# CHAPTER 1

# The Nature of Real Estate and Real Estate Markets

**Test Problems**

1. A market where tenants negotiate rent and other terms with property owners or their managers is referred to as a:

b. User market

1. The market in which required rates of return on available investment opportunities are determined is referred to as the:

d. Capital market

1. The actions of local, state, and federal governments affect real estate values

d. Through all of the above

1. What portion of households owns their house?

b. Approximately two-thirds

1. Of the following asset categories, which class has the greatest aggregate market value?

d. Nongovernment real estate

1. Storm water drainage systems are best described as:

b. Improvements to the land

1. What is the single largest asset category in the portfolio of a typical U.S. household?

a. Housing

1. Real estate markets differ from other asset classes by having all of the following characteristics except:

d. Homogeneous product

1. Which of the following is *not* important to the location of commercial properties?

c. Access to schools

 10. Which of the following attributes of a home are the most difficult to observe and value?

 c. Location attributes

**Study Questions**

1. The term *real estate* can be used in three fundamental ways. List these three alternative uses or definitions.

*Solution*: Real estate is most commonly defined as land and any improvements made to or on the land, including fixed structures and infrastructure components. The term is also used to describe the “bundle of rights” associated with the ownership and use of the physical characteristics of space and location. Finally, real estate may be described as the business activities related to the development, construction, acquisition, operation, and disposition of real property assets.

1. The U.S. represents about 6 percent of the earth’s land service, or approximately 2.3 billion acres. Who actually owns this land? What is the distribution of this land among the various uses (e.g., developed land, federal, land, forest land).

*Solution*: Developed land, consisting of residential, industrial, commercial, and institutional land, represents approximately 6 percent of the total land in the U.S. Federal lands and water areas occupy about 23 percent of the land; crop land and CRP land represent about 20 percent; and pasture land comprises about 6 percent of the land. Finally, the remaining land is divided between range land and forest land, with each representing 21 percent of all U.S land.

1. Describe the value of U.S. real estate by comparing it to the values of other asset classes (e.g., stocks, bonds).

*Solution*: As of 2016, real estate (including owner-occupied housing, but excluding real estate held by non-real estate corporations) was the second largest asset class in the U.S., valued at approximately $30.8 trillion. The value of publicly traded corporate equities at that time was $35.7 trillion. The value of mortgage debt (on all property types) was approximately $13.8 trillion. This is larger than the existing stock of both corporate and foreign bonds and just slightly less than the outstanding value of U.S. Treasury Securities.

1. How much of the wealth of a typical U.S. household is tied up in housing? How does this compare to the role that assets and investments play in the portfolios of U.S. households?

*Solution*: Housing is the single largest asset in the typical U.S. household’s portfolio, representing approximately 22 percent of household wealth in 2016. In comparison, the total value of corporate stocks and mutual fund shares represents 21 percent of household assets. Pension reserves, excluding stocks, also represent 21 percent of household assets. Deposits and money market funds represent 11 percent of household assets.

1. Real estate assets and markets are unique when compared to other assets or markets. Discuss the primary ways that real estate markets are different from the markets for other asset that trade in well-developed public markets.

*Solution*: Real estate is unlike other asset classes because it is heterogeneous and immobile. Real estate assets have unique and distinctive characteristics, such as age, building design, and location. Real estate is also immobile; therefore, location is an important attribute. Because real estate assets are heterogeneous and immobile, real estate markets are illiquid and localized. Potential users of real property and competing real estate are typically located in the same area or region. Additionally, real estate markets are highly segmented because of their heterogeneous nature. Therefore, potential users of a specific type of real property generally do not seek to substitute one property category for another. Finally, most real estate transactions are privately negotiated and have relatively high transaction costs.

1. Explain the role of government in real estate at the federal, state, and local level. Which has the most significant impact on real estate markets?

*Solution*: Local government has the most influence on real estate markets. It affects the supply and cost of real estate through zoning and land use regulations, fees on new land development, and restrictive building codes. It also affects rental rates through the assessment of property taxes. Finally, local government affects the supply and quality of real estate through the provision of community infrastructure and through building codes. The Federal government influences real estate through income tax policy, housing subsidy programs, federal financial reporting requirements, fair housing laws, and disclosure laws. State government generally has the least influence on real estate. State government affects real estate through the licensing of real estate professionals, establishment of statewide building codes, the creation of fair housing and disclosure laws, and through numerous housing related subsides for low and moderate income households. In addition, the state may protect some environmentally sensitive lands from development.

1. Identify and describe the interaction of the three economic sectors that affect real estate value.

*Solution*: The three economic sectors that influence real estate value are user markets, capital markets, and government. In real estate user markets, households and firms compete for physical location and space. This competition determines who will obtain the use of a specific property and how much will be paid for the use of this property. Capital markets provide the financial resources necessary for the development and acquisition of real estate assets. Real estate competes for resources against other investment opportunities in the capital market based on investor required rates of returns and risk considerations. Capital markets are segregated into two categories: equity interests and debt interests. Government influences the interaction between the user markets and capital markets through tax policy, regulations, provisions of services and infrastructure, subsidies and other means.

1. Real estate construction is a volatile process determined by the interaction of the user, capital, and property markets. What signals do real estate producers (i.e., developers) use to manage this process? What other factors affect the volatility of real estate production?

*Solution*: When real estate market prices exceed the cost of production, this signals producers to build, or add additional supply. As the supply of real estate increases relative to demand, rental rates decline in the user market, which lowers property values and signals the real estate market to slow the production of real estate. Furthermore, shocks in the capital markets and the volatility of construction costs add to the volatility of real estate production. For example, higher interest rates adversely affect property values, all else equal, thereby reducing the attractiveness of new construction. Additionally, shortages of key building materials and organized labor disputes may contribute to the volatility of real estate production.