PIA Property Investment Advisors, Inc.
Real Estate Insights
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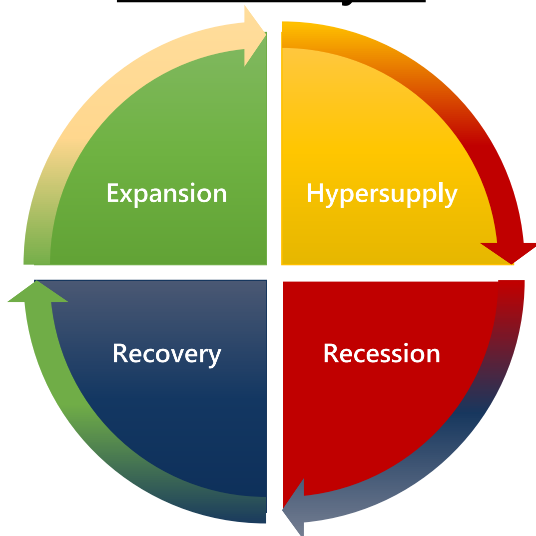
# Neighborhood by Neighborhood: The Importance of Understanding Real Estate Cycles

Real estate markets, like most markets, have a cyclical component that investors must be aware of. Commercial real estate professionals typically consider four phases of the real estate cycle: expansion, hypersupply, recession, and recovery. It is important to note, the phase any given market is in at a particular time will vary from city to city and even neighborhood by neighborhood.

**Real Estate Cycles**[1]




1. Predicting Long-Term Trends & Market Cycles in Commercial Real Estate, Glenn R. Mueller, 10/24/2001

During the expansion phase, economic growth drives increased demand for real estate, which results in increased occupancy and rental income. In response, developers begin new construction projects. This expansion eventually gives way to hypersupply, where new construction deliveries outpace the rising demand, and occupancy begins to decline.

Ultimately, if developers continue delivering new product with no change in demand, new construction saturates the market and occupancy drops below long-term averages. Owners are then forced to reduce rents to encourage move-ins, and developers then stop building new projects as market conditions worsen and investment capital dries up. Decreased operating performance and reduced investment eventually push the market into a recession.

After some recessionary period where economic activity slows, activity begins to rebound, and occupancy rates increase as demand rises, and the cycle starts anew.

The stage of the real estate market cycle in the United States as a whole is often not a mystery and is easily found through any reputable broker, research, or investment service. While we believe an awareness of the broader macroeconomic climate is critical, we also believe that investors must evaluate the phase of the real estate cycle in the specific region, state, city, and submarket, they are considering before making any investment decision.

Let's look at Charlotte, NC as an example, since this is an area we have invested in recently. In the first quarter of 2018, CBRE reported multifamily occupancy in the area has consistently averaged 95% since 2013. High job growth, affordable cost of living, a desirable climate, and other factors drive residents to the city. CBRE describes it as "an attractive option for [multifamily] developers and investors alike." We obviously agree with that sentiment in general. While we like the city as a whole, there are specific areas that give us pause.

One of these areas we approach with caution is the downtown submarket known as Uptown. It is an employment center, has attractive amenities, is easily accessible by highways and public transportation, and it is often one of the first places new, young, and affluent residents look to live. It would seem to be a perfect place to invest in an apartment. But a deeper look at the numbers paints a different picture.

From 2015 to 2018 Real Data reports that the number of apartment units in the downtown submarket doubled from approximately 2,532 to 5,137, and the vacancy in the submarket currently stands at 21.8%, meaning more than 1,000 units are unoccupied. As a result, many developers must use incentives to boost occupancy and retain residents, quickly eroding profit margins and investor returns. Perhaps even more troubling is that Real Data also reports an additional 1,650 units are planned. Put simply, we believe this is the definition of hypersupply.

Of course, this does not mean the city's downtown apartment market will necessarily enter into a recession, and a talented developer and operator might still make a new project work. However, such high levels of new supply mean the margin of safety for any apartment investor in this area is becoming increasingly narrow.

When a market is in hypersupply, construction and leasing delays could extend investment timelines by months or years. This increases the opportunity for risks posed by macroeconomic shocks and also impacts underwriting assumptions, operating results, and ultimately, returns. Finally, diminished investor interest in submarkets with high levels of competition may push cap rates up and exit prices down.

*"Charlotte demonstrates the point well: because the city is an attractive option for development and investment overall, does not mean every area of the city is equally attractive."*
– Chris Boggs, President

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