



REDEFINING REAL ESTATE INVESTING

THE VALUATION SERIES: COMMERCIAL REAL ESTATE 202

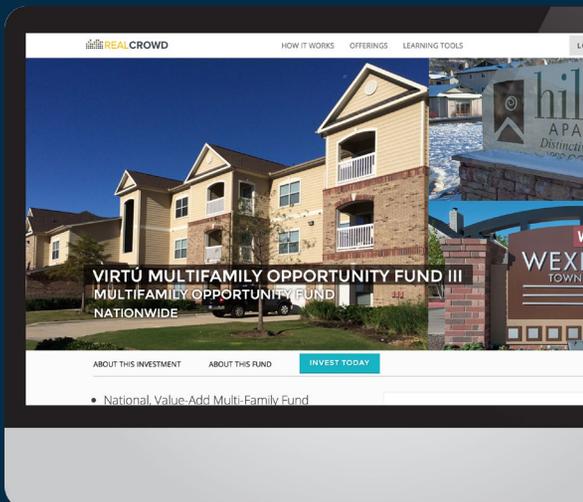
HOW IT WORKS

ABOUT REALCROWD

RealCrowd is a private, secure and simple-to-use online platform for accredited investors to access, review and invest in commercial real estate opportunities across the nation.

Using the platform, investors can inspect investment offers and materials, such as legal documents and due diligence items, allowing them to make informed investment decisions in what is widely considered one of the greatest wealth creation tools on the planet.

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THE VALUATION SERIES

RealCrowd's Valuation Series is a set of informative ebooks to enhance investors' knowledge of commercial real estate investing, from the fundamentals of valuing commercial real estate to more advanced analysis techniques.

After completion of the Valuation Series you will know how to:

- Understand different investment styles
- Analyze market conditions
- Evaluate risk profiles
- Carry out cashflow analysis
- Read financial models
- Apply a quicksnap analysis

INTRODUCTION TO CRE202

HOW IT WORKS

In the last entry of RealCrowd's Valuation Series, we introduced the essential concepts and basic methods used to analyze real estate opportunities. Now that you can apply the ideas of risk and return to make useful comparisons between multiple properties, it's time to get a bigger picture of the real estate system.

In **CRE202: How it Works**, we'll look at the three main components of real estate: the rental market, the asset market, and the development industry. The interactions and behaviors of these components affect how much we pay for our apartments, how much our employers pay for our office space, and how much retailers charge us for goods and services. It is the key driver of how our cities are built. And it's what ultimately determined returns to investors.

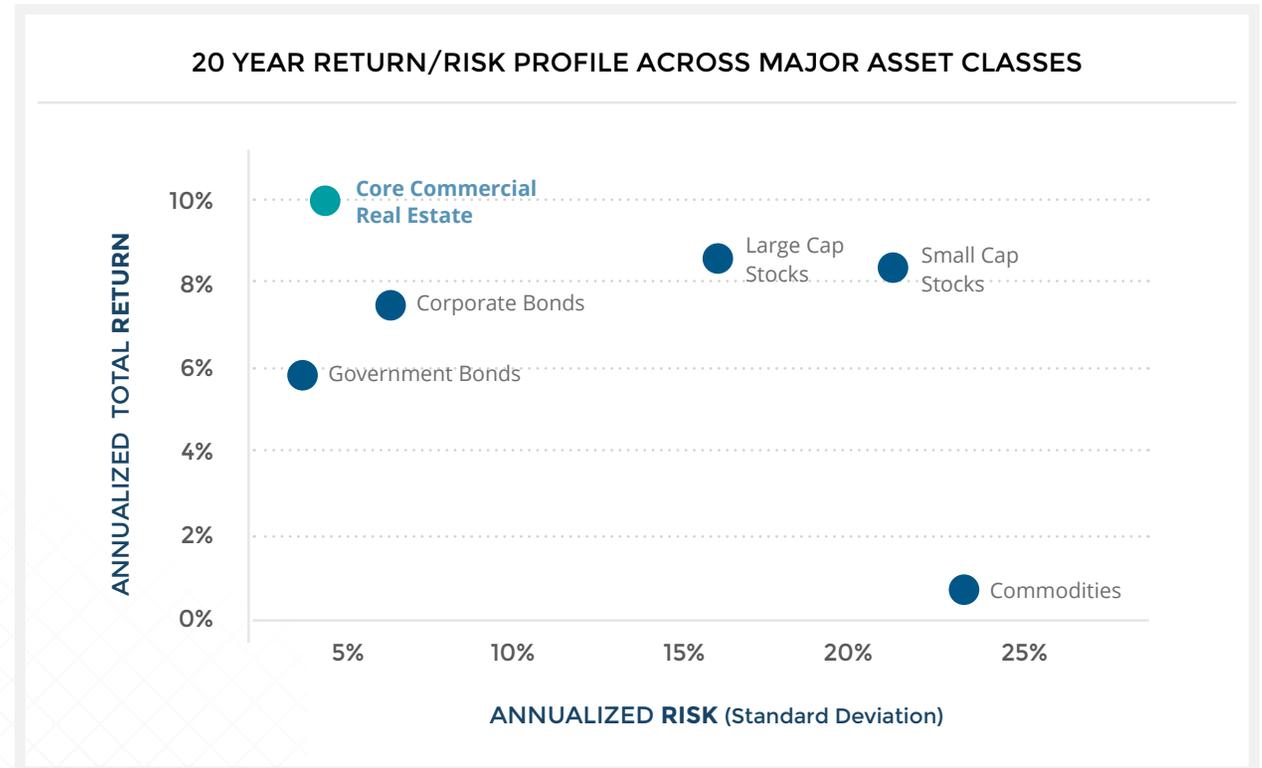
A Bird's Eye View of the Real Estate System

Real estate is a vast and complex system, but the fundamentals are easy to grasp. Concepts like “rent,” “occupancy,” and “construction costs” are part of the everyday language of real estate investment. Investors often acquire an intuitive grasp of such basics as a matter of necessity.

Yet by drilling down and taking a closer look at the basics, investors stand to gain a clearer understanding of their assumptions. A concrete understanding of how real estate works on a broad scale should help with making intelligent, forward-looking and comprehensive investment decisions.

This brief introduction aims to take the fundamentals of the real estate system and shed a little light on their connections, putting them into a larger, systematic framework.

It's important to understand how commercial real estate works, because it offers some of the best risk adjusted returns when compared to other asset classes.



Source: Thompson Reuters Datastream, Data from 1993-2013

Broad Connections: Rental Market, Asset Market, and Development Industry

On the broadest scale, the real estate system is best thought about as a large feedback loop consisting of three main parts: the rental market, the asset market, and the development industry. In the order listed and driven by the overall economy, each “feeds” into the next, outputting (and inputting) a mix of information, money, goods or services.

It’s through the interactions and behaviors of these primary components that the “hows” and “whys” of real estate are determined. This brief introduction aims to take the fundamentals of the real estate system and shed a little light on their connections, putting them into a larger, systematic framework.



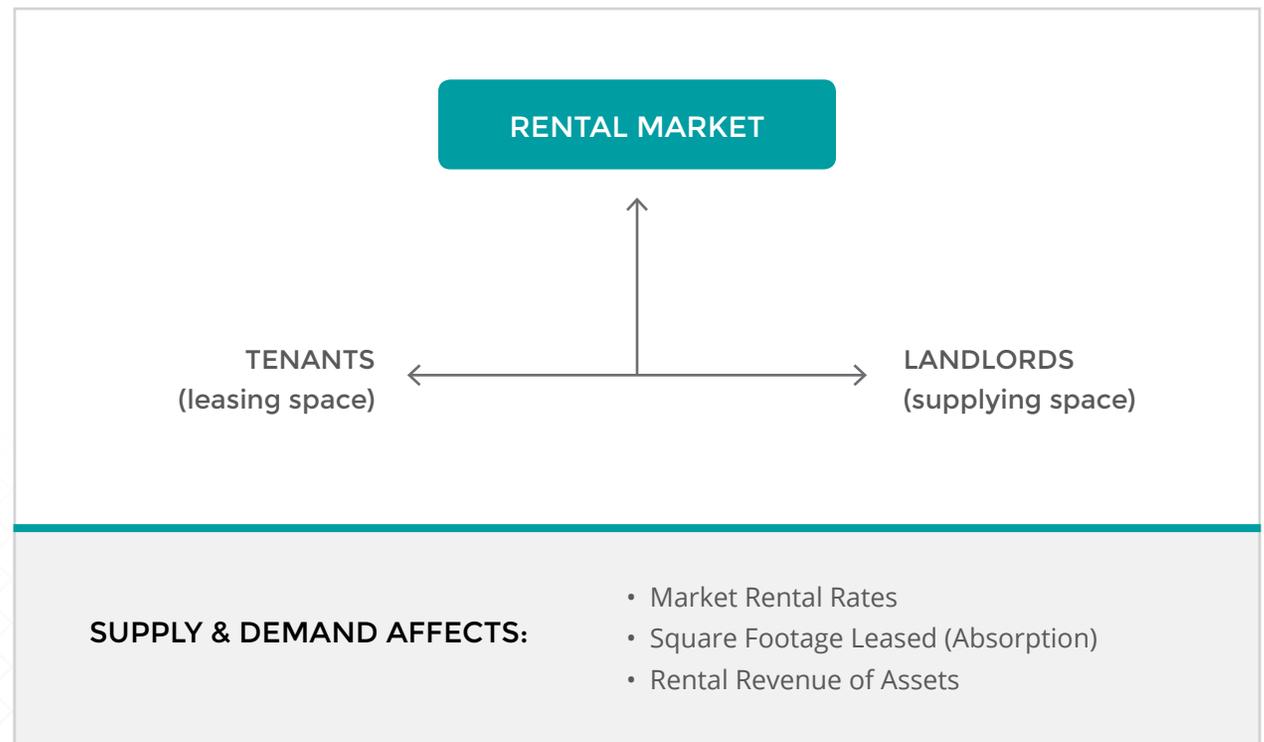


The Rental Market

The **Rental Market** consists of property owners (the supply side) and tenants (the demand side) which contributes to rent and occupancy levels.

These parts work together in the familiar way: rents increase or decrease based on available space weighed against demand for that space. This is nothing more than the dynamics of supply and demand applied to rental properties, with the price of rent fluctuating accordingly. When available space remains constant and demand strengthens, rental prices increase. Likewise, if space remains constant and demand weakens, then rental prices decrease in response.

One of a real estate operator's objectives is to maximize rental income, which is the primary link between the rental market and the asset market, and acts as the key determining factor of a real estate asset's operating cash flow, and ultimately its overall market value.





The Asset Market

The **Asset Market**, as with the rental market, also has a supply side and a demand side, both of which consist of invested owners looking to sell real estate assets on the one hand, and investors looking to buy those assets on the other. The behavior of real estate investors in the real estate asset market is determined by perceptions of comparative investment opportunities in other capital markets, say, the stock market, as compared to present risks and returns in real estate.

These comparisons and perceptions, along with forecasts of the future price of rent in the rental market, determine the market capitalization rates (cap rates), or yield, that investors consider acceptable in real estate deals. That is, cap rates must be high enough compared to other investment opportunities or investors will look elsewhere for returns.



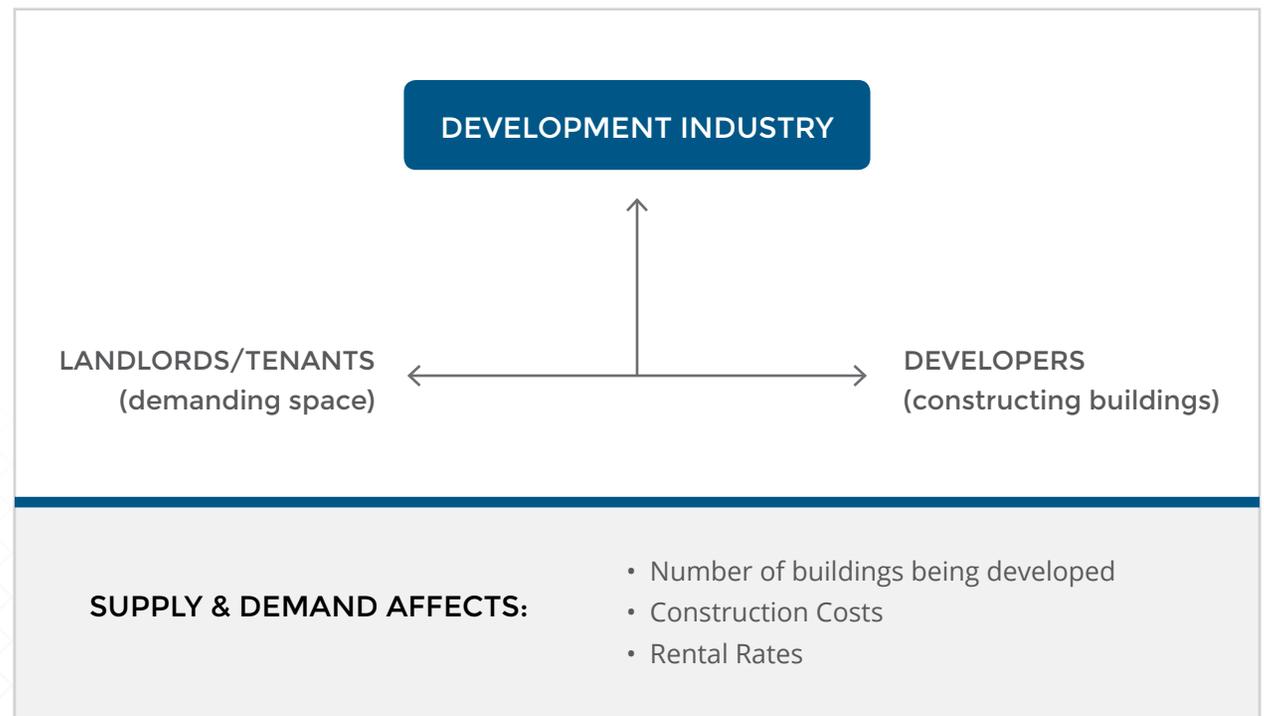


The Development Industry

The value of a real estate asset, determined by the interaction of operating cash flows and cap rates, brings us to the third and last main component of the real estate system, the **Development Industry**. The activities of the development industry determines the availability of space in the rental market.

Recall, the main response to weakening or strengthening demand in the rental market impacts rental prices. There is another possible response, however, which is to expand or contract the amount of available space on the market.

Physical property is more inelastic than rental price, however. Adding or subtracting space is an expensive, complicated, and time-consuming enterprise. As a result, it happens under limited circumstances only. Specifically, the development industry adds more space to the market when asset values equal or exceed development costs. When asset values meet that criteria, then the rental market's supply side is expanded.





The Real Estate System Affects the Daily Lives of Everyone

This brings us full circle in the main loop in the real estate system. We've seen that the rental market outputs operating cash flows into the asset market, which then interacts with investors to determine cap rates returns and asset values, which, finally, signal the development industry to build more space if asset values are high enough.

The real estate system affects how much rent we pay for our apartments, how much our employers pay for our office space, and how much retailers charge us for goods and services. It is the key driver of how our cities are built. And it is ultimately what determines returns to investors.

Of course, this loop is not self-contained. For instance, demand fluctuates according to trends in national and local economies, and, as mentioned, the cap rates returns that investors require are determined through comparison to opportunities in other capital markets. Nevertheless, the value and trends of real estate assets can be thought of as a result of the interactions of the three main components we've outlined: the rental market, the asset market and the development industry.

**ONCE YOU KNOW THE CYCLICAL NATURE OF THE INDUSTRY,
YOU'LL BE BETTER EQUIPPED TO INVEST.**



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