FOCUS ON THE MARKETS

Challenges & Opportunities Mark Real Estate Sector

by Dale Anne Reiss

Even though the national real estate market maintained equilibrium throughout most of the 1990s, the sudden slump the national economy underwent in 2001 has placed significant stress on many segments of the real estate market. As a result, the real estate industry in 2002 is fraught with challenges. Adding to the challenges facing the industry as a whole has been the ongoing impact from the September 11 tragedies and the continuing fallout from the Enron debacle.

September 11, in particular, continues to rattle the real estate industry. After the initial shock over the vulnerability of one of the world's most visible structures—and resulting questions as to whether tenants would ever again go back into tall buildings—it is clear that high profile buildings have not witnessed a mass exodus. However, issues of security (too much or too little?) weigh heavy among owners of such buildings. The resulting uncertainty over the availability of adequate insurance coverage against acts of terrorism also threatens to cast a pall over the ownership of high-end office buildings, malls, and even hotels. Many owners of real estate and high-end users, especially Fortune 500 corporations, are conducting threat assessment and security audits to determine their vulnerability to devastating events. For real estate investors this has added a new risk profile beyond the typical real estate risk they have learned to underwrite. Now they must also learn to underwrite against potential loss.

The threat is not always from physical attack. The Enron debacle has shown how one corporation can turn an entire stock market—not just its industry sector—upside down. As many other corporations that entered into synthetic lease transactions in the 1980s and 1990s are now finding out, even legitimate, accepted financial vehicles can become tainted if they are misused. One of the major dominoes to come crashing down on real estate from Enron is that synthetic leases are now tainted in the eyes of investors. It will be difficult for some public corporations to execute such transactions in the future without attracting skepticism from Wall Street. Yet, now more than ever, corporations are under pressure to monetize their real estate assets and unlock capital to fuel corporate growth in the next economic expansion. Likely many will fall back on the more traditional sale/leaseback (despite its increased cost to the shareholder) or an outright sale—with its uncertainty of being able to control the space being leased.

The bright side to the current market is that where there are challenges there are also opportunities. A recent survey by Ernst & Young revealed that private equity funds—also known as opportunity funds—are holding about $20 billion in equity for investment in real estate over the next 24 months or so. This is a huge investment pool even when viewed globally, as the survey suggests that

60 percent of this equity may be headed abroad. For an insight into where the opportunities might be for these funds and others in the future, let's look at the major sectors of the real estate economy.

RESIDENTIAL

After a decade of steady growth, the construction market is expected to slow but homebuilders are still likely to prosper from strength in the single-family home construction market. Low mortgage rates have brought a surge in refinancing. Last year, new home sales increased against expectations. The 946,000 units sold during December 2001 were the fastest pace of sales since the beginning of the year. Sales for 2001 hit a new record of 5.25 million units, an extraordinary performance considering that the economy was in recession for 10 months out of the year. That performance is expected to continue, albeit at a slower pace.

In the multi-family housing sector, apartment conditions are softening. The National Multi Housing Council's market index fell for the 6th consecutive quarter to the lowest reading in the survey's two-and-a-half year history. Hardest hit are the luxury buildings in downtown areas. Managers are reporting occupancy rates in the 85 percent range—the lowest since the recession of the early 1990s. As the economic slump continues, roommate doubling-up is increasing and younger adults are moving back home. Marginally maintained units or properties saddled with poor leasing agents will suffer. Look for the recession to weed-out poorly capitalized, less efficient operators.

OFFICE & INDUSTRIAL

Companies have quickly responded to the slowing economy by placing their excess space on the market for sublease. This poses one of the real estate industry's biggest problems. Subleased space—offered at substantially discounted rents—is putting pressure on asking rents for primary space. National office vacancy rates soared to 13 percent in the later part of 2001 and are expected to continue to rise before peaking later this year. At the same time, the cost of ownership is rising. Post-9/11, security has become a way of life and an increased cost. Firms across the country are reevaluating and shoring up their security protocols and infrastructures. Property-insurance premiums have also increased. Additionally, the lack of terrorism insurance is impacting the sales and financing of major properties. Increasingly, office landlords are passing along additional expenses for security and insurance to tenants.

In the industrial market, the sluggish economy is having somewhat of a negative impact. Many corporations are divesting excess facilities—a major shift from the last five years, where many companies were frantically seeking new space. However, this in turn is providing the opportunity for real estate operators with skills to reposition assets.

HOSPITALITY

Lodging is among the most vulnerable real estate sectors in economic downturns. U.S. hotel room revenues fell almost 7 percent in 2001—more than twice that predicted by analysts. The post-9/11 travel crisis hurt an industry already hit hard by the economic slowdown. U.S. revenue per available room (RevPAR) showed the worst decline in 34 years. Analysts predict U.S. hotel occupancy levels for 2002 will be flat to slightly higher than 2001. Many hotel operators have been cutting costs and renegotiating loan covenants in an effort to preserve cash and avoid bankruptcy. Only those with the strongest balance sheets will be in a position to weather the coming year and so it is likely that some will become acquisition candidates.

RETAIL

While the retail property sector continues to weather the nation's current recession, the outlook is not entirely cloud-free. Unlike past recessions, consumer spending this time around appears strong. Should the recession deepen, and consumers scale back spending, more retailers could feel the brunt of the downturn. Mall owners should be cautious. Kmart has filed for Chapter 11 and will shutter 300 stores. Dillard's and The Gap also continue to struggle. Toys "R" Us recently announced plans to close 64 under performing stores and eliminate 1,900 jobs. Cinemas are also closing their doors. Grocery-anchored shopping centers may see more appeal because they are perceived as largely recession-proof.

CONSTRUCTION

Finally, construction companies are also facing challenges from the sluggish economy. Many banks are no longer offering working capital credit facilities to

construction companies. As existing credit facilities expire, construction companies could be forced to turn to expensive capital sources to meet working capital needs. At the same time, insurance costs are rising, putting greater financial pressure on the sector.

CONCLUSION

In summary, the real estate markets will be challenging for the foreseeable future. Just when some in the industry were starting to believe that the nature of the sector had changed from a volatile, cyclical industry to a more stable sector, the cycle rolled through again. Yet, there are reasons to be hopeful: Housing markets appear robust. Today, as corporations begin to emerge from the recession, they see a market returned to the rent levels of 1999-2000 and, for many tenants, that means there are space bargains to be had. It won't take too long for corporate expansion to begin again in earnest and put in motion a more modest pace of growth in the real estate sector. REI

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