SLIDE 14 - **Economic Characteristics of Real Estate (Cover Page)**

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Productivity and Costs

To produce a good or service, a supplier incurs costs, or those expenses necessary to generate and deliver the item to the market. The essential production costs are the costs of capital, materials, and supplies; labor; management; and overhead.

Costs play an important role in the dynamics of supply, demand, and value. Since a producer has limited resources, it is imperative to maximize the efficiency of the production process and minimize its costs. Moreover, since consumers will pay the lowest possible price for comparable goods and services, the producer must be price-competitive to stay in business. A competitor who can produce an item of similar quality for less will eventually force higher-priced items out of the market.

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Cost and price – Consider a producer who is efficient and produces the product or service in demand at the lowest possible cost. Adding to the cost a required profit margin, the producer establishes a minimum price for the item. In this scenario, cost essentially equals price. To the efficient producer, costs and sufficient profit are paramount, since a lower price puts the producer out of business. At that point, the elements of value-- desire, utility, scarcity, and purchasing power-- do not matter: if the consumer wants the item at all, he or she must cover the producer's costs and profit.

In summary, supply, demand, and price interact continuously in a market. Underlying and influencing these forces are the dynamics of value and the costs of producing goods and services.

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Market Interaction

What is a market? A market is a place where supply and demand encounter one another: suppliers sell or trade their goods and services to demanders, who are consumers and buyers. It is a *transaction arena* where the price mechanism is constantly defining and quantifying the value produced by the relative elements of supply and demand.

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Supply, Demand and Price Relationships

In a market economy, the primary interactions between supply, demand and price are:

If supply increases relative to demand, price decreases

If supply decreases relative to demand, price increases

If demand increases relative to supply, price increases

If demand decreases relative to supply, price decreases

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These relationships reflect simple common sense: if a valued product becomes increasingly scarce, its value and price go up as consumers compete for the limited supply. If there is an overabundance of a product, the price falls, as demand is largely met.

On the other side, if demand for a product or service increases in relation to supply, prices will go up as consumers compete for the popular item. If demand diminishes, the price drops with it.

If price decreases, demand is declining in relation to supply

If price increases, demand is increasing in relation to supply

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To assess price movements, the supply and demand of a product or service must always be considered together. It is always possible for demand and supply to rise and fall together at the same rate, with no detectable price change resulting.

For example, if demand for bicycles jumps a million units, and manufacturers easily produce the necessary new supply, there may be no increase in price.

The price may even go down as manufacturers obtain better prices on the larger quantities of raw materials they now use.

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Real Estate Market Dynamics

As an economic commodity, real estate is bought, sold, traded, and leased as a product within a real estate market.

Like other products and services real estate is:

- Subject to the laws of supply and demand
- Governed in the market by the price mechanism
- Influenced by the producer's costs to bring the product to market
- Influenced by the determinants of value: utility, scarcity, desire, and purchasing power

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Distinguishing features. In comparison with other economic products and services, real estate has certain unique traits. These include:

Inherent product value

Land is a scarce resource as well as a required factor of production. Like gold and silver, it has both inherent value and utility value.

Unique appeal of product

Since no two parcels of real estate can be alike (each has a different location), every parcel of real property has its own appeal. Likewise, no two parcels of real estate can have exactly the same value, except by coincidence.

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Demand must come to the supply – Since real property cannot be moved, real property investors and users must come to the supply. This creates risk, because if demand drops, the supply cannot be transported to a higher demand market.

Illiquid – Real estate is a relatively illiquid economic product, meaning it cannot always be readily sold for cash. Since it is a large, long-term investment with no duplicate, buyers go through a complex process to evaluate and purchase real estate.

SLIDE 24

Slow to respond to changes – Real estate is relatively slow to respond to market imbalances. Because new construction is a large-scale, time-consuming process, the market is slow to respond to increases in demand. The market is similarly slow to respond to sharp declines in demand, since the product cannot be moved and sold elsewhere. Instead, owners must wait out slow periods and simply hope for the best.

Decentralized, local market – A real property cannot be shipped to a large, central real estate marketplace. Real estate markets are thus local in nature and highly susceptible to swings in the local economy.

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Real Estate Supply and Demand

Supply – In real estate, supply is the *amount of property available* for sale or lease at any given time. Note that supply is generally not the number of properties available, except in the case of residential real estate. The units of supply used to quantify the amount of property available differ for different categories of property. These supply units, by property type, are:

Residential: dwelling units

Commercial and industrial: square feet

Agricultural: acreage

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Factors influencing supply. In addition to the influences of demand and the underlying determinants of value, real estate supply responds to:

Development costs, particularly labor

Availability of financing

Investment returns

A community's master plan

Government police powers and regulation

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Demand – Real estate demand is the amount of property buyers and tenants wish to acquire by purchase, lease or trade at any given time. Units of demand, by property classification, are:

Residential: dwelling units

Commercial and industrial: square feet

Agricultural: acreage

Section 15 – Part 2

SLIDE 1

Real Estate Supply and Demand

The unit of residential demand is the household, which is an individual or family who would occupy a dwelling unit. Residential demand can be further broken down into demand to lease versus buy, and demand for single family homes versus apartments.

Residential demand can be very difficult to quantify. One measure is the number of buyers employing agents to locate property. Another measure is the net population change in an area, plus families that attempted to move in but could not.

SLIDE 2

The unit of commercial (retail and office) and industrial real estate demand is the square foot, further broken down into demand for leased space versus purchased space. In most instances, the area demanded refers to the improved area rather than the total lot area.

SLIDE 3

Demand for office and industrial real estate is calculated by identifying employment growth or shrinkage in a market, then multiplying the employment change times the average area of floor space a typical employee uses.

For example, consider an office property market where employment in the community increases by 500 employees. If each employee uses an average of 120 square feet, the increased demand for space is 60,000 square feet.

Factors affecting demand. The demand for particular types of real estate relates to the specific concerns of users. These concerns revolve around the components of value: desire, utility, scarcity, and purchasing power.

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Residential users are concerned with:

Quality of life

Neighborhood quality

Convenience and access to services and other facilities

Dwelling amenities in relation to household size, lifestyle, and costs

SLIDE 5

Retail users are concerned with:

Sufficient trade area population and income

The level of trade area competition

Sales volume per square foot of rented area

Consumer spending patterns

Growth patterns in the trade area

SLIDE 6

Office users are concerned with:

Costs of occupancy to the business

Efficiency of the building and the suite in accommodating the business' functions

Accessibility by employees and suppliers

Matching building quality to the image and function of the business

SLIDE 7

Industrial users are concerned with:

Functionality

The availability and proximity of the labor pool

Compliance with environmental regulations

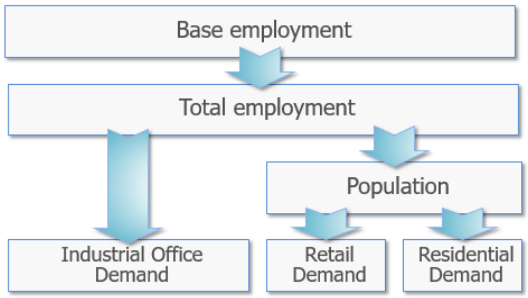
Permissible zoning

Health and safety of the workers

Access to suppliers and distribution channels

SLIDE 8

Base employment and total employment – The engine that drives demand for real estate of all types in a market is employment:



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Base employment – the number of persons employed in the businesses that represent the economic foundation of the area. For example, the auto industry has traditionally been the primary base employer of the Detroit metropolitan area.

Base industries lead to the rise of supporting and secondary industries in the market. If the auto industry is the base, auto parts manufacturers and assembly industries will develop to support the auto manufacturing plants. In addition, service businesses emerge to support the many needs of the local population engaged in primary and secondary employment.

SLIDE 10

Total employment creates a demand for a labor force. From total employment derives demand for industrial and office space on the one hand; on the other hand, as employment grows, so grows the population, leading to the demand for housing and for retail support.

Base

The industry forming the foundation of the areas market economy.

Secondary

Businesses springing up to serve the base industry.

Support

Service businesses to support the population. Grocers, entertainment, financial, education, etc.

In addition to creating demand for real estate, employment creates the purchasing power necessary for households to acquire dwellings and retail products.

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Without employment, a real estate market evaporates, as there is no demand for commercial or industrial facilities, nor is there demand for retail services or housing. The best example of this phenomenon is a gold rush boom town: as soon as the gold runs out, there is no more mining. Without mining employment, everyone moves away and the town becomes a ghost town.

Supply and demand interaction. Real estate supply and demand, like supply and demand for other economic products, interact in the marketplace to produce *price movements.*

SLIDE 12

Market Adjustments

Supply and demand – The availability of certain properties interacts with the strength of the demand for those properties to establish prices. When demand for properties exceeds supply, a condition of scarcity exists, and real estate values rise.

When supply exceeds demand, a condition of surplus exists, and real estate values decline. When supply and demand are generally equivalent, the market is considered to be in balance, and real estate values stabilize.