

FOCUS ON INVESTMENT CONDITIONS

Searching for Clarity in An Uncertain World

BY KENNETH RIGGS, JR., CRE



IN LATE 2003 AND THROUGHOUT MUCH OF 2004, economic events finally began falling into place. GDP growth took off and has since settled down to a slower but steady rate. The Federal Reserve Board has been increasing the funds rate at a "measured" pace to normalize interest rates. Job growth continues, and the markets are improving. We've even seen commercial real estate vacancy rates begin to fall and rental rates inch upward.

While some of these events seem to solidify our investment outlook, other factors—both secular and cyclical changes—continue to impact real estate return expectations and leave us even more uncertain. Capital flows, which increasingly are being driven by demographics and the need for income-oriented returns, are affecting pricing. Outsourcing, logistics management, and other technological enhancements are continuing to increase productivity while reducing GDP in general and the demand for real estate. And consumers, who have sustained the economy through a recession, terrorist attacks, corporate scandals, and a war in Iraq, are expected to begin tightening their purse strings a bit as interest rates go up, inflation increases, and high oil prices eat away at their discretionary income.

WHAT DOES THIS MEAN FOR REAL ESTATE?

As noted in *Expectations & Market Realities in Real Estate: 2005—Navigating through the Winds of Change*, produced by Real Estate Research Corporation (RERC), Torto Wheaton Research, and Principal Real Estate Investors, a close examination of this uncertain environment, along with a realistic look at the return expectations for various property types, gives us a better idea of what investors can

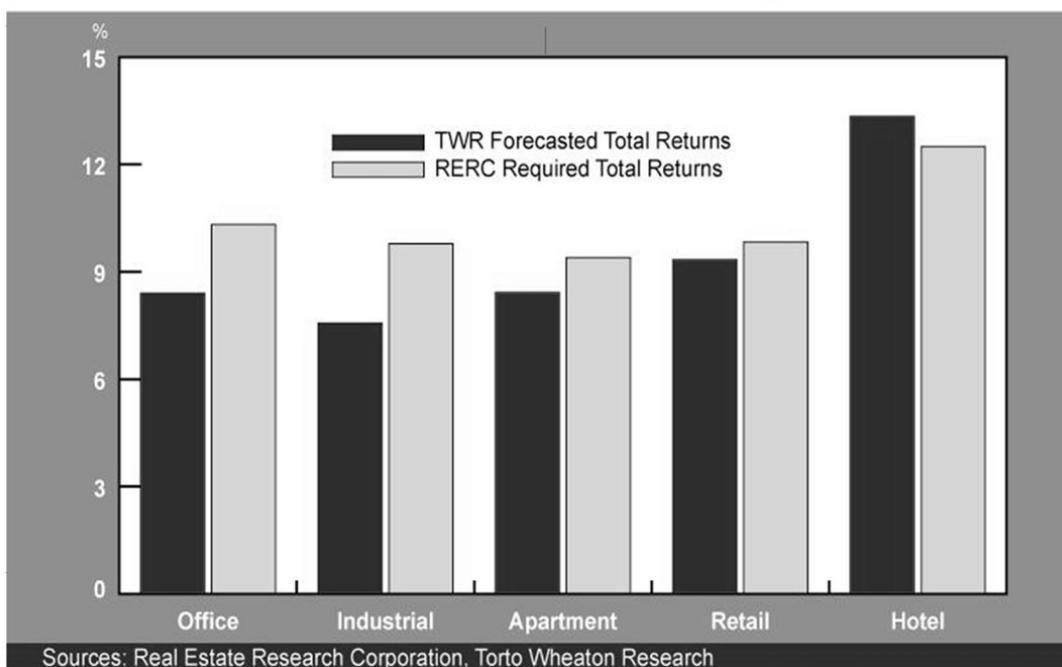
expect for returns. Real estate returns are certainly less volatile than those for many other investments, but there is no shortage of risk for any of the major property types. As noted in the following property discussion and in Figure 1, investors continue to require higher returns than those forecasted by Torto Wheaton Research. RERC believes the higher return expectations are due primarily to the uncertainties that remain in the market, which we believe will be resolved to some extent next year.

Demand fundamentals for the office sector are beginning to improve, and tenant credit quality is generally on the rise. However, job recovery and its effect on the office market will be uneven over the near term due to the economic health of various industries, businesses, and geographies. Prices and values continue to be driven up by the capital markets, despite weak occupancy and cash flows. RERC notes that although office continues to be one of the most volatile property types for the near term, longer-

About our Featured Columnist

Kenneth Riggs, Jr., CRE, FRICS, is chief executive officer of Real Estate Research Corporation (RERC). RERC offers research, valuation, independent fiduciary services, portfolio services, corporate advisory services, litigation support, and other real estate-related consulting services. RERC also provides research, analysis, and investment criteria (cap rates, yield rates, expense and growth expectations, recommendations, etc.) for nine property types on a national and regional level and for 40 major U.S. markets through the quarterly RERC Real Estate Report, the annual Expectations & Market Realities in Real Estate, and the RERC DataCenter.

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Figure 1—Forecasted Total Returns Vs. Required Total Returns

term prospects remain good due to population growth and the resulting demand for goods and services, which will spur business expansion and growth.

As the U.S. and global economy continues to grow and industrial-using employment improves, demand fundamentals for the industrial market are beginning to improve. However, increased logistic and distribution productivity and global trade will challenge demand for existing properties while increasing demand for larger, more efficient warehouse facilities in primary markets. In some secondary markets, however, there is a shortage of quality industrial space for smaller, niche users, and excellent redevelopment and repositioning opportunities exist in supply-constrained, in-fill locations. RERC believes that from a long-term perspective, the outlook for industrial space is quite favorable due to the continuing expansion of global trade and expected U.S. population growth.

Apartments continue to face pressure from continued high levels of new construction, but have generated strong total returns, as apartment capitalization rates have compressed to an all-time low. RERC's research indicates that demand is expected to continue to improve due to job growth, new growth in household formation, high housing prices, and increasing interest rates. Apartments have the ability to continue to generate strong absolute and risk-adjusted investment performance relative to other property types, but given current market prices and val-

ues, selectivity and pricing discipline are critical in optimizing performance.

Although retail performance has been exceptional during the last couple years, RERC believes it is not sustainable due to a combination of factors including high pricing relative to reproduction costs, the bond-like nature of retail leases, the fact that capitalization rates cannot compress much further, and an expected slowdown in consumer spending during the next few years. Given this information, RERC projects that the retail sector will endure the greatest challenges in delivering acceptable returns over the next 5 to 10 years. Value opportunities continue to remain within this property sector, however, it will be much more difficult going forward and the winners will rise through active management. Despite our slightly bearish mid- to long-term outlook for this sector, retail centers in high population areas and especially those that offer elements of convenience are expected to perform quite well.

Although hotels have been trailing with respect to risk-adjusted returns, RERC notes that they have clearly started to rebound from the downturn that affected the travel industry after the terrorist attacks of September 11. Recent positive developments in the hotel sector are increasingly attracting investor capital. Given still relatively low prices and the strong income growth potential in this sector,

RERC expects hotels to generate double-digit total returns in the years ahead.

We will all be a lot smarter in 2005, but until then, geopolitical clouds still prevail. Even so, the economy is still growing, and the election and the negativity associated with it are over. As events solidify, RERC expects:

- Economic growth to continue, with a 3.5- to 4.0-percent GDP growth rate during the next several years. But with projected productivity growth of 2.5 to 3 percent, employment will not reach its previous peak until 2005.
- Secular capital to continue to flow into real estate in 2005 due to real estate's income-oriented nature. This income, coupled with inflation-like growth, will continue to create a lower risk profile when compared to other asset classes.
- Real estate investment strategies to be part of a broader asset allocation mix. In an increasing interest rate environment, total returns on bonds will be affected more adversely than will real estate returns. With respect to the

stock market, a combination of very low dividend rates (which suggests that most of the total return equation is dependent on upside) and still high P/E ratios (which suggests that additional upside will be a challenge) may cause stock market valuations to move in a sideways pattern for some time. Given this environment, some investors, especially those holding significant amounts of cash, will increase their allocations to real estate since the alternatives are somewhat unappealing, especially on a risk-adjusted basis.

■ The hotel sector to draw significant amounts of capital, contributing to an increasingly competitive transaction environment. Given the strong income growth potential, we expect hotel prices to increase, allowing double-digit returns in the years ahead. The apartment and industrial sector will remain stable. With their high performance, we expect retail to undergo a re-pricing phase. The office sector in general presents the greatest risk.

Whether it is real estate, the stock and bond markets, or other alternatives, RERC reminds investors that sound risk management remains key to earning appropriate returns. ■