FOCUS ON INVESTMENT CONDITIONS

THE DAWNING OF A NEW ERA FOR COMMERCIAL REAL ESTATE INVESTMENT

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The last 18 months have been arduous for even the most resilient among us. A recession, the September 11 terrorist attacks with continuing threats of terrorism, corporate accounting scandals and company bankruptcies, the tumbling stock market, and now the likelihood of military action with Iraq have taken their toll on our nation's psyche.

Most investors were hopeful that the economy would be back on a firm growth track by now but that is not the reality. Working off the excesses created during the tech bubble is taking more time than expected. Slow economic growth is killing demand for commercial real estate, and as a result, our outlook is more bearish now than it was just a few months ago.

Despite the slow growth, the U.S. economy has held up relatively well thus far, thanks to consumers and the aggressive low rates initiated by the Federal Reserve. Mid-term elections may be over, but there remains plenty of uncertainty ahead. The expectation is that 2003 will be the year that the business environment shows life beyond the tech run up, but we are not out of the woods yet. Commercial real estate markets will lag behind the economy by six to twelve months, which means that the space markets will not see improvement until 2004.

REAL ESTATE ATTRACTS INVESTMENT

With the debacles of Enron, Global Crossing, Adelphia, Tyco, and dozens of other company failures, the stock market gambling days are over for many investors—at least for the foreseeable future. Instead, investors have directed their investment dollars away from the volatility of the stock market and toward more stable and income-driven assets, like real estate.

However, until corporate earnings begin to increase and transparency and disclosure improve, expect disciplined asset allocations to public and private real estate investment trusts (REITs) and real estate limited partnerships (RELPs) to continue. Consistent cash flow and leveragability also make real estate attractive, but in the long run, demand from portfolios to invest in real estate will eventually help drive down returns.

Meanwhile, however, the low interest rate environment and low return expectations for investment alternatives have resulted in real estate returns becoming extremely attractive. As of this writing, 10-year government bonds are near 4.0% while expected real estate yields cling toward 11.4%, resulting in a yield spread of 7.4%—the widest gap ever witnessed in the 20-plus years that RERC has tracked this relationship. There are many theories as to why this spread is so wide today, but in the final analysis, the result is that real estate yield requirements are being lowered and compressed in the current economic and financial environment. Based on RERC's spread and competitive analysis, yields on solid assets that are properly underwritten should see total yields below 10%.

Buying right and adequately projecting cash flows and values have always been key to successful investing. Like other forms of investing, real estate investment comes down to the balance between risk and rewards. Hotels and office investment have historically offered strong upside potential, but also have been considered high-risk as vacancies can fluctuate greatly and eat away at the bottom line. Industrials and apartments, on the other hand, offer strong income growth but typically do not offer strong appreciation potential. Beyond diversification of one's portfolio, including the real estate portion, property value and pricing analysis should be viewed more quantitatively by separating out the components in order to reduce risk and increase overall reward.

There is plenty of capital chasing real estate, which is pushing up prices and reducing returns. However, this will change as stocks start coming back and real estate works through the lag factor.

WHAT DOES THIS MEAN FOR COMMERCIAL REAL ESTATE INVESTMENT?

We hate to be pessimistic, but it appears that a major paradigm shift—or the dawning of a new era for real estate investment—may be underway. Investment in most property types presently is characterized by low returns in an environment where deflation is more of a concern than is inflation. We're seeing slow economic and corporate growth, and a conservative posture in most companies. Perhaps more important is our concern about how the economy will bear the necessary and ongoing cost of homeland security required by the continuing war on terrorism.

Although certain real estate sectors have shown signs of stress for some time, the effects of our struggling economy are now becoming much more apparent. RERC's third quarter 2002 research indicates that **office** rents slipped another 5 to 10%, and rents and values/prices are expected to be weak throughout 2003 as the office market adjusts to the realities of a slower growth environment. **Industrial** properties are expected to be one of the first beneficiaries of an economic recovery, with rents and values/prices expected to decline further before beginning to show improvement in 2003. Asking rents for **apartments** have held but concessions are common in most markets, and effective rents and values/prices are expected to continue to remain flat in 2003. **Retail** rents and prices/values also look to remain flat through 2003. On the other hand, ADR for **hotels** is expected to increase 2 to 4% in 2003, with values/prices expected to strengthen in 2003. Owners will recognize necessary downward price adjustments which will continue into 2003.

Commercial real estate prices have peaked, and given real estate's lag on the economy, do not expect space markets to recover until 2004. We expect that real estate will lose its lustre in 2003, given current pricing levels, as the stock market stabilizes.

ABOUT THE AUTHOR

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