

3.2.7 REAL ESTATE CYCLES

Develop a great deal of respect for timing. Many people, including a number of long-time investors, follow the latest “real estate fashion trend”. Various types of properties (industrial, office, etc.) are more, or less, popular depending on the period. For example, apartment buildings during the 2000 to 2007 period were a popular investment in Canada and the US. They will not stay so forever. The problem is that too many people follow the crowd, buying yesterday’s winners. There is nothing wrong with buying at the beginning or in the middle of a trend, but it is not recommended that you do so at the end of it. And unless you are closely attuned to the market, you have great advisors and lots of cash, you will rarely be at the forefront of a trend.

Real Estate is linked to the fortune of businesses, since most income revenue producing properties are used by businesses, with the exception of apartment buildings, governments, and institutions. Business goes in cycles. It is feast or famine, usually with some short periods of equilibrium between. To make significant money, you have to be a contrarian. This means that you buy when most other people are filled with pessimism, thinking that the earth is soon going to stop spinning, and vice versa. Bargains, both in terms of price and purchasing terms, can be had only when everybody else is thinking, “Boy, things are really bad”. Of course, it takes a strong personality to go against the tide, but it is only hard at the beginning!

As an example, a sophisticated businessman, Mel, borrowed money and bought a site consisting of two acres of industrial land for \$110,000 per acre. The land was, in 1989, at the very height of the Toronto market, in an excellent location –“in the path of development”. Four years later, in 1993, an investor, Jack, bought the piece of land abutting Mel’s for \$30,000 per acre. It had the same zoning, services, frontage, exposure, etc., but the vendor was in trouble. Four years hence, in 1997, both men sold their lands for \$110,000 per acre. The profit to Mel was zero, less carrying costs and property taxes for 8 years, which amounted to a loss of \$84,750 per acre (\$194,750 - \$110,000). The profit for Jack was \$68,000 (\$10,000 - \$42,000) per acre (\$30,000 plus carrying charges and taxes for 4 years). See Figure 3.1 for calculations.

Economists have long debated economic cycles in terms of their causes, predictability, and duration. While most agree that there are no predictable patterns to these cycles, others contend that long-term cycles are caused primarily by Demographics, transportation patterns, infrastructure, and government policies. Others attribute economic trends to interest rates, general economic conditions, and consumer’s confidence and, therefore, spending. Short-term cycles, which some define as lasting. Between six and ten years, have a more regional impact than the longer-term cycles, which tend to have a national impact.

Real Estate runs in cycles, in varying supply and demand levels, which affect prices more than any other factor, even interest rates. There are four phases to each cycle commonly known as the following:

1. development (optimism),
2. overbuilding (uncertainty),
3. adjustment (pessimism), and
4. acquisition (hesitant optimism).

— **Phase 1 – Development.** Symptoms: Inventory is low and demand is strong; developers respond by building new units; completion time lags demand; prices rise sharply; optimism prevails. Strategy: Buy

very early in the phase, if the price is right; sell as the phase matures for a short-term profit; remember the maxim “make your money when you buy rather than when you sell”; the late development phase, early over-building phase, is the optimum time to sell.

— **Phase 2 – Overbuilding.** Symptoms: New-construction starts exceed demand; prices level off; demand slows; optimism turns to uncertainty. Strategy: Sell and do it fast; don’t hold out for top dollar; timing is more important; if you don’t sell now, be prepared to wait out several more years.

— **Phase 3 – Adjustment.** Symptoms: Demand slows even more; new-construction starts to drop sharply but units already under way continue to come on line; inventory peaks and prices decline; power-of-sales are more frequent; pessimism prevails. Strategy: Hold what you have for the long-term sale; be slow to buy but start buying distressed properties late in the phase.

— **Phase 4 – Acquisition.** Symptoms: New construction starts are at a virtual standstill; prices have bottomed out; demand is slow but steady; new inventory is down; resale price firm up; pessimism is beginning to fade. Strategy: Buy now; the early part of the acquisition phase is the ideal time to invest; sell only if you can quickly roll your equity into something more valuable; the next phase will bring sharply increased prices (refer back to Phase 1).

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