhaps, at a price less than its cost of construction) with a net return. Total revenue (P x Q) is greater than total cost (C x Q). But usually a to-be-built property will have higher costs than an existing property; thus, total cost will be greater than total revenue. Under these circumstances, the owner of an existing property expects to be protected from the competition of new properties.

To Build or Not to Build

Economic theory is helpful in conceptualizing these circumstances and in monitoring market expectations. Financial feasibility analysis, as used by real estate professionals, helps to determine whether or not a proposed property should be built. Using current land and construction costs, current market rental rates and operating expense estimates and the cost of expected debt and equity financing, a to-be-built property is analyzed to determine if it will be financially feasible. To be financially feasible, it must produce sufficient income to pay its operating expenses, support sufficient debt to finance the property and provide a satisfactory cash return to the owner. Obviously, if market rental rates are too low, costs are too high or both, the property will not be financially feasible. Thus, a property's financial feasibility is determined by its expected income and costs, the same concepts considered in economic theory.

Understanding Market Rental Rates

But new construction, particularly of retail and multifamily properties, is taking place in many markets where new construction was considered infeasible a short time ago. Are eager, but naive, investors who are ignorant of the market responsible? To the extent that this is so, the outcome of their development activities may be unfortunate.

Before dismissing the current development activity as the result of ignorance, however, it may be wise to consider the assumptions of economic theory and financial feasibility analysis. Both are dependent on a precise understanding of what the market rental rate represents in each analysis. Consider, for example, a multifamily housing market where current market rental rates were assumed to be insufficient to support the construction of new units. The following questions might be asked about such a conclusion:

Were the existing multifamily housing properties reasonably homogenous? If not, the derived market rental rate will not be meaningful for analysis. For example, within a particular market area, different multifamily properties may serve distinctly different market segments. Rental rates for the existing high-end multifamily properties may be much closer to the necessary rate to support new construction than the average market rental rate. Market research can reveal the existence of different market segments; market rental rates can then be developed for each segment.

Were any market segments unserved? A market segment may be willing to pay a higher rental rate for a product that is currently not offered in the market area. A new multifamily property will be viewed as a different product if the existing multifamily properties are old, poorly maintained or lacking amenities. Market research can reveal the existence of unserved market segments.

Were the linkages between the existing multifamily housing and employment centers, educational centers and shopping centers satisfactory? Have these linkages improved since the existing multifamily housing was built? Poorly located multifamily properties may be occupied because no other choice is available. Market research can reveal whether new, well-located multifamily properties that take advantage of new roads and improved public transportation will find a ready market.

Were any of the new multifamily properties financed with tax credits? If so, the developer's use of tax credits reduced the project's cost sufficiently for it to achieve financial feasibility at lower market rents than would have been required without the tax credits.

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In some retail markets, additional development is considered unnecessary because retail space is vacant. However, the location of some of this retail space is poor, and a low rental rate will not make it attractive to retail tenants. Unless a site is expected to be a profitable business location, the space will remain vacant while new retail space is developed. Moreover, a number of national and regional retailers have a distinctive building design as part of their marketing strategy, and, therefore, they usually are uninterested in vacant retail space when they move into new market areas.

Evaluating Market Needs

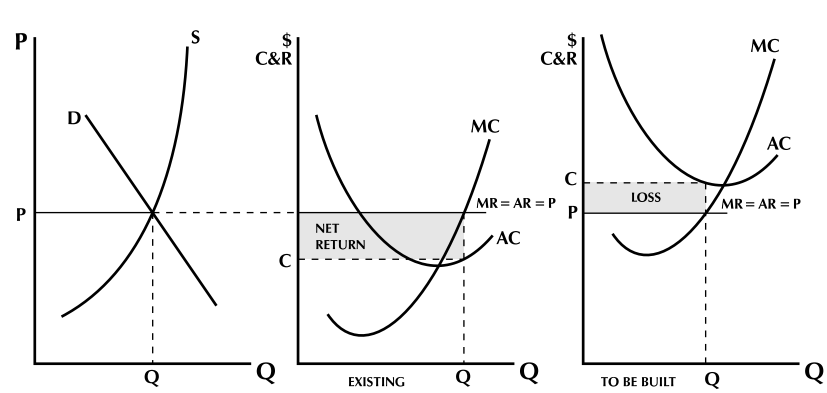
Investors who purchased multifamily properties in the late 1980s and early 1990s at prices less than the original cost of construction did so with the expectation that rising rental rates would gradually increase their properties' profitability and value. Investors in retail properties believed that in time rising demand for retail space would gradually increase occupancy rates in partially vacant retail centers. At the same time, they did not expect competition from new properties because rental rates were too low to support new construction.

Despite this, new multifamily and retail space development is taking place in many markets. For both property types, the analysis concluding that new development would not occur failed to take into account the needs of various segments within each market and their willingness to pay an above-market rental rate for those other products when they were offered. In such markets, successful development can take place while currently available space remains vacant.

In the case of multifamily properties, current tenants who desire and can afford higher quality apartments will shift to the newly developed properties, leaving the older, less well-maintained properties with larger vacancy rates. In some cases, the owners of existing properties will rehabilitate them to compete or to attract a new market segment unable to afford the newly developed multifamily properties. In the case of retail properties, poorly located retail properties with high vacancy rates may continue with high vacancy rates because little can be done to increase their attractiveness as a retail location.

Those who are developing new multifamily and retail properties, however,

Market Rental Rates Related to Costs



should carefully evaluate the size of the market segments with unmet needs. If demand exists for 250 upscale apartment units within a market area, developing 1,000 units will lead to the familiar 1980s scenario once again. And even if a site appears to meet every criteria for being an outstanding retail location, a tenant that sees the same opportunity is mandatory. No profit comes from oversupplying the needs of a market segment or in supplying space for retail tenants who are not attracted to a particular market location.

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