

# Market Analysis:

*How to Determine if Your Property  
Is the Peach or the Pit*

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## If I Buy It, Will They Come?

There is an old saying you've probably heard so many times, that unless you've really thought about it, you may believe it's true.

How many times have you heard the old saw, "*If you build it, they will come?*"

No one who's ever been to the grand opening of a new retail center, office or apartment building, airport, or any other large project would blame you for believing it. After all, the crowds, flowers, balloons, and ribbon cutting ceremonies create a pretty convincing picture of success. But there are plenty of projects that have splashy grand openings and then no one ever comes back.

For instance, developers in major cities nationwide so overbuilt office space in the 1980s, that it took nearly 20 years for all of it to be absorbed into the marketplace. Talk about an imbalance between supply and demand!

So whether you're looking to buy a rental house or an apartment building, how can you determine what factors to look for when buying a property so that you'll have lots of people eager to rent from you?

The answer is doing smart *market analysis*. Market analysis means figuring out who your target tenants are and how to provide them with the right product, at the right time, and at the right price.

Market analysis also involves pinpointing the external factors that might influence your investment. Knowing these things is critical to your success.

This brings me to another old saying that you usually hear from investors who bought something to which nobody came: "*It's what you don't know that'll hurt you.*"

That statement leads quite naturally to a question that you'll always want to keep in mind as you consider an investment opportunity: "What *don't* I know about this?" Even if it's in your own neighborhood, you need to ask this question before you invest.

Residential market analysis is primarily concerned with three issues:

1. Will there be tenants to rent or buy the units
2. How quickly and at what price points will the units be rented or purchased?

### 3. How could we market the property to make it appealing to prospective tenants?

You should always try to learn all you can about the local market you're investing in. You need to be certain that there will be tenants who'll want what you're planning to offer.

With that in mind, we're going to look at the factors that drive the housing market. We'll explore how the local economy, housing supply, and demand for units affect the rental market and therefore your investing decisions. I'll also show what to look for in a market study. And then I'll give you some shortcuts to getting the information you need to determine the demand for rental units. So let's dig in!

## Identifying the Market Area

You start your market analysis by developing an understanding of the local market. And you begin to do that by identifying the market area.

The *market area* is the geographic area that contains most of the nearby competing properties. It's also where you'll draw most of your residents from.

The size of the area will vary depending on population density and the number of competing properties. The denser the area, and the more nearby competition you have, the smaller your market area will usually be.

For example, a multifamily building in a high-density urban neighborhood with several similar apartment buildings within a few blocks will likely have a relatively small market area. On the other hand, a luxury high-rise on beachfront with few competing properties nearby may have a market area of a hundred miles or more. However, a market area this big is rare. Most buildings have a market area of no more than a one to five mile radius.

A market area can be either urban or suburban. It is usually centered on a major transportation corridor, employment center, or other neighborhood amenities such as rivers and lakes, resorts, and colleges. They are often bordered by physical or psychological boundaries.

*Physical boundaries* are geographical features that divide one neighborhood from another. For example, a freeway or river might separate two distinct neighborhoods. Even though a bridge may provide access to the other side, rivers and traffic corridors are common delineating features between residential districts. Parks, commuter railroads, hills, lakes, and wetlands are also common physical boundaries.

*Political boundaries* that separate one locale from another include state and county borders, urban growth boundaries, urban renewal area boundaries, school district borders, and zoning regulations.

If you're driving or walking from one neighborhood to another, you may not notice any delineation from one jurisdiction to another. You may not notice that you just entered an urban renewal area or crossed a county line. But there are political and economic differences that will affect the demographics and economic status of residents in that area, as well as differing property tax laws that will impact your balance sheet.

It's important to be aware of these boundaries and their effects on a property. For example, *all other factors being equal*, which property do you suppose will rent for more: the property that's across the freeway and around the hillside from the closest grocery store, or the one that sits closer to the grocery store?

On the other hand, if the side of the freeway where that same property sits is in an urban renewal area, it may well be a good investment because of the tax incentives available to owners of property in urban renewal areas. So be aware of the boundaries that affect your property, because they can have a substantial influence on your bottom line.

**Commute times:** Another important issue to consider when identifying a market area is how long people will be willing to sit in rush hour traffic to get to work. Assumptions about reasonable travel times to major nearby employment centers can really help you determine the size of a property's market area. *All other factors aside*, the closer a building is to an employment area, the smaller the market area and the higher the demand for units.

Commuting times are largely dependent on access to mass transit and transportation corridors. So, to more accurately define your market area, identify the nearest access points to mass transit and traffic arterials.

## Mapping Market Areas

Okay, time to bust out the coloring pens! I suggest you get a map of your city, and tack it to a bulletin board. Then, get a set of color markers and multi-colored push pins. We're going to do some mapping!

**Map Urban Renewal Areas:** City planners designate certain area of town "urban renewal areas" to incentivize home owners and property developers to invest in blighted neighborhoods. Incentives include tax abatements and public subsidies for properties and projects that meet certain criteria.

Even if you're not a developer, you can still profit from investment in these areas by buying properties within a URA. Since property values are usually quite low in these blighted areas compared with the rest of the city, when developers start to build new projects, the value of nearby properties goes up much faster than other areas. You can realize significant gains by buying property at the beginning of an upswing in an urban renewal area.

Your city planning department can give you maps of each URA in your city. I suggest you use these maps to color in the URA areas of your city on your map, and try to focus on buying properties in these areas.

**Map Your City's Home Price Appreciation (or Depreciation):** Any local Realtor should be able to give you a list of neighborhoods in your city and their home price appreciation over the last year or two. I recommend taking this information, and using different colored highlighters or colored pens, color the areas of town according to their home price appreciation rates.

For example, Neighborhoods A and B might have gone up in value by 3% last year. Neighborhood C might have increased by 5%, and let's say that Neighborhood D went up by 7%. Color Neighborhoods A and B the same color, and use two different colors for both Neighborhoods C and D. I suggest using rainbow colors, with cool colors like blue and green for areas with low appreciation rates, and yellow, orange and red for areas with high rates of appreciation.

**Map Major Shopping Districts:** On the same map, draw lines on streets that you consider to be major shopping districts. Also draw a circle around major shopping malls.

**Map Individual Grocery Stores:** Again, on the same map, put pushpins or tacks in the map to note the locations of grocery stores. I'm talking about major grocery stores and specialty food stores such as Whole Foods. The convenience store on the corner doesn't count here.

Now look at your map. What do you see?

Try to target properties in urban renewal areas with high rates of appreciation. Then look closer for properties near shopping areas and within walking distance to grocery stores. All things being equal, from a market perspective you'll have the best chance of finding properties that will always be in high demand, as well as increasing in value over time.

## Collecting Your Data

If you're planning to invest in single family homes, one of the best ways to learn about your market and how much sellers are asking for properties is to collect "for sale" flyers from Realtor's signs. These flyers can give you a lot of information about what buyers in your area consider important (it's what the sellers and their agents are highlighting as important features of the property on the flyer), as well as indications about prices in the neighborhood.

I suggest that you collect as many flyers as you can, and organize them by neighborhood. Once you have ten or so flyers for a given neighborhood, figure out the price per square foot for each property. To do this, take the asking price and divide it by the number of square feet in the house or building. For residential properties, this includes finished space only— not garages, unfinished basements or unfinished attics. If these areas are finished (the walls have sheetrock, the floors have a floor covering such as hardwood, carpet, tile, linoleum, etc, and the space has heating and lighting) then you may count that area in the square footage number.

Once you calculate the price per square foot of each property, throw out the high and low for the neighborhood and average the remaining properties. This is the approximate asking price per square foot for the area.

Then when you see other properties in the same neighborhood, quickly calculate the asking price per square foot and see how it compares to the average. You'll quickly know if the price is competitive for the market. If it's considerably higher than the average, you should be able to tell why. If you can't tell why it's priced the way it is, ask the seller or their agent. If they don't have a compelling answer, the sale price may be too high for the market.

On the other hand, if the price is well below the average asking price per square foot for the neighborhood, ask why it's priced so low. It may be either a motivated seller trying to dump the property quickly, or it may need physical upgrades or repairs to be competitive with the other properties in the neighborhood. Either way, try to discover why the price is higher or lower than the average for the neighborhood.

Another great way to learn what houses are selling for in your neighborhood is to go to [Craigslist.org](https://www.craigslist.org) and look at asking prices of properties there. Again, organize the listings here according to neighborhood the same way you did with the "for sale" flyers you collected. Again, calculate the asking prices per square foot, and you'll get a good idea of what a house should sell for in a given neighborhood. Just remember though, that variances in size, style, condition and location will affect the asking price and final sales price, so use this as a guide, not as gospel.

Before you buy an investment property to hold long term, you'll need to know how much you can reasonably expect to rent it to a tenant for. One good way to

determine the potential rent for a property is to look at "for rent" listings on [Craigslist.org](http://Craigslist.org).

Remember, it's important to categorize these listings by neighborhood, and also by size of unit. This usually means the number of bedrooms in the property, so compile your data accordingly. Also, apartments typically rent for a little bit less than a house of equal size and number of bedrooms. So compare apartments to apartments, and houses to houses. Try not to mix the two together.

## Drivers of the Rental Housing Market

This is as much art as science. You have to think like a tenant. Ask yourself questions like: If I lived here, how long would it take me to:

- Buy a gallon of milk?
- Go to the bank?
- Rent a movie?
- Go to a restaurant?
- Get to work?

You should be able to answer specifically where your tenants will be able to do each of these things. Once you can, get out your map of the area and mark your property's location, and where the above services are found near your building. Be sure to also mark the location of competing properties.

Then draw in political boundaries such as city or county borders, urban renewal area boundaries, school district lines, and so forth. This should give you a pretty good idea of the size and dynamics of your market area.

After you've defined the area where your tenants will live, work, and play, you can explore the economic factors in the area that will either help or hurt your building, and determine if it is a good place to invest.

Now let's take a look at how the local economy can affect the demand for a specific building.

## Employment Levels

One of the biggest drivers of the rental housing market is the health of the local economy, specifically employment.

The local job market will determine whether people will move into or out of an area, resulting in higher or lower demand for units. Generally a property in an area with strong job growth will experience lower vacancy rates than an equal building in an area where jobs are harder to find. So when considering any rental property, find out what the local job market is like. Is it strong or weak? What is the unemployment rate for the area, and how does that compare with the rest of the city, state, and country?

Also, what new companies might be planning to move into or expand into the area? What existing employers are poised for layoffs? Business newspapers and your local chamber of commerce can give you unemployment numbers and details on the state of the local economy.

## Median Incomes

Household income largely determines the price points at which you as an owner can realistically rent units to tenants. It is also a strong indicator of the economic health and vitality of a given area. Pay attention not only to level of income in a given area, but also to the rate of increase or decrease of that income. If an area is experiencing a decrease in household income, think twice before investing there.

Generally speaking, you begin to determine how much you can rent units for by looking at the median income for your market area, and assuming that a household can afford to pay roughly 30-35% of their monthly gross income toward rent. Note that this rule of thumb is not an accurate formula for pricing your units. It just provides a rough starting place for determining the median rent level for the neighborhood.

Another part of determining potential rents is to consider the number of households in specific income brackets. When deciding what to charge, you can choose one of two approaches:

1. Your first option is to offer units with amenities and rental rates that would be attractive to most potential tenants in the market area. Doing so will expose your property to the highest number of potential tenants. But it will also cause it to compete directly with most other buildings in the area. That means you'll have to market the advantages your property has over its competition.
2. Your second option is to cater to households that are either above or below the median income range for the area. This will put your property

into more of a niche category, but you'll likely also have less competition from other buildings.

Either option is viable, but you'll want to make a conscious choice about what market segment makes the most sense for the property you're looking at and the market in which it competes.

You can get income information from the city planning agency or the U.S. Census Web site.

## Population Growth or Decline?

The number of people moving into or out of an area will greatly impact the demand for housing. As part of your market analysis, it's a good idea to find out what the recent population trends are for the area.

If an area has strong in-migration, the demand for housing will be strong. If people have been moving out of an area in the past few years, it probably means the rental market is soft. If a major employer just announced plans to move into that area, however, it might be a great time to invest. As always, it's important to look at the big picture to see how each piece of information fits with the others.

On the [U.S. Census Web site](#), you can find out what an area's migration trends have been for the last few years. You can also find population projections for the future. While not a guarantee of future growth, this should give you a sense of the general direction of the demand for housing.

## Health of Office and Retail

Another important, yet often overlooked indicator of the health of the rental housing market in an area is the health of its office and retail properties. The more people earn and spend, the stronger the office and retail market will be. And this means the multifamily rental market is likely to be strong too.

A strong office market implies that people have jobs, business is thriving, and that demand for housing is strong. A weaker office market with high vacancies usually means that rental properties will have higher vacancies than they otherwise would. People move to where the jobs are.

Retail vacancy rates can also tell you a lot about the economic vitality of an area. If there are few vacancies in both large and small local retail centers, residents in the area probably have enough disposable income to spend money on things they want and need beyond basic shelter. If they can buy enough consumer goods to keep retail strong, they can also afford to pay higher rent.

This brings us to the topic of supply and demand...

## Analyzing Demand

Before you invest, you need to know your market area's balance between supply and demand for apartment buildings. The level of demand for rental units in the area should be one of the first questions you seek to answer before getting serious about buying a building.

There are several indicators you can use to determine the demand for rental housing in a market area. Here are the most common:

**Vacancy rate:** We've touched on this a bit already, but let's define it more specifically. A vacancy rate is the percentage of units either in a building or in a neighborhood that are currently unoccupied. For example, a vacancy rate of 5% means that 5% of all the units in a building are empty and not generating income for the owner.

The lower the vacancy, the better the property is performing. Typically, a vacancy rate of 3-5% is considered good. More than 10% vacancy usually indicates a weak rental market or an underperforming building.

If a neighborhood has a low vacancy rate, but the building you're looking at in that neighborhood has a higher-than-average vacancy rate, the building is underperforming the market. This may be a signal that an opportunity to buy below market is at hand. For example, the building may be underperforming because it is in need of repair, or is poorly managed. If you can remedy the problem that is causing the high vacancy rate, you can buy low and increase the income from the property.

On the other hand, a high vacancy rate may also indicate a flaw in the building that is not easily curable. A functionally obsolete building or a poor location is not easily fixed. In such cases, it's probably best to move on.

Once you identify the reason for the high vacancy rate, you can determine whether or not it's worth fixing.

**Occupancy rate:** An occupancy rate is essentially the other side of the vacancy rate coin. An occupancy rate is the percentage of units in a neighborhood or building that are currently occupied. You'll hear both vacancy rate and occupancy rate used to describe the level of demand for a building.

**Absorption rate:** An absorption rate is the pace at which all the units in an apartment building are renting. It is expressed in the actual number of

apartments that will be rented each month, rather than as a percentage. In other words, it is the rate at which residents in the market for apartments absorb units.

I know a developer who put a 100-unit high-rise condominium tower on the market a while back. It took about 10 months for all the units to sell. That's an absorption rate of 10 units per month. A year later, the same developer built a second, almost identical tower two blocks away. The building was 80% sold in just six days! Talk about an increase in demand! The second building eventually had an absorption rate of all 100 units in a single month.

He then built two more 100-unit buildings in the neighborhood, and the sales market crashed just as they were finished. He couldn't sell any units, and had to switch them from condos to apartments. He rented both buildings out in just four months' time. His absorption rate for selling the units, therefore, was zero, and his absorption rate for renting them was 25%.

As a tool, the absorption rate is used most frequently with brand new buildings. By learning the absorption rates for new buildings in the area, you can get a sense of the demand for rental housing in the area.

While vacancy and occupancy rates are snapshots of demand at a single point in time, an absorption rate gives you a sense of demand over the course of a given timeframe, usually a month or a year.

## Configuration and Amenities

Vacancy, occupancy, and absorption rates are *quantitative* measurements of demand. As an investor, you should also learn what *qualitative* demand exists in the marketplace. That means determining the lifestyle and tastes of your market area's residents. What size units would they want? What bedroom and bathroom configurations would appeal to them? What amenities?

Taking the time to visit competing properties, especially new developments, will help you answer a lot of these questions. For example, if the demographic you intend to target in your market area is young families, a building with three bedroom units will likely have more demand than a building with mostly studios apartments. On the other hand, if the building you're looking at sits on a college campus, the opposite may be true.

If your market research suggests that the proper target tenants are urban professionals, then it may be important to offer upgraded kitchen appliances, wireless Internet service, and retail within walking distance. By touring new developments that target similar tenants, you can easily see what features you might incorporate into your building at a reasonable cost.

Understanding the lifestyle and personal tastes of your target tenant is vital to creating demand for your building. Visiting new developments and talking with multifamily property brokers and building managers are great ways to quickly learn about the demand in the marketplace.

## Homeownership and Affordability

The cost of an area's single-family homes relative to its median income is also an important factor in determining demand for rental housing.

In many locations, the last few years have seen a boom in single-family home ownership. As more people buy homes, the rental market usually softens. This is largely because low interest rates allow people to become home owners who otherwise wouldn't be able to qualify for a loan.

When this happens, however, housing prices usually shoot through the roof in most metropolitan areas. This makes home ownership all but impossible for those who have yet to buy. In fact, home price appreciation outpaces income growth so dramatically that in the boom years of a few years ago, only 19% of Californians earned the \$108,450 a year needed to qualify for a loan to purchase the median home in their state. The same phenomenon repeated itself to varying degrees nationwide.

When home prices increase beyond the reach of many would-be buyers, renting becomes a more attractive alternative. The same is true when interest rates go up. When interest rates are high, the rental market is typically strong because lenders are stricter in their underwriting guidelines, and fewer marginal buyers can afford to buy. This puts downward pressure on home prices, and homes become more affordable.

As interest rates come down and loans are easier to come by, buyers rush out to buy homes, increasing home prices and softening the rental market. Then as home prices get to the point where many people can no longer afford to buy, the rental market comes back. And the cycle continues.

At the end of this article, you'll find a link to a Web site that gives yearly rankings of the most expensive housing markets compared to median incomes.

## Analyzing Supply

Along with demand, the supply of existing units and planned developments affects the health of an investment property. For investors, there are several warning signs of an imbalanced or overbuilt market:

**Rising vacancy rates:** If a single building has a high vacancy rate, it could be due to something property-specific, such as poor management, location issues, or disrepair. However, if vacancies are generally on the rise in a neighborhood, city, or region, it usually signals a softening rental market. This can be caused by a number of things, including a hot home buying market, plentiful new construction, a weak economy, and so forth. Once you determine the cause of an area's rising vacancies, you can make an informed decision about whether you want to buy there. Usually, market areas with rising vacancy rates are not the best place to invest.

**Negative absorption:** When more tenants move out of a market area than move in over a specified time period, you have negative absorption. If an area has negative absorption, the rental market is weakening. If residents are moving out of an area, retaining good tenants may be difficult even in the best-managed building.

**New construction that significantly outpaces demand:** Unless vacancy rates are already extremely low, a flurry of new construction that exceeds population growth will likely cause at least a temporary softness of the local rental market. Some new construction is to be expected in a healthy market, as new buildings replace old ones and supply keeps up with increasing demand. But if entire neighborhoods spring up overnight and new units are slow to rent, buyer beware.

**Dropping rental rates:** Sometimes in a market area, there's an overall drop in the amount of rent landlords are able to charge tenants. This often leads to conditions in which landlords have to offer concessions such as free rent or rent reductions in order to keep tenants in their buildings. This not only means attracting and keeping tenants is difficult, but also that the majority of properties in the area are generating less income than they used to.

**Condominium Conversions:** Condo conversions are a telltale sign of an oversupply of rental units. When an owner converts a building from rental units to condos, it often means there's less profit in renting the property than there'd be in selling each individual unit and moving on to another project.

On the other hand, condominium conversions help restore equilibrium to the supply side of the market by reducing the number of rental units in an area. Once a market achieves equilibrium, the vacancy rates of competing properties may experience a decline, making the local rental market healthier.

Condo conversions have the opposite effect of new construction on the supply of units in the market. Having some conversions and some new construction is healthy. But a large amount of either one is a sign of a softening rental market.

## Market Trends

By looking at the dynamics of the local economy together with the area's supply and demand for rental housing, you can see trends in the rental market. Knowing these trends is important to determining whether an area is ripe for investment.

When considering a specific building, compare its rental, vacancy, and absorption rates with the rest of the market area, city, and region. Also, compare the building's current rates to what they were in the past quarter and year. If you discover that its rents are dropping or vacancies increasing, find out why. If it's something you can cure, it may be a good investment.

Also, compare the present rental, vacancy, and absorption rates of the market area, city, and region, to what they were in the past quarter and year. Which direction is the market heading? If the price per unit for a given unit type is rising or dropping, find out why. Most brokers and property managers have an opinion as to what factors are currently driving the local market. They can give you the specific reasons for a shift in the rental market.

So how do you go about finding all this market information? You don't have to collect and analyze it all on your own. Many brokerages and property management firms publish reports on market trends in major cities. I've provided links to a few of them at the end of this article to help you find information on your area or the closest major city.

Now that you know what to look for in a market study, with the help of published data, evaluating a market and spotting trends should be relatively easy. It would also be a good idea to talk with brokers and property managers to get their real world opinions on the market. Once you've read the report for an area, you'll be able to speak intelligently with building managers about their tenants' desires, and with brokers about investing there.

### In Conclusion...

Knowing your market is the key to making smart investments. The more you know about your tenants, your competition, and the supply and demand of the local market, the better investing decisions you can make.

You should always try to learn all you can about the local market you're investing in, so you know there will be tenants who'll want what you intend to offer.

Employment levels, median incomes, population growth, and the health of office and retail properties are all good indicators of a market area's economic health.

Once you establish your market area, you can determine which types of buildings appeal to your target tenant. Commute times and proximity to retail and other

services can be deciding factors for potential tenants. So can unit size, configuration, and amenities. By talking with brokers and property managers, you can learn what units are most in demand in your market area.

Vacancy, occupancy, absorption, and rental rates are all quantitative indicators that give you a sense of the demand for rental housing. Qualitative indicators include unit size, desired amenities, and evolving lifestyle needs. Homeownership and affordability also play roles in creating demand for rental units.

There are several warning signs that a market may be out of balance or overbuilt. These include rising vacancy rates, negative absorption, new construction that significantly outpaces demand, and declining rental rates. A moderate number of condo conversions can restore equilibrium to a market area. However, a high rate of them can indicate that renting out apartments in the area is less profitable than selling the individual units and then investing in other projects.

Condo conversions have the opposite affect of new construction on the supply of units in the market. Some of each is healthy, but an extreme of either is a sign of a softening rental market.

It's important to spot trends in both the market you're considering investing in, and the actual building itself. Many brokerages and property management firms publish reports on market trends in major cities. Property managers are also a great resource for discovering the current state of the market and a specific property. By reading market reports and talking to brokers and managers, you can get a good idea about whether a neighborhood or building is worth your time.

## Next Steps

Colliers International is a multinational real estate services company. They offer market reports for major metropolitan areas al around the world. Click the link below to check out their free quarterly market reports for major cities in over 40 countries worldwide:

<http://www.colliers.com/Corporate/MarketReports/>

Also, contact a multifamily property broker in your area & ask for their two most recent industry reports for your area. You may be able to get these online; otherwise ask them to email them to you.

What do the reports tell you? What is the vacancy rate in your area? How does it compare to the vacancy rate from the previous quarter and the previous year? What do the reports conclude in terms of the market forecast for the coming year? Why?

Identify three multifamily properties in your neighborhood. Call or visit the site manager of each, identify yourself as a student taking a class on multifamily real estate, and ask the following questions:

1. What are their rates for 1 and 2 bedroom apartments?
2. What specials are they currently offering?
3. How many vacancies and total units do they have?
4. Is their current vacancy rate typical? If not, why?