FOCUS ON INVESTMENT CONDITIONS

Commercial Real Estate Keeps Its Healthy Pace

BY KENNETH P. RIGGS, CRE

ALTHOUGH MANY SIT ON THE EDGE OF THEIR SEAT as commercial real estate continues to provide relatively strong and solid returns, commercial real estate as an investment class is being viewed in a new light and is considered to be an increasingly important asset in the financial world.

Buoyed by low interest rates during the last few years, we watched as record-level home sales and new construction, along with loan refinancing, helped pull the U.S. out of a recession. GDP grew, employment grew, and as a result, in 2004, soaring home values and rising stock prices drove the wealth of American households up by 9% to a record $49 trillion, states the Federal Reserve.

With consumers spending even more and businesses growing and finally beginning to occupy more space, record levels of capital flowed to the commercial mortgage markets in 2004. In fact, real estate was among the biggest mutual fund winners in 2004, earning 32% returns on average for the year. This was the fifth consecutive year that public real estate investment trusts (REITs) outperformed the major stock market indices, reported Lipper.

Although private real estate returns are decreasing, real estate returns overall remain less volatile than stocks, and as shown in Table 1, are outperforming those for other investment classes. As such, demand for real estate remains high, with pension funds, endowments, foundations, and individual investors boosting their investment in commercial real estate.

COMMERCIAL MARKETS REFLECT BUSINESS AND CONSUMER TRENDS

The Federal Reserve indicates that it will continue to raise the federal funds rate and to monitor the rate of inflation. The fear is that an increase in interest rates and inflation, along with high fuel rates and a slowdown in consumer confidence, will slow consumer and business spending, and that the real estate recovery—now off to a solid start-will stall. However, real estate's propensity to lag the economy is also one of its most stabilizing features. Since most commercial real estate properties do not move on a moment's notice, there is time for investors to study the fundamentals, evaluate return expectations, and make more informed investment decisions.

One of the most significant findings that Real Estate Research Corporation's (RERC's) second quarter 2005 research indicated was that required pre-tax yield rates

About our Featured Columnist

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Table 1—What Do The Financial Markets Tell Us?

Total Return % as of 6/30/2005

Market Indices	YTD	1-Year	3-Year	5-Year	10-Year
Consumer Price Index	2.15%	2.48%	2.37%	2.43%	2.46%
10-Year Treasury Bond*	4.18%	4.20%	4.13%	4.54%	5.25%
Dow Jones Industrial Average	3.65%	0.66%	5.92%	1.69%	10.58%
NASDAQ Composite	-5.45%	0.45%	12.02%	-12.31%	8.22%
NYSE Composite	-0.45%	9.31%	8.59%	1.21%	8.87%
S&P 500	-0.81%	6.32%	8.28%	1.21%	9.93%
NCREIF Index	9.03%	18.03%	12.18%	10.70%	11.41%
NAREIT Index	4.90%	30.08%	20.34%	20.72%	14.57%

* Based on Average End of Month Returns
Sources: Morningstar, NCREIF, NAREIT

and required going-in and terminal capitalization rates continue to decline for all the major property types except hotels. How much more investors will lower their expectations is unknown, but we believe this further decline suggests that the changes in the financial and commercial real estate arenas are increasingly more structural rather than cyclical, and a larger proportion of this downward shift is here for the long term.

WHAT ABOUT RETURNS ON INVESTMENT?

Office Sector—As for the office sector, RERC's survey respondents indicate that investment conditions have improved quarter by quarter for both CBD and suburban office properties during the last year. Office jobs continue to increase, especially in the financial and services sectors, and little by little, vacancy rates are improving.

As shown in Table 2, NCREIF 1-year returns are averaging above 13% for CBD and suburban properties. However, due to several factors, including high capital expenditures and relatively higher vacancy rates, there is a great deal of uncertainty associated with office investments, which is reflected in the variation in return from this asset. As such, the risk-adjusted returns for the office sector reside in the bottom half of the spectrum. However, what made office properties so risky over the last several years may be investors' biggest ally in generating higher total returns today. Investors are advised to be wary of rising interest rates, as many of our survey respondents believe capitalization rates have bottomed-out, as demonstrated by RERC's relatively high required returns for suburban properties.

Industrial Warehouse—Warehouse properties generally are not the fanciest properties on the block, but their returns are definitely looking good. The risk-adjusted return metric (shown as RAR metric on Tables 2 and 3) for the industrial warehouse sector is second among all the property types, ranking only behind apartments. Demand for industrial warehouse space, especially in port and distribution hub cities, continues to be very robust. As such, the availability rate for industrial properties continues to decline in the near term.

Industrial warehouse properties rarely receive recognition for quality performance, and in the recent past, clearly have been overshadowed by impressive retail sector returns. However, the bread and butter investment characteristics of warehouse properties will allow this investment to offer better risk-adjusted returns for both the short and the long term. Realized capitalization rates cited by Real Capital Analytics are higher for warehouse properties than they are for office properties, while office properties generally exhibit greater risk. One would think this is due to the higher growth potential of office properties and the potential relative under-pricing of industrial properties. But according to Torto Wheaton Research, rental growth for warehouse space is expected to be consistent with inflation and not materially different than rental growth for office properties. Overall, RERC expects industrial warehouse properties to be a solid performer over the next several years.

Retail Properties—Despite increasing interest rates, higher fuel prices, and inflationary trends, consumers thus far have refused to draw down completely. As a result, real estate returns for retail properties have been strong and are expected to continue to perform well throughout 2005. As shown in Table 2, the second quarter 2005 NCREIF index shows that neighborhood/community center top the list with 1-year returns of 24.50%, followed by

Table 2—Rolling Four-Quarter Returns—Second Quarter 2005

Property Type	NCREIF Returns	NCREIF St. Dev.	RAR Metric*	RERC Returns	NCREIF vs. RERC
Apartment	17.12%	2.60%	6.6	9.03%	8.10%
Industrial—Whse	17.31%	3.14%	5.5	9.40%	7.91%
Neigh/Comm	24.50%	5.19%	4.7	9.33%	15.17%
All Property Types	**18.08%**	**3.98%**	**4.5**	**9.80%**	**8.28%**
Power Center	18.52%	4.40%	4.2	9.58%	8.94%
Regional Mall	23.79%	7.35%	3.2	9.13%	14.67%
Office—CBD	15.99%	5.06%	3.2	7.38%	6.61%
Office—Suburban	15.71%	6.74%	2.3	9.98%	5.74%
Industrial—R&D	16.38%	8.71%	1.9	10.20%	6.18%
Hotel	15.24%	10.86%	1.4	12.13%	3.12%

* Risk Adjusted Return
Source: NCREIF, RERC

regional malls and power centers at 23.79% and 18.52%, respectively.

However, given the volatility associated with retail, the risk-adjusted returns for this property type are only about average. Risk-adjusted returns can be somewhat deceptive, given that risk is based on standard deviation or the variation (both negative and positive) of the return around its average. However, the recent run-up in appreciation in this sector has contributed to a significant amount of positive variation, which is good for investors. In addition, Torto Wheaton Research reports an overall vacancy rate of 10.0%, which is expected to increase slowly over the next several years. This, combined with stabilizing rent levels, equates to a stabilizing asset class that will report significantly lower appreciation yields than those we are currently observing, as demonstrated by RERC's required returns. Given our current financial environment, RERC forecasts that retail properties hold the greatest amount of risk of declining returns and downward pricing adjustments. The foundation of this forecast rests on the expectation that increasing interest rates coupled with long-term bond-like leases, along with slowly increasing vacancy levels and stabilizing rent levels, ultimately will result in a downward shift in the investment prospects of retail properties.

Apartments—With 2004 seeing the strongest net absorption of apartments in 4 years and the national vacancy rate declining to 5.9%, there is little wonder that capital continues to flow to apartments. However, the construction pipeline for apartments remains full, and more apartment and condo conversion completions are expected in 2005 alone than during the last 2 years combined. With continued low interest rates, apartment occupancy is not expected to improve much more until 2006, despite increased hiring and strong household formation.

Even so, we all need a roof over our heads, and as such, apartments have proven to be the least volatile asset class with respect to risk-adjusted returns, both over the short and long term, as shown in the risk-adjusted returns metric in Tables 2 and 3. RERC's going-in capitalization rates for apartments are 6.8%, the lowest point in all the years RERC has been tracking these rates, and the expectation is that they are about to begin heading upward. This is consistent with trends from Real Capital Analytics that new product is being brought to the market at higher capitalization rates. With their low volatility, apartment capitalization rates are typically a leading indicator among the various real estate sectors. As such, during the next few quarters, RERC expects to see the capitalization rates of other real estate asset classes show signs of bottoming out or even increasing.

Hotels—According to the Commerce Department, travel is back, with 46.1 million international visitors traveling to the U.S. in 2004. These visitors spent $93.7 billion, an increase of 17% from the previous year on lodging, transportation, and other expenditures. All signs point to continued growth in the lodging industry this year, due in part to the strengthening tourism industry, but also to increasing business travel.

However, as anyone who has spent much time in hotels this year can attest, the cost of an overnight stay has gone up. The question for investors is whether the income streams from hotels provide enough return on their investment to compensate for the degree of risk. As shown

Table 3—10 Year Average Returns—Second Quarter 2005

Property Type	NCREIF Returns	NCREIF St. Dev.	RAR *	RERC Returns	NCREIF vs. RERC
Apartment	11.96%	2.60%	4.6	10.63%	1.33%
Industrial—Whse	12.07%	3.14%	3.8	10.77%	1.31%
Power Center	12.99%	4.40%	2.9	11.29%	1.70%
All Property Types	11.47%	3.98%	3.0	11.20%	0.27%
Neigh/Comm	12.60%	5.19%	2.4	10.99%	1.61%
Office—CBD	11.64%	5.06%	2.3	11.08%	0.56%
Office—Suburban	11.85%	6.74%	1.8	11.30%	0.54%
Industrial—R&D	13.37%	8.71%	1.5	11.38%	1.99%
Regional Mall	11.20%	7.35%	1.5	10.96%	0.24%
Hotel	13.60%	10.86%	1.3	12.91%	0.69%

* Risk Adjusted Return
Sources: NCREIF, RERC

in Tables 2 and 3, 10-year returns on hotels according to NCREIF are higher than the other property classes, but NCREIF returns for the last year show a different story, with industrial R&D properties as the only property type earning lower returns than hotels. Furthermore, the risk-adjusted returns for hotels are lowest among all the property types tracked, while RERC's required returns for hotels remain at more than 12%, the highest percentage among all the property types for a 10-year period. Despite their risk, hotels provide a good investment alternative for those who are prepared to ride the ups and downs of the travel industry.

WHAT CAN INVESTORS EXPECT?

Commercial real estate continues to garner very high respect among investors—both institutional and retail—as they search among the investment alternatives and recognize the diversification benefits and solid risk-adjusted returns. The challenge rests with the pricing side of the commercial real estate equation—it is not cheap at this point in the investment cycle. Unless interest rates increase sharply and capitalization rate increases follow, real estate prices likely will remain high. Even with high prices, RERC expects commercial real estate to remain a relatively attractive investment and to be considered a solid performer, with the following points in its favor:

- Low 10-year treasury rates will help to keep capitalization rates low with little pressure from alternative investments.
- Since the stock market remains volatile and is moving sideways, investor demand for commercial real estate is likely to continue to put upward pressure on prices.
- All property types are seeing improving space fundamentals with lower vacancy rates, which is beginning to drive rental growth and ultimately will support price increases.
- Despite recent stellar performance, retail properties stand the greatest risk of a downward adjustment in prices.
- Apartments historically have been classified as low-risk, but low capitalization rates are beginning to create risk with apartments being priced for perfection.
- The industrial sector is generally expected to perform well over the next several years, as demand continues to increase.
- Hotels are an attractive investment alternative with strong upside potential, as business and consumer spending continues, and solid income returns with lagging appreciation returns are reported. ■