FOCUS ON RESEARCH

PICKING THE BEST MARKETS

by Raymond G. Torto, CRE

Probably one of the most frequently asked questions we hear is "What are the best markets? "

Often times we answer this question with a question. "What do you mean by best?" While this may seem odd on its face , it is actually meant to suggest that "best markets" mean very different things to different people. Depending on the investment strategy, there can be a wide variety of answers.

For example, the list of best markets for buying stabilized income properties, developing new buildings, taking on leasing risk, or renovating existing buildings are all very different. Other considerations revolve around the risk and return expectations of the strategies. Are you willing to take on additional risk to achieve higher returns or are you risk averse? We can identify two markets with expected IRRs of 15 percent, but one may have a risk of 3 percent and the other 7 percent. Which would you think is "best? "

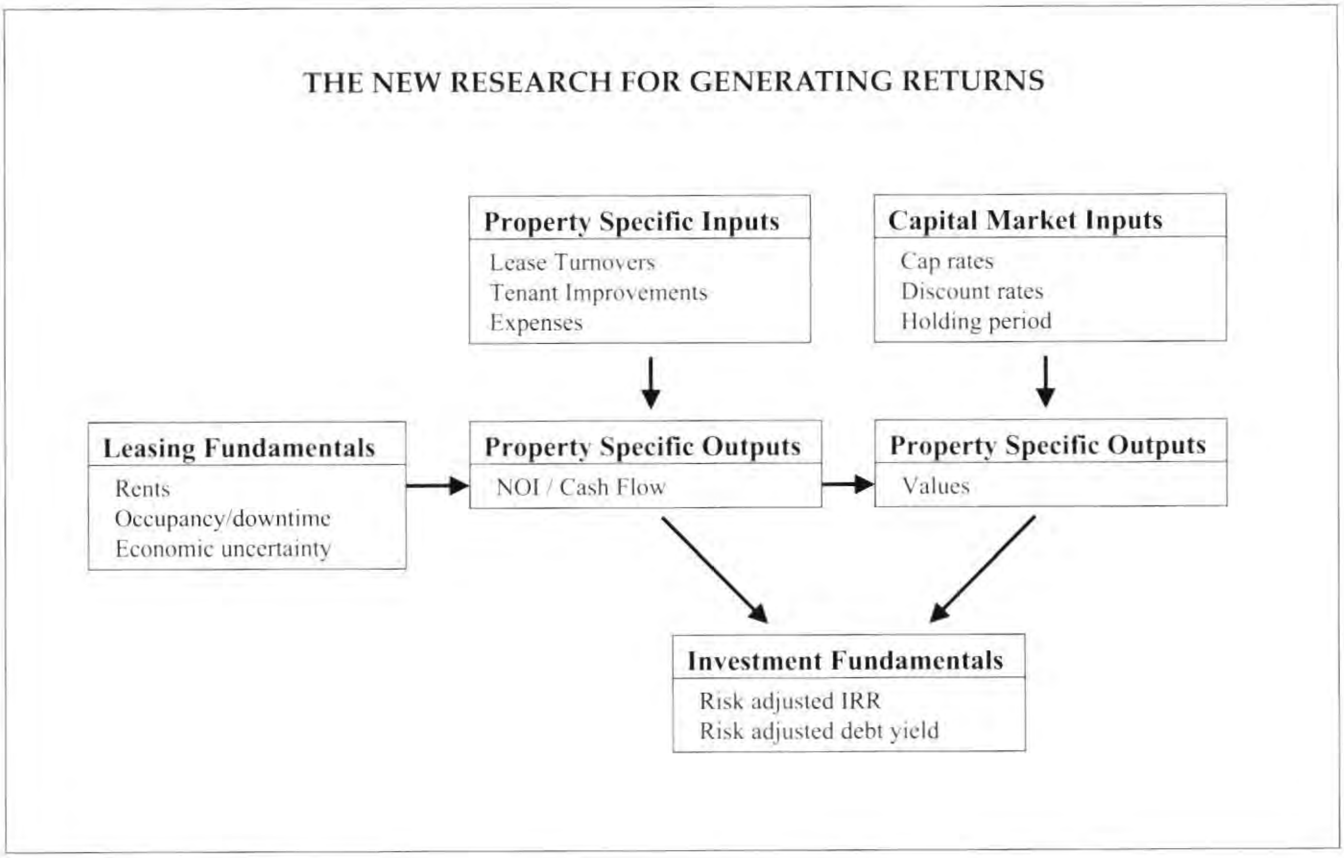
The determination of "best" is multi-dimensional and requires a research approach that provides the proper flexibility. In today's research world, research analysts are combining a top-down and bottom-up approach to market analysis as outlined in *Figure 1*. The goal is to combine the macroeconomic approach of forecasting market rents and occupancy with the deal-specific details to forecast property returns.

Market research models in the "old" days produced analyses that ended with the leasing fundamentals box shown on the left side of *Figure 1*. This information provides an excellent starting point to the process of determining market risk and performance, but fails to consider what all this means to a specific investment.

Today investors want to link **market risk** and **deal or property risk**. The property-specific risk is based on the extent to which a specific property is affected by market wide fluctuations due to such idiosyncratic characteristics as its lease rollover schedule, existing rent levels, occupancy percentage, operating expenses, capital expenditures, etc. Thus, in measuring risk and returns it is important to go an additional step and examine how sensitive a specific property's cash flow is to market wide fluctuations, given such idiosyncratic characteristics. This approach is outlined in the balance of *Figure 1*.

Our own research has addressed this issue by generating returns for individual markets and individual properties. Specifically, a discounted cash flow model that takes into account building characteristics and market specific forecasts translates the rent and vacancy forecasts generated from our econometric models into expected cash flow and returns. This cash flow analysis considers existing building rents in place, lease rollover and renewals, operating costs, and tenant improvements. This methodology directly links the fundamental performance of the marketplace to the expectations for property specific NOI growth, expected return, and risk.

Figure 1



So what does this all mean as we look into the new millennium? Clearly, with more reliable and intuitive income, and risk and return measures, real estate research will be applying more advanced applications to both debt and equity portfolios. This includes the application of modern portfolio theory, enhanced techniques for ranking markets, better methods for identifying appropriate investment strategies by market, and the ability to quantify market risk in commercial mortgage and equity portfolios.

We expect the strongest demand for more sophisticated market analysis to come from the financial community, especially rating agencies, buy-side REIT/CMBS analysts as well as sell-side REIT/CMBS analysts, but also from whole loan lenders and private equity portfolio managers.

Real estate research has come a long way.REI

ABOUT OUR FEATURED COLUMNIST

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