RECENT EVIDENCE ON INVESTOR PREFERENCES AND YIELD REQUIREMENTS*

by Hugh F. Kelly, CRE

**The principal compendium of information upon which this article relies is a database of sales compiled for the* CCIM/Landauer Investment Trends Quarterly, *a joint venture between the Commercial Investment Real Estate Institute and Landauer Associates. Sales resident in the database, with a closing date of January 1, 1995 or later, are the subject of the analysis and commentary in the article. Such sales number more than 1,600 nationwide and have an aggregate investment value of more than $13 billion. While it is conceded that the database simply represents a sample of U.S. commercial property activity, it does provide a powerful approximation of activity on the national scale.*

Following the industry depression during the early years of this decade, there are voices that claim to discern revolutionary change in the structure of the real estate industry. The purported causes of the revolution range from the job market effects of the aging Baby Boomers to yet another death watch for Central Business Districts, from the impending obsolescence of whole ownership of real estate in the face of equity and debt securitization to claims that technological advances are doing nothing less than making real estate use optional for businesses. Perhaps apocalyptic fears are expected with the approach of a new millenium. Certainly all the Nostradamuses in our industry can point to clues, if not proof, to support their visionary projections. However, this article is not the place to refute or vindicate any such rationalizations. Instead I will look at the body of evidence to see how the behavior of the investment community, in its preferences and return requirements, displays its implicit expectations for the future.

Summary Of Property Markets

The follow statistics recapitulate the activity reported in the *CCIM/Landauer Investment Trends Quarterly* for January 1995-March 1996. *Office properties* led the property types in the number of sales and aggregate value of transactions, with 480 deals totaling $6.2 billion. This represented 70 million square feet of office space, approximately equal to the combined office inventory of Miami, Orlando and Tampa. *Retail properties* were somewhat less favored over the 15 month period, with 276 sales registering an aggregate price of $2.1 billion. Store area of 28 million square feet was included in the transaction sample, which equates to a typical retail inventory for a metropolitan area of about 1.6 million in Sacramento or Denver. The *industrial sector* accounted for 217 sales and a dollar volume of $821 million for 24 million square feet, the equivalent of a market like Columbia, South Carolina or Bridgeport, Connecticut. Multifamily residential assets tallied 196 deals worth $1.2 billion for 34,202 apartment units, about right for a town the size of Reno, Nevada. *Hotels* also were actively traded despite protestations of investors that they would never again buy any property with a bed in it. Hospitality sales of 103, comprised of 22,502 rooms, brought a total sales price of $1.9 billion. The balance of the sales in the database consisted of *land* (220 deals, 7,513 acres, $400 million), *portfolio transactions*, *mixed-use* and *speciality properties*.

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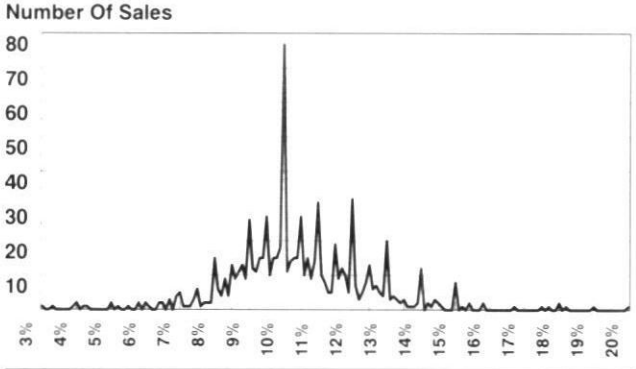
EXHIBIT I

Range of Initial Yields in the CCIM/Landauer Database



Analysis based on actual yields reported through June 1996

This capsule summary illustrates that the liquidity crisis of the early 1990s was indeed a temporary phenomenon, rather than a precursor of permanent structural change in the commercial property investment arena. While we lack a commensurable set of data for prior periods (and must recognize that this database itself is just establishing its own benchmarks), both the pace of recent activity (3.0 sales per day reported into the database for 1995, and 4.7 sales per day submitted for the first quarter of 1996) and its breadth currently indicate that a liquid transaction market exists for all major property groups.

Does this mean that real estate has returned to normal? In an arena so vast and complex as the U.S. property markets, it is safest not to respond by generalizing. But, as any good detective would advise, the best answer is to follow the money. The distribution of activity among the property types offers one perspective, and the capitalization rates indicated by the transactions provide another.

Capitalization Rates

Cap rates were reported for approximately 800 of the sales in the sample, and the number of transactions observed at each cap rate are graphed in Exhibit I. The extremely wide spread of initial returns is readily seen, with a very thin layer of sales at cap rates of less than 8 percent and greater than 13 percent. A prominent peak occurs at 10 percent, which, in fact, was the reported capitalization rate for about one sale in every ten. This is only the most dramatic spike in the entire graph, but closer inspection shows repetitive crests at each integer value cap rate (i.e., 8.0 percent, 9.0 percent, 11.0 percent, 12.0 percent), with another set of peaks at the half-percent cap rates (8.5 percent, 9.5 percent, etc.). It is not clear whether this pattern in rates resulted from a rounding bias in the reporting of yields or whether investors negotiate to prices which are convenient to understand at 50 basis point intervals on the cap rate scale. If the latter, this would be a sign that properties are still being priced on their ability to offer current return, versus futures as measured by prospective improvement in cash flow and appreciation, discounted to a net present value.

Sophisticated mixed-asset investors (i.e., investors holding portfolios of bonds, stocks and real estate) are likely to cast a wary eye at the spikes displayed in Exhibit I, based upon recent irregularities in the penny-stock market. There regulators have found evidence of price manipulation in the clustering of prices at what are called even bits. A bit is one-eighth of a dollar (a unit of price which survives only in the financial markets and in the archaic phrase "shave and a haircut: two bits"). Theoretically, in an efficient market, there ought to be a smooth continuity of bid-and-asked pricing. Consequently, market monitors suspected dealers of rounding up prices to the next quarter-dollar per share in order to inflate commissions.

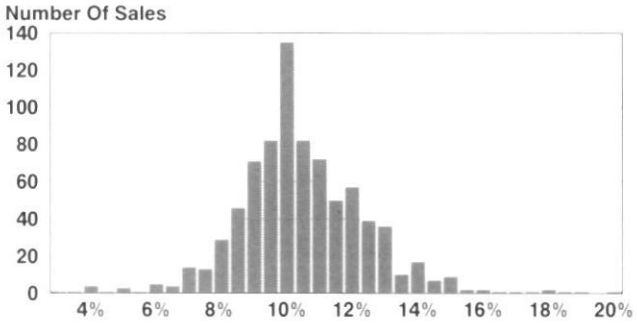
Lumpiness Of Data

The nature of the cap rate data, which is drawn from hundreds of totally independent sales—without common links as to individual buyers, sellers or brokers—eliminates the possibility of manipulation in the pricing information. However, it does point to another area of concern for professional investors: the lumpiness of real estate as an asset class. On one level, that lumpiness is the sheer volume of price needed to acquire individual real estate assets, typically in the millions of dollars per property, as opposed to much smaller per unit prices of stock shares and bonds. This is one reason cited for the growing popularity of securitized real estate investment. Certainly, there are other instances of rounding in the real estate transaction data. The higher the price the more likely the transaction amount will be rounded to the nearest hundreds-of-thousands or millions of dollars, a phenomenon unusual in the bond and stock markets where margins are finely separated and fluctuate minute to minute. Does the preponderance of integral and half-point cap rates suggest some market inefficiency and consequently, some money left on the table in real estate investments? The answer is likely to be "yes."

But part of the apparent lumpiness of the data is simply a question of scale. Even the smoothest block of polished marble when placed under a microscope will appear as a jagged composite of hills and valleys. Most investors when asked to articulate their rate-of-return requirements, will express these in terms of integral or half-point percentages. It may, therefore, be most appropriate to examine the data at that scale.

EXHIBIT II

Range of Initial Yields in the CCIM/Landauer Database



Analysis based on yields rounded to the nearest .5%; through June 1996

The Meaning Behind The Curves

When the individual sales data are conflated into a histogram of cap rates, clustered on the nearest half-percent, the statistical information assumes the familiar shape of the bell curve representing the normal distribution. (See Exhibit II). The distribution of returns is not perfectly symmetrical. There is a slight but definite skewing of the curve with cap rates in the 12 percent-13 percent range appearing more frequently than the complementary cluster of rates at 7 percent-8 percent. There may be a variety of reasons for this asymmetry: property age and size, the weighting of property types across the range of cap rates, the buyers and sellers operating at various levels of return and the possible influence of geography.

Having noted the skewedness, some fundamental points deserve to be underscored. First of all, failure to fit the normal distribution perfectly doesn't mean that the data sample is somehow upward biased. Indeed, it would be very rare to find a natural set of data (that is, measurements of sampled observations of behavior) which exactly fit the statistical ideal. The distribution curve is a close enough approximation of the standard that a high level of confidence can be inferred from the data.

Secondly, the shape of the curve is consistent with a single, coherent data set. We do not see a bimodal distribution, one with twin peaks to suggest there are distinctive subsets of behavior. The classic example from statistics texts is a chart measuring the time to complete a puzzle that has two separate solutions. From time to time in real estate discussion, we hear about two-tier markets or similar concepts which imply there is a sharp distinction or discontinuity between the behavior of different investor classes, such as institutional versus small investors, domestic versus foreign purchasers or whole asset versus securitized owners. The CCIM/Landauer data set does not support such a claim for initial return requirements for 1995 and early 1996, although some evidence can be adduced that shows important preference shadings along the yield spectrum.

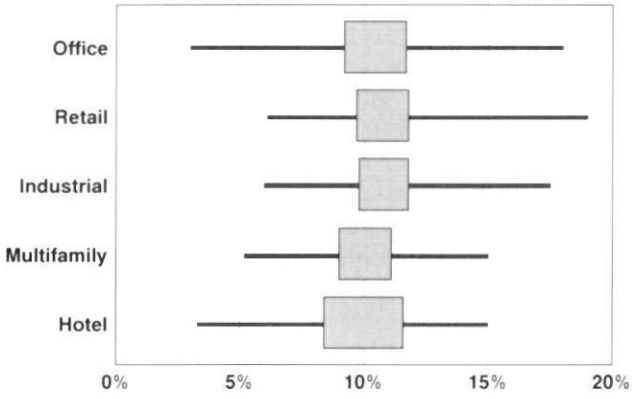
Third, the curve allows us to look at the entire range of data, to listen to the full span of market information. Most analyses tend to look at central tendencies: averages, medians, transactions that are typical of marketplace behavior. Outlier information tends to be regarded as a problem that needs to be explained away. I recall two comments, made by astute senior property professionals, that ought to be engraved on plaques awarded at the conclusion of every course in real estate statistics. The first I heard from a Counselor after a demonstration of a computer-assisted mass appraisal program. He said, "But, if I'm selling my house, I don't really want to know what 80 of the last 100 houses sold for. I want to know what the house across the street that sold last week got." And, from the manager of one of the largest pension fund property portfolios in the nation came this observation: "Appraisals are a very important part of the investment process, and the valuation discipline really can't be ignored in managing our assets. But, in all honesty, my whole job can be defined as disagreeing with appraisals. If I only bought or sold properties at their appraised value, I wouldn't be bringing anything in the way of improved performance to my investors. And that's what they pay me for."

What happens on the tails of the normal curve is as much a part of the investment universe as the bulge in the middle. To the degree that the herd instinct is a recurrent danger of the commerial property investment world, the behaviors of buyers and sellers at the upper and lower reaches of the cap rate range help us identify where investors identify special risks and opportunities. We look at the entire range of the distribution to avoid the blindness to information that comes from imposing a priori limits to what data is relevant. Our job is to make sense of the data and not only look at data that make sense.

Having said that, one of the most compelling stories to emerge from the array of capitalization rates is the concentration of yields near the center of the range. In Exhibit III the graphic display technique of the box and whisker-type graph illustrates the extent of the range of cap rates for each of the five major commercial property investment categories, i.e., offices, retail, industrials, multifamily and hotel (land is not typically sold on the basis of income capitalization). Box and whisker graphs, perhaps unfamiliar to some real estate professionals, are rather easy to understand. The lines or whiskers of the graph extend from the highest to the

EXHIBIT III

National Capitalization Rates



Source: Landauer Associates, Inc.; Investment Trends Quarterly, 1/1/95 through 5/31/96

lowest observations. The box in the center represents the middle 50 percent of the observations, that is, the data between the 25th and 75th percentile of all observations.

Two things are striking in the Exhibit III data. First, across all property types, there is a remarkably tight clustering of cap rates within the boxes. Second, there is substantial overlap in the boxes when property types are compared to each other. Clearly the market evidence suggests that we are in a period of rather keen competition for investment. For all property types, the 25th percentile of capitalization rates is marked at 9.3 percent and the 75th percentile is 11.6 percent. A span of only 230 basis points encompasses both conservatively and aggressively priced deals, at least as such characterizations apply comparatively to the entire range of transactions. All commercial property types find their mid-range of cap rates, as displayed by the boxes, substantially congruent. Investors do display a variety of property-type preferences, and there is a measurable distinction among the property types when average and median cap rates are calculated. But, taken on the whole, there is a similarity in the initial rates of return reflected in the sales data across property types. In 1995 and early 1996, the market achieved substantial consensus on the level of going-in returns needed to generate bidding on investment real estate. This apparent consensus suggests the growing influence of national players on price levels, either directly on the part of REITs and institutional equity investors, or indirectly through the underwriting requirements of whole asset lenders or through investors eying a CMBS strategy. Without a consistent historical series of comparable cap rate data, it is difficult to determine definitively the extent of the role of the big players in establishing pricing parameters. The tight ranges of cap rates displayed by the majority of sales, however, does call into question the supposed information inefficiency of the property markets.

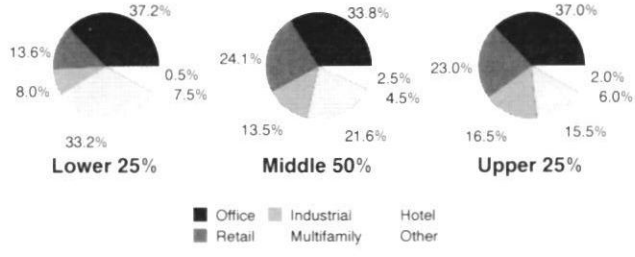
There is, on the contrary, an ostensible agreement on the current viability of commercial property and its future performance that is undergirding return requirements. As we shall see, this is true not only across property types but among investor groups and around the nation as well. As in the lumpiness of the cap rate curve in Exhibit I, the question of scale must be considered. Although there is undoubtedly a long way to go in providing standardized and timely information on the real estate investment market, the box and whisker chart in Exhibit III and the yield curve in Exhibit II look anything but random. Instead, they describe a rational market of buyers and sellers with a significant awareness of pricing expectations in an asset class where the individual items traded are decidedly not uniform.

Cap Rates And Property Types

How do the cluster of sales in the lowest (under 9.3 percent) and highest (above 11.6 percent) cap rate quartiles differ from the mid-range sales? We can look at the data in several ways: by distribution of property types, geography and buyer/seller activity. As shown in the pie charts of Exhibit IV, *office properties* were the most actively traded real estate in 1995 and early 1996, capturing 34 percent to 37 percent of the total number of sales at all levels of cap rate, ranking first at the low, mid-range and high levels of initial return. There is a manifest appetite for office investments across the spectrum of risk and return. Investors are loudly voting no to the proposition that telecommuting, alternative office utilization schemes and advances in technology will render the office building obsolete over any meaningful investment horizon.

EXHIBIT IV

Distribution of Transactions by Property Type



Source: Landauer Associates Inc.; Investment Trends Quarterly, 1/1/95 through 5/31/96

Likewise, investors believe there is a favorable future for *multifamily properties* and have bid up prices accordingly. Apartments represent a third of the sales in the lowest quartile of cap rates, but only 15.7 percent of sales in the cap rate range above 11.6 percent. If the principle of anticipation is sound, that current value is the present worth of expected future benefits, investors are saying they are willing to accept somewhat lower initial returns for multifamily properties because of the potential for higher rents and capital appreciation in the coming years.

Industrials and retail, on the other hand, must provide high levels of current yield to attract buyers. The share of the pie captured by industrial transactions grows steadily as the cap rate rises, a characteristic which may be attributable to the flatness of income streams based upon long-term net leases, but which also may point to some investor nervousness about vulnerability to supply/demand equilibrium changes over the holding period. Shopping center yields vary significantly according to the size of the property, with regional malls still commanding the best price-to-income multiples. But retail properties garnered only 13.6 percent of the total number of sales with cap rates in the lower quartile, as opposed to 23 percent-24 percent in the midrange and upper quartile. Proven performers, therefore, have the advantage among shopping centers as investors are most comfortable with assets throwing off significant net operating income at the time of sale. *Hotels, mixed-use developments, recreational properties,* and *portfolio sales* account for approximately 7 percent-8 percent of activity across the entire range of cap rates.

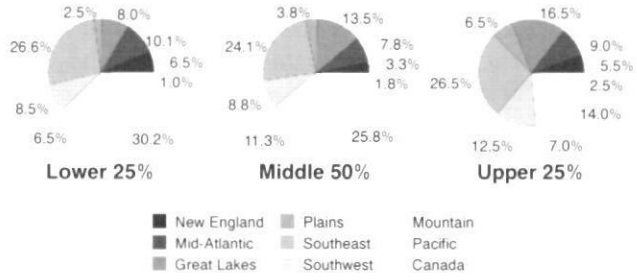
Regional Differences

When we examine the transaction activity regionally, it is evident that investors are pricing the economic growth prospects of the Southeast and Pacific states favorably, while demanding higher levels of current return to acquire assets in the Southwest and Midwest (see Exhibit V). The West Coast, driven by signs of revival in the California economy, posted 30 percent of the sales in the lower quartile of cap rates, about a quarter of all sales in the midrange, and only 14 percent of the transactions at the high-end of going-in rates. The Southeast, the most active of all regions in the aggregate amount of commercial property sales activity in 1995 and early 1996, was remarkably consistent in its share of volume at all levels of cap rate, ranging from 24.1 percent of the midrange sales, to 26.5 percent of the high cap rate deals and a nearly identical 26.6 percent of deals in the lower quartile.

A less favorable assessment of risk and appreciation potential is influencing prices in other regions of the country. The Great Lakes area, for example, captures only 8 percent of all deals represented in the lower quartile of cap rates, but its share more than doubles to 16.5 percent in the upper cap rate range. Likewise, in the Plains states, the shift in share is from 2.5 percent at the low end of the range of initial returns to 6.5 percent on the high side. The Southwest (Texas, Oklahoma, Arkansas and Louisiana) has approximately the same share in the lower quartile (8.5 percent) as in the midrange (8.8 percent), but its slice of the pie jumps to 12.5 percent of deal with cap rates of 11.6 percent or above.

EXHIBIT V

Distribution of Transactions by Region



Source: Landauer Associates, Inc.; Investment Trends Quarterly, 1/1/95 through 5/31/96

The importance of location, then, is still a potent influence on investor preferences, as it should be. The links of property investment performance to the underlying economic base are quite strong. Commercial real estate exists to house economic activity, and the greater that activity the more likely that rents and values will be bid upward. This is one theme where a back-to-basics movement is never out of date.

Investors, Investors, Investors

Finally, some indications of investor behaviors can be noted, although the data is so complex and rich it could warrant its own article. First, the continued importance of the small private investor in commercial property is clearly discernable in the transaction activity. Both in the number of transactions (cited in this article) and in terms of aggregate dollar amounts, individual investors constitute a strong force in the marketplace, notwithstanding the huge amount of attention given to REITs and institutional investors. *Individual private investors* accounted for 35.7 percent of all sales in the lower quartile of cap rates and more than half of the sales in the upper quartile. Besides the propensity of these investors to seek current income from their property acquisition, they describe an active appetite at all levels of yield, and consequently an

influence on pricing which must affect even the larger players.

Insurance companies are enormous net sellers of property at the present time. Their buy/sell distribution across the cap rate spectrum is telling. As buyers, they have a 6 percent share of all sales in the lower quartile of cap rates and are vitually absent at the midrange and upper quartiles of initial return. As sellers, though, the life companies are in the midst of huge divestiture programs and accounted for 12.2 percent of sales at the lower quartile of cap rates, 11.3 percent in the midrange and a stunning 18.1 percent at cap rates in the upper quartile. Clearly, there is a sharp discounting of price coming from this sector in order to lighten real estate portfolios.

Limited partnerships and *joint ventures*, by contrast, represent 13.5 percent of acquistions in the upper cap rate quartile, but only 8 percent of the deals at the lower end of returns. As sellers, though, they have 14.2 percent of the lower quartile deals and 9 percent of the high cap rate sales. These appear as fairly astute market timers and are perhaps representative of the traders' mentality that emerges in more liquid real estate markets.

Developers, meanwhile, have been able to take advantage of the greater liquidity to sell assets built toward the end of the 1980's construction cycle, assets which were held as inventory (usually involuntarily) in the market trough. Both as buyers and as sellers, developers follow the bell curve in their distribution along the cap rate spectrum.

An Industry In Flux

The real estate industry is, as always, in a period of evolution. The Darwinian imperative to adapt to a changing environment speaks to the very nature of our market discipline. The information on current investor return requirements and property preferences suggests that the current era affords a rather coherent environment in which to make real estate investment decisions. Rather than being a frightening time of revolutionary discontinuous shifts, the late 1990s appear as a time in which rational, almost traditional investment parameters are governing the behavior of the market.