FOCUS ON MARKETS

Of "Boomers" and "Bubbles"

BY DALE ANNE REISS

THE CURRENT U.S. ECONOMY SHOULDN'T be appealing to real estate investors. After slow second and third quarters, economic growth projections were downgraded for the fourth quarter of the year and into 2005. The stock market is sluggish. Consumer spending could be slowing. Oil prices are at record levels. Yet capital continues to pour into real estate as investors seek higher returns, portfolio diversification, income-oriented investments, capital preservation, steady cash flows, potential capital gains, and opportunities to defer or shelter taxes.

The money is coming from a range of individual and institutional investors including retirees, baby boomers, Gen-Xers, partnerships, syndicators, pension funds, mutual funds, opportunity funds, public and private Real Estate Investment Trusts (REITs), foreign investors, corporations, and other investors. They are putting their capital into an array of direct and indirect property investments including vacation or retirement homes, direct property investments, public or private REITs or real estate operating companies, opportunity funds, real estate mutual funds, interests in partnerships, limited liability companies, or subchapter S corporations that own real estate; real estate timeshares, or hotel condominiums. One sign of real estate's popularity is the growth of the private REIT market. Investors put more than $7 billion into shares of private REITs last year, or nearly double the 2002 figure.

Investors are taking advantage of near-term opportunities to acquire real estate while interest rates and financing costs remain relatively low. But they also are investing for the long term.

Consider the baby boomers. As the largest and wealthiest generation in history, boomers have billions of dollars in capital to spend or invest. As the first boomers near the traditional retirement age, 60% or more of the economy's investment assets will be controlled by Americans older than 60. With longer life expectancies, boomers will need to put their investments to work for longer periods, and real estate can deliver consistent, annuity-type returns. This year boomers and other individual investors are expected to pump more than $7 billion into direct commercial real estate investments.

U.S. pension funds and plan sponsors have growing pension obligations that real estate can help to meet. At the beginning of 2003, about 16% of corporate pension plans were less than 75% funded and 45% were less than 95% funded. U.S. pension fund assets invested in equity real estate jumped from $175 billion in 2002 to $192 billion in 2003—roughly 50% higher than investment levels of the late 1990s.

With more investors attracted to real estate, demand for properties should remain strong despite rising property

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prices and the likelihood of higher interest rates. Investors will continue to acquire real estate if they expect increases in property cash flows to offset higher interest rates and financing costs. While investment yields may decline as property prices increase, real estate will remain competitive with other investments, and investors may have more buying opportunities as some owners decide to cash out of mature investments.

The flood of capital into real estate has created challenges for developers, owners, and money managers to meet the return requirements and other investment goals of a broad range of investors. In response, developers are expanding beyond mainstream office, industrial, apartment or hotel investments and into niche markets such as infill development, condo-hotels, low-income housing development or rehab, preservation and adaptive reuse of historic properties, or mixed-use developments near transit stops. Investment advisors are seeking more opportunities in global markets. Of the $100 billion in equity capital currently in the hands of major real estate private equity funds, about 40% of this capital is targeted at large commercial real estate assets in the United States, with the balance focused on a wide range of property-related opportunities abroad.

To be sure, some individual investors may move to the sidelines as the cost of acquiring assets increases, as could some REITs and other institutional investors. But other REITs as well as pension funds, opportunity funds, foreign investors and some individuals will stay in the game. The sources of capital may change, but capital will continue flowing into property.

ARE U.S. HOUSING MARKETS "ON THE BUBBLE?"

Historically low interest rates have fueled the housing boom, but now that the Fed has started to increase rates, concerns are being raised about the housing market's vulnerability to higher mortgage costs. Buyers traditionally have financed homes with fixed-rate mortgages that provided protection against higher rates, but recently adjustable rate mortgages (ARMs) have accounted for about a third of all new home loans nationally. More lenders are packaging ARMs with interest-only payments and up to 100% financing. To sustain home sales, some homebuilders are beginning to offer mortgage financing at lower rates than traditional lenders.

Cheap financing has fueled demand for housing and driven up prices, raising concerns about a housing bubble in red-hot markets from California to South Florida. (The multi-billion dollar price tag and impact of the recent hurricanes in the Southeast—Charley, Frances, Ivan and Jeanne —will result in re-evaluation of housing codes throughout the country particularly in those areas vulnerable to wind damage. Also, look for more efforts to deal with non-native vegetation, which has been proven more susceptible to storm damage by recent events.)

Further fueling housing demand, European buyers are taking advantage of the weak dollar to buy luxury condominiums and co-ops in Manhattan. In the second quarter 2004, the average price of such units topped $1 million for the first time. More Latin American buyers are acquiring properties in Florida, despite the recent hurricanes. Signs of speculative investment in housing are evident in more markets such as Chicago and Las Vegas. To cool speculative fever, builders in markets such as California, Arizona, and Virginia are adopting such practices as requiring buyers to live in their homes for a year or refusing to sell homes to buyers who recently have purchased other homes.

Yet, the biggest potential concern in the residential sector is the ARMs market. The popular hybrid ARM typically converts from fixed to adjustable rates in three to seven years, and borrowers who use such financing could be squeezed if their mortgage payments increase faster than their incomes. (A September 20th cover story in Fortune magazine already puts prices in 28 major markets—including Portland, Ore., Sacramento, San Francisco, Los Angeles, San Diego, Miami, Washington, D.C., New York, and Boston, more than 15 percent ahead of incomes.)

Buyers are betting that the rapid appreciation in home prices of recent years will continue, enabling them to refinance on better terms, but if housing markets cool, prices may grow more slowly or even fall in some markets. Price declines could reduce or wipe out the equity of some highly leveraged owners, and if interest rates increase, they might walk away from their mortgages. The percentage of equity already held by U.S. homeowners has declined steadily over recent years, especially with the advent of home equity loan programs. Other owners, unable to make higher mortgage payments, could risk losing their homes in foreclosure. Higher defaults and foreclosures could have severe ripple effects in the secondary market.

Such a scenario suggests that borrowers and lenders should be cautious about financing home purchases. Loans that seem attractive today may not look as appealing in a higher interest rate environment.

CHINA'S HOUSING MARKET NOT AS BRITTLE

One housing market that doesn't seem to show potential for weakness is China. Construction activity in Beijing has to be seen to be believed. Just about anyone who wants to build there seems to have a project underway. Many of these projects are apartments or homes for China's rapidly growing middle class. Builders are selling projects to speculators or end buyers before construction is finished and using the money to start new projects. Some buyers are paying cash for their units, but if they require mortgage loans, up to 80% financing is available. In addition, the government is privatizing state-owned housing by selling apartment units to the occupants.

The government reportedly wants all construction in Beijing completed by the end of 2006, or about 18 months before the 2008 Olympics, to allow time for the dust to settle and projects to be cleaned up. This has added to developers' sense of urgency, and they are scouring Beijing as well as Shanghai and other major cities for new construction sites. Some are acquiring commercial properties in key locations and obtaining approvals to rezone the land for housing—a former factory site not far from Beijing's Forbidden City is being redeveloped for residential use.

Meanwhile, some international developers and investors are considering whether to try and participate in China's construction boom. This will require them to find local public or private partners with the relationships, market knowledge and acumen to take projects from start to finish, and to identify development and investment opportunities. In addition, the global investment banks and opportunity funds that have acquired assets in China's initial nonperforming loan sales are using their toehold in the market to expand into mainstream property markets. Some global companies are trying to enter the market through acquisitions of companies that have a presence in China. Following the example of U.S. real estate companies in India, some U.S. developers might try to get into China by working as merchant builders or providing property management, consulting, design or other services to Chinese companies. Developers and investors are trying many approaches to China, an embryonic but rapidly growing property investment market. No talk of a bubble there…yet. ■