Property-Level Analysis: the Key to Successful Investing in Today's Changing Landscape

by Kenneth P. Riggs, Jr., CRE, Jules H. Marling, Jr., CRE, & Ryan W. Harms

Introduction

Today, investors are looking at a much hazier economic environment for the future than a year ago. There is excessive uncertainty about future profits of both new and old economy businesses. Market expectations govern investment activity in all financial investments (capital chases risk-adjusted returns). Further, expectation levels can reach unbelievable highs (irrational exuberance) before predictably crashing, as witnessed by the dot-coms recently and real estate in the early1990s.

A close look at the psychology of risk, however, may allow real estate investors to use such doubt to their advantage. In general terms, risk is the uncertainty that an investment will not earn its expected rate of return. The larger the range of possible expected returns, the riskier the investment. Although risk is usually viewed from its volatility around its mean, behavioral finance confirms that investors do not mind upside volatility (but they despise downside movements). When discussing classic decision-making, economist Herbert Simon differentiates between investors displaying completely rational behavior and investors displaying "bounded rationality." According to Simon, bounded rationality is characterized by many factors, including emotional influences and the failure to understand all information (which creates an inefficient market). Exploiting the psychology of the market offers investment opportunities that have the highest return given a specific risk level.

ABOUT THE AUTHORS

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The three types of risk that a real estate investor faces are:

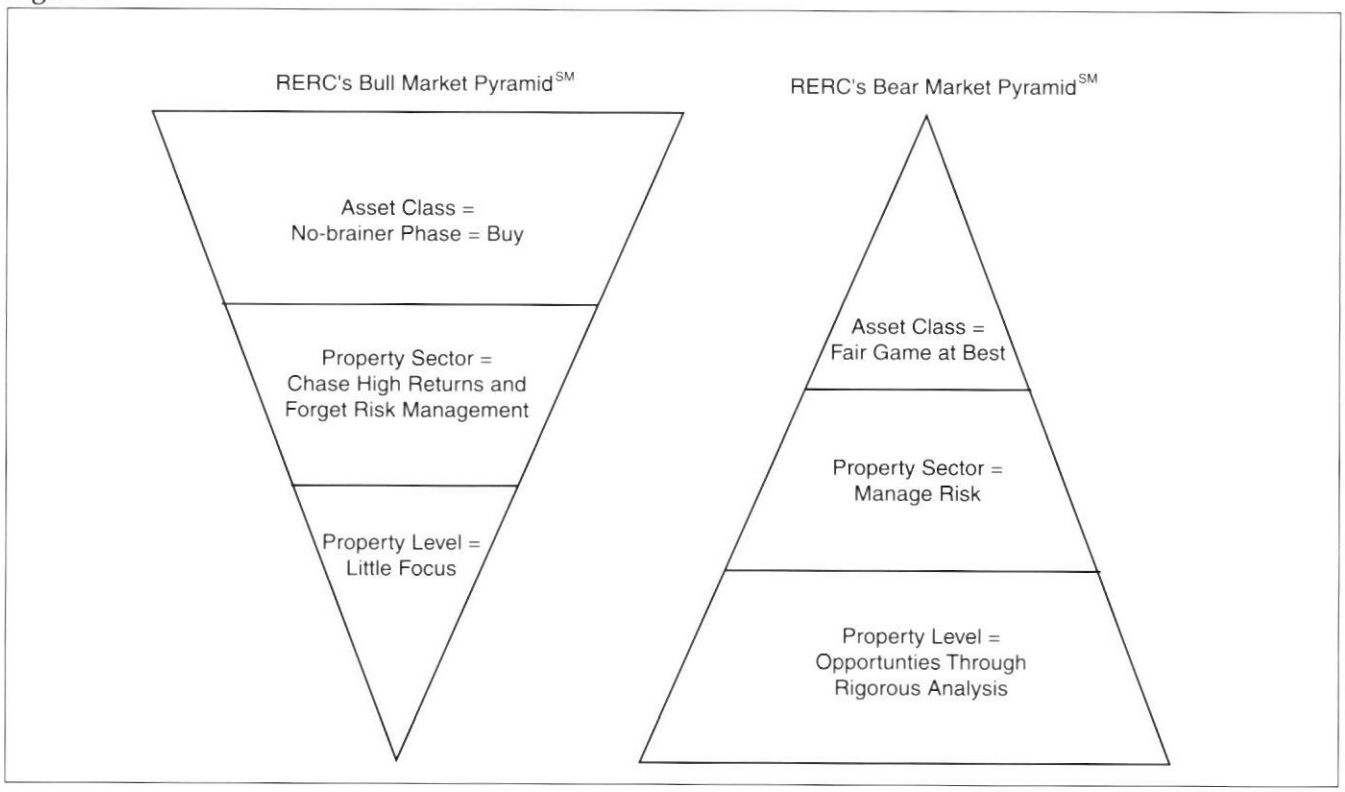
1. Overall market risk (i.e., national market risk of inflation, interest rates, capital flows), which is considered unavoidable;
2. Property sector risk (i.e., inherent risk differences among office, retail, industrial), which is theoretically avoidable and can be minimized; and
3. Individual property risk (i.e., physical characteristics, location, leases in place), which is avoidable.

In efficient markets, investors are not rewarded for the latter two forms of risk because theoretically they can be eliminated by diversifying your portfolio. However, real estate markets are not nearly as efficient as the stock and bond market. For example, managing risk (as opposed to managing the return on investment) in real estate markets is crucial for expected performance. In today's economic environment, and given the inefficiencies in the real estate market, an investor can identify opportunities at the individual property risk level, and thereby outperform the market by doing superior research.

The market's ability to seize on real estate opportunities has clearly shifted from the no-brainer investment phase of the late 1980s to a very selective property level opportunity base *(Figure 1)*. To be successful, investors have to shift their focus to meticulous property cash flow and price analyses, as demonstrated in *Figure 1*.

Identifying opportunities today, (either selling or buying commercial real estate assets), demands that investors be rigorously grounded in understanding property sector risk analysis—that is, they must be able to develop a credible cash flow forecast and to complete an unbundling analysis of the components of value to measure the relative risk of the asset. Investors also need to apply both fundamental and technical analysis to the property sector risk. By understanding the expected and required returns of a specific property, opportunities can be predicted. For example, a positive factor, such as a 12 percent future return minus 11 percent required return equals 1 percent positive satisfaction, indicates a buying opportunity; conversely, a negative factor indicates a selling situation. A critical piece of this analysis is developing insights into the market regarding investment criteria of available capital, discount and overall capitalization rates, property sector risk levels, and so on. Historically, such information has been limited to large institutional lenders, appraisers, consultants, developers, and advisors. Today, however, research firms offer this data to large and small investors and lenders in

Figure 1



such a way that opportunities with the appropriate risk level can be sought.

OVERALL MARKET RISK

Early in 2001, many investors believed that the real estate market had done such a good job of keeping supply in check that it would escape the same turmoil that the stock market experienced. However, this turned out not to be the case given that overall market risk is unavoidable. Real estate demand for space is driven by businesses' need for space in office and industrial properties. Also, hotels, along with the airlines and all other travel-related businesses, continue to depend on business travelers for an important part of their revenues. Finally, consumers, who represent some two-thirds of our economy, remain critical to the residential housing sectors of single-family and multifamily properties.

Through its surveys, Real Estate Research Corporation (RERC), determines perceived investment risk levels on metropolitan, regional, and national levels. Tracking the performance of property types in specific markets in terms of their price cycle is key to successful lending and investing. As shown in *Figure 2*, investors continue to be skittish and highly selective on an overall market risk level. A strong hold recommendation has continued to be the rule of thumb as prices in the last year have skyrocketed and investors have ridden the ship to the top.

There is a new capital order of discipline in the real estate markets—capital is rationally priced and allocated along the risk spectrum ranging from debt/mezzanine-preferred equity, to pure equity. Information gathered indicates that capital will be more restricted and lenders will become more particular in the coming months. What is more interesting is the perceived discipline of capital in the industry, as depicted in *Figure 3*.

The commercial real estate market is maturing and in turn, so is the discipline of capital. Investors must have a clear understanding of the relative discipline of capital flows to the market. A determination has to be made if capital is being rationally allocated (capital is chasing risk-adjusted returns) or if it is being thrown at the investment (capital is chasing product). As we saw in the late 1980s for real estate, and in the late 1990s for the tech sector, if capital is chasing product, then the market is doomed for large corrections later on. But for real estate today, capital is chasing risk-adjusted returns, which means that investors should look at real estate as a solid investment opportunity compared to alternative investments.

Yields have decreased in the past year, mainly due to the drop in interest rates. Required total returns usually follow the trend of interest rates, as investors and lenders are accepting a lower rate of return as deals become more positively leveraged. However, as risk has increased from economic conditions, going-in capitalization rates have edged up slightly and terminal rates have remained steady. As the gap between going-in and terminal capitalization rates narrows, investors' long-term perception of the market becomes cautious. Investors expect nothing above inflationary increases in property values as the market struggles to be in equilibrium.

Figure 4 reflects a positive message for real estate on a risk-adjusted basis. Discount and overall capitalization rates are properly aligned to provide an appropriate return to the asset class. Further analysis of this data indicates that the current spread of real estate's expected yield over 10-year treasuries is 600 basis points (bps). This is the largest spread that has been recorded since 1993 when the real estate market was at the bottom of its last cycle. In fact, it is at record levels since we have been tracking this data in 1979. This confirms the earlier observation of capital being disciplined—real estate is offering a solid risk-adjusted return in today's financial and economic environment.

As the economy stagnates, we can expect that those investors who have been sitting on the sidelines to "get out while the getting is good." This is another positive market signal, demonstrating that we have gotten rid of real estate's old mentality of "buy and hold forever." Large institutional players are "tapped out" of capital and sellers should prevail. As many prices have peaked, investors who have waited too long have asking prices above market value and are not about to attract potential buyers. This creates a sort of a stalemate until the future direction of real estate becomes clearer. Patient and astute investors can take advantage of this market factor by being on the buy-side of the equation.

PROPERTY SECTOR RISK

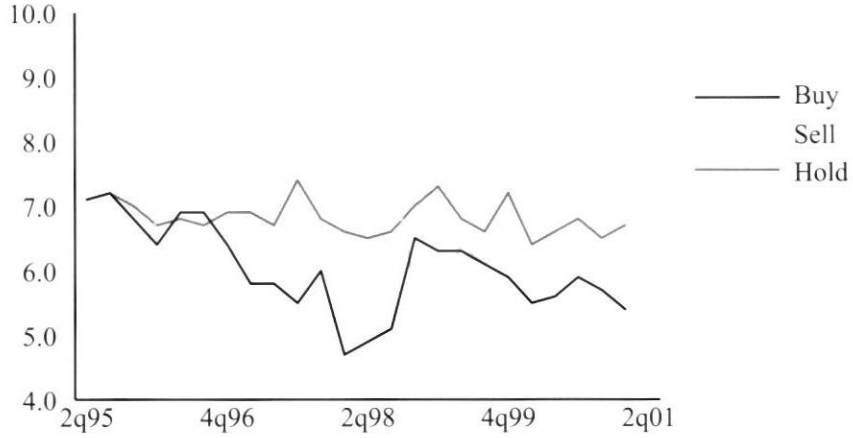
Office

Commercial real estate, and specifically office properties, has benefited greatly from the economy's recent bull run. NCREIF-realized returns for 2000 for all commercial property types were around

Figures 2, 3, 4

Figure 2

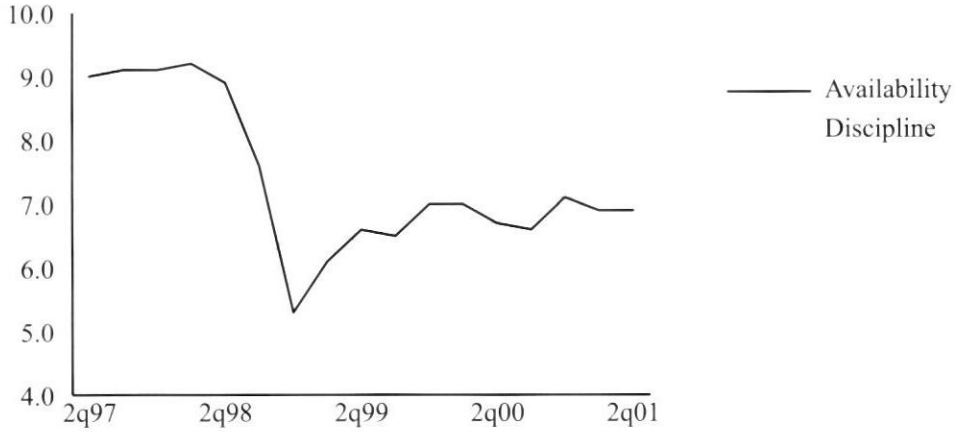
Historical Buy, Sell, Hold



Source: RERC Investment Survey

Figure 3

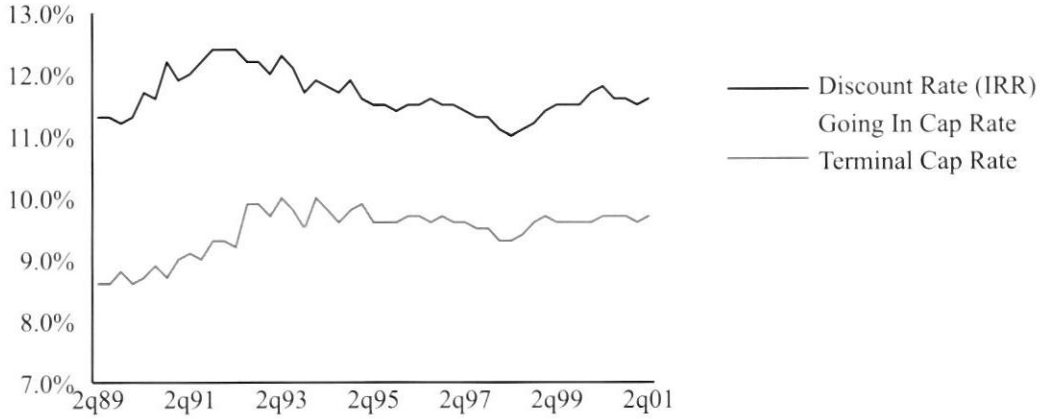
Historical Capital Availability and Discipline



Source: RERC Investment Survey

Figure 4

Historical National Expected Rates of Return



Source: RERC Investment Survey

12.00 percent, while office properties turned in an overall return of 13.75 percent. The strength of the office sector was buoyed by CBD properties, especially those located in 24-hour market environments—Boston, Chicago, New York, Washington, D.C., and San Francisco.

Although office development capital continues to be very disciplined, the large corporate layoffs, dot-com closures, lost venture capital, company consolidations, and falling stock prices in the first half of 2001 are casting a shadow over future office demand. Investors evaluating the risk of CBD and suburban office properties are faced with very different market dynamics: supply-constrained markets (generally CBD properties) versus growth-driven markets (generally suburban properties). In today's market, supply-constrained environments are preferred. The authors expect that suburban markets will under-perform and that CBDs will be a fair market bet.

Industrial

Industrials are attempting to adhere to the solid fundamentals that have made them a property of choice for investors, but when opportunities are available, they have ventured into the new economy telecommunications/Internet business of high-risk, high-return deals. However, as is happening throughout the tech industry, telecom companies are being weeded out through mergers and closures. As a result, industrial space will generally become more abundant.

Distribution properties centered near major transportation hubs—especially airports—will continue to be market performers, while research and development properties and those built-to-suit dot-com companies will show the greatest industrial risk. Small, traditional properties located in major industrial hubs are expected to hold their own.

Apartment

From all vantage points—realized returns, expected returns, growth, and supply and demand—apartment investments are the least risky among the nine commercial property types. This continued high ranking has caused some investors to express concern about over-inflated prices and too much optimism, but apartments are delivering what the market needs—safety and stability. Certainly there are exceptions, but all in all, the multifamily sector continues to be strong and stable, and looks to top the real estate pyramid of property investments for 2001.

This low risk/high return forecast for apartment investors is supported by the age-old story of supply and demand. The population aged 18 to 34 years (typical apartment dwellers) is projected to increase by over 5 million people between 2000 and 2010. In addition, the immigrant population, which also typically rents, continues to increase. Further, census data for the last three years indicate that the fastest growing segment of apartment renters has been households earning $50,000 or more (this sector posted a more than 8 percent increase in the number of renters as compared to 1999), which suggests that people who in the past tended to steer away from renting are now choosing to rent. Even if the economy should slip into a full-blown recession, apartment demand is so strong that a recession can only help to ease record high rents and low vacancies. The return on risk for apartments is good, with low volatility.

Retail

The most publicized aspect of the retail sector in 2001 thus far has been the loss or decline among major retailers such as Montgomery Wards, J.C. Penney, Bradlees, Home Depot, and among major movie theater chains such as General Cinemas, United Artists Theatre Co., Loews Cineplex Corp., and Regal Cinemas. Malls have been traumatized from the loss of such anchors—the space is difficult to absorb, and often other inline tenants are lost.

The bright spots in retail properties are the large-scale players, especially the retail REITs and community centers, which are expected to outperform the rest of the industry. Still, the real estate retail industry, in general, takes on too much of the retail merchandising risk, and retail in general, will under perform other property types.

Property Sector Risk Summary

With the various property types, come different property cycles. Economic dynamics directly affect each of the property types differently. As would be expected, real estate is relatively slower to respond to changes in the economy as compared to many other businesses. Tenants that occupy commercial real estate are generally tied to long-term leases and do not quickly make major changes in a real estate occupancy in the face of a short-lived economic adjustment. The most important element to the relative health of the commercial real estate markets is the fact that new supply additions did not outpace demand, and in many cases, new supply significantly lagged behind demand. This is especially true for apartments in several regions of the country.

Knowing the background of a market and property type within a market can help to determine the risks and cycle length of a market. *Figure 5* and *Figure 6* review the expected performance of particular property types in the major markets around the country. As illustrated, each market and property

Figures 5 & 6

Figure 5

Metro Rankings

First Tier Markets	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992	1991	1990
San Francisco	7.4	7.4	7.4	7.2	6.9	6.9	6.2	5.9	5.5	5.3	6.2	7.0
New York	7.3	7.3	6.8	6.6	5.7	5.7	5.0	3.8	3.0	3.5	3.8	6.2
Boston	7.1	7.0	6.8	6.8	6.6	6.9	5.8	4.7	3.6	3.0	3.5	6.1
Los Angeles	6.6	6.8	6.4	6.4	6.0	4.9	4.4	3.4	3.8	4.8	6.0	7.6
Washington, D.C.	6.6	6.8	6.4	6.4	5.8	6.5	6.9	7.0	6.0	4.9	5.6	7.3
Seattle	6.6	6.5	6.9	7.0	6.6	6.7	6.1	5.3	5.7	5.5	6.4	6.4
San Diego	6.4	6.5	6.3	6.4	6.1	5.9	5.1	4.5	4.6	5.2	5.4	NA
Chicago	6.3	6.6	6.6	6.6	6.2	5.8	5.3	4.7	4.2	4.4	5.6	6.7
Denver	5.7	5.4	5.5	5.7	6.1	6.6	6.3	6.1	5.1	4.1	3.1	3.4
Miami	5.5	5.7	5.6	6.1	5.5	5.5	5.5	5.0	4.3	4.2	3.7	4.7
Minneapolis	5.5	6.1	6.0	6.2	5.8	NA	NA	NA	NA	NA	NA	NA
Atlanta	5.0	4.9	4.7	5.1	6.0	7.1	6.7	6.6	5.7	4.9	4.4	5.1
Phoenix	4.9	5.3	5.4	5.2	5.5	6.2	6.1	5.6	4.9	4.2	3.3	3.4
Philadelphia	4.7	4.9	5.0	4.8	4.4	4.7	4.5	3.8	3.6	3.7	4.4	5.5
Dallas	4.5	4.6	5.3	5.6	5.9	6.0	6.1	5.5	5.2	5.4	5.4	4.8
Detroit	4.4	4.8	4.5	4.3	4.0	NA	NA	NA	NA	NA	NA	NA
Houston	4.4	4.8	5.5	5.4	4.9	4.8	5.4	5.1	5.0	4.9	5.2	4.9
St. Louis	4.4	4.5	4.6	4.5	4.7	5.1	4.7	4.1	3.7	3.6	3.8	5.0

Source: Emerging Trends in Real Estate

Figure 6

Property Markets Investment Potential

		1993	1994	1995	1996	1997	1998	1999	2000	2001
Apartments										
	Investment Potential	6.2	5.9	5.5	6.0	5.5	5.3	5.5	6.3	6.5
	Developmental Potential			5.3	5.9	4.9	4.9	5.3	5.6	6.1
** Industrial										
	Investment Potential	5.8	5.9	5.8	6.3	6.0	6.1	6.1	6.3	6.1
	Developmental Potential			5.2	6.0	5.8	5.9	5.9	5.7	5.8
Downtown Office										
	Investment Potential	2.7	3.6	4.0	4.7	5.3	6.2	6.6	6.6	6.1
	Developmental Potential			1.6	1.8	2.2	3.5	5.5	5.9	5.6
Research & Development										
	Investment Potential		3.9	4.7	5.0	5.4	5.9	6.1	6.2	5.9
	Developmental Potential			3.4	3.8	4.3	5.3	5.8	5.7	5.5
* Community Shopping Centers										
	Investment Potential	3.6	5.5	4.9	5.4	5.3	5.4	5.2	5.6	5.2
	Developmental Potential			3.8	4.5	4.3	4.7	4.9	5.4	5.0
Suburban Office										
	Investment Potential	2.2	4.4	5.5	6.0	6.2	6.1	5.6	5.5	5.0
	Developmental Potential			2.9	3.8	4.5	5.8	5.6	5.4	4.6
Hotels										
	Investment Potential	2.0	3.5	5.1	5.8	5.9	6.0			
	Developmental Potential			2.4	3.6	4.2	5.2			
Full-Service Hotels										
	Investment Potential							5.5	5.7	4.8
	Developmental Potential							5.1	5.1	4.5
Regional Malls										
	Investment Potential	5.0	5.5	5.4	4.9	4.9	4.6	4.7	4.7	4.4
	Developmental Potential			3.8	3.3	2.1	2.5	3.3	4.3	3.8
Power Centers										
	Investment Potential			5.3	5.3	4.1	3.9	3.8	3.7	3.3
	Developmental Potential			4.6	4.7	2.9	2.9	3.3	4.3	3.2
Limited-Service Hotels										
	Investment Potential							3.7	3.4	2.9
	Developmental Potential							3.4	3.3	2.7

***Before 1996, considered Retail - Other; in 1994, Power Centers were also added to Other Retail**

****Before 1994, Industrial included both Warehouse and R&D**

Source: Emerging Trends in Real Estate: 1993-2001

type has seen its peaks and valleys, but each has its particular time frame in which these cycles occur. For example, New York, which in the early 1990s was considered the worst city in the country in terms of investment potential, is now considered one of the best, ranking only behind San Francisco (which may suffer as the tech-centered cities will decelerate at a much quicker rate than the diverse old economy cities). The suburban office sector is another example of a property type with a historically short investment cycle. In 1993, suburban office was considered the worst property type in terms of investment potential, while in 1997 it was considered one of the best.

The majority of property types in most markets today are fairly priced, and in the best of cases, will perform in a manner that is consistent with market expectations. In other words, the market is pretty much in equilibrium. Opportunities at this vantage point are limited, and as a result, the authors maintain that one thing that investors hoping to find true opportunities in today's mature real estate market may do is look to the second-tier cities that have been ignored. Once an opportunity has been identified, an individual property risk analysis should be completed to confirm its volatility.

INDIVIDUAL PROPERTY RISK ANALYSIS

Property selection (tactical) decisions take precedence over strategic decisions (asset allocation and property sector) in today's slowing market. Further, the authors believe that property selection or underwriting is the key to successful investing in any type of real estate investment environment (if property performance fails, the capital structure will not save your returns). For real estate, the focus on strategic issues, which incorporates modern portfolio theory (MPT), is spurred by studies on investment performance for stocks and bonds. These studies have concluded that 85 percent to 95 percent of overall investment returns arise from the asset class selected and the weight assigned to the asset class regarding long-term asset allocation decisions. The belief is that good stock or bond pickers may add some value over time, but the major source of investment return and risk over time is the asset allocation decision. This may be true, and to a lesser extent, to real estate as an asset class. But regardless of the quality and thoroughness of the asset allocation decision, if an investor has pooled marginal properties, the performance will suffer.

The authors subscribe to Warren Buffet's statement on investing courses: "What you really want an investing course to do is to teach you how to value a business—as that's how you evaluate a stock. You determine the value and compare the price." To the authors, this is the bottom line—investing in real estate assets or properties that will generate solid earnings that create value and can be held and/or sold to produce a profit.

This supposition is evident in the pricing of real estate through the selection of discount and overall capitalization rates applied to various property types. The market generally uses a very tight band of rates to value properties throughout the U.S., although there are clearly different risk factors for an office in Washington D.C., versus San Francisco, for example. Risk management through property level cash forecasting suffers because of linear forecasting (i.e., the belief that the market goes in the same direction as it did in the recent past). Additionally, the market fails to complete honest downside scenarios. Investors need to complete scenario analyses of best, worst, and most likely cash flow forecasts. Understanding this market characteristic and exploiting the resulting price inefficiencies allow investors to make better investment choices in a decelerating market environment.

An improved understanding of markets and property economics can be obtained through research, market analysis, and property-specific due diligence. While obtaining information on individual properties (income and expenses, conditions, environmental problems, etc.) requires work, it can be accomplished through a fairly simple and straightforward process. The understanding obtained through this process substantially reduces risk.

CONCLUSION

The information age has provided the real estate market with more advanced methods to research and identify opportunity markets and property opportunities within a market. Properties can now be analyzed on a microscopic level as compared to yesteryear when only national information was readily available. Physical market data, sub-market, or property-specific information can be downloaded from the comfort of your own home. For the first time in history, both institutional and non-institutional investors have about the same access to information.

Employment reductions, dissolving companies, and fading consumer confidence are all current issues. However, institutional investors and lenders have learned many lessons from the past, and despite the

current weariness, opportunities still exist. Identifying these opportunities, however, will take more time and effort as decelerating markets, the tech sector fallout, and other events like the energy crisis place greater emphasis on research and property selection. In this market, just putting a chip on the table does not guarantee a profit.

Imperfections in the real estate market do not correct themselves as quickly as they do in other financial assets that are traded in a continuous auction market place (such as stocks, bonds, and other marketable securities). Because real estate is illiquid, imperfections in the market can exist for considerable periods of time. Opportunities exist for investors who are capable of spotting these imperfections and quickly accessing capital to take advantage of them before the opportunity is gone. Real estate also lends itself to research and market analysis that can greatly increase an investor's understanding of the economic fundamentals affecting a potential investment in a specific property. Research and analysis, properly done, substantially reduce risk. In today's market environment, this is essential to success.

While it is difficult to predict precise market timing, it is not difficult to spot a trend and profit from it by relying on fundamental economics and market analysis, coupled with a rigorous property level analysis. To choose a real estate investment, it is necessary to analyze both the market and the specific property. Focusing in on property-level factors in today's shifting economic and real estate environs is the key to successful investing on a risk-adjusted basis. REI

NOTE

The **RERC Real Estate Report** summarizes the expected rates of return, property selection criteria, and investment outlook of a representative sample of large institutional investors and regional firms in the United States. The survey data is used as a tool by investors, developers, and financial institutions to monitor changing market conditions and to forecast financial performance. The RERC survey acts as a barometer of current market perceptions and confidence among the nation's top real estate professionals. Return data shows a normal range of expected returns for categories of investment-grade properties in 21 markets and nine property types.

ABOUT THE AUTHORS *(continued from page 8)*

that originates and manages investments for itself and its clients. [redacted]

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