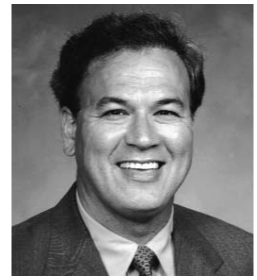
FOCUS ON INVESTMENT CONDITIONS

Something Has to Give—Or Does It?



BY KENNETH P. RIGGS, CRE

As the new year gets underway, many of us are taking stock of the economic outlook for the year ahead. We've watched as the U.S. economy has demonstrated its resilience over and over again during the last 5 years. It has survived the bursting of the dot.com bubble, major terrorist attacks on U.S. soil, wars in Afghanistan and Iraq and the ongoing war on terrorism, and corporate and accounting scandals, along with numerous smaller shocks. We knew, however, with Hurricanes Katrina and Rita late last summer and higher gasoline prices that the strength of the consumer would be challenged. Our concerns have been whether the business sector would prove to be strong enough to pick up the slack as consumer spending faced strong head-on challenges and whether inflation could be held in check in a rising interest rate environment.

These shifting currents create quite a balancing act for the economy and reflect just a few of the challenges impacting real estate and other investments. In looking at the strengths and weaknesses in our dynamic economy, real estate has offered outstanding returns as compared to the stock and bond markets. However, the new challenges we are facing give rise to a host of new concerns related to real estate performance. Will consumer spending slow, and how will the retail property sector be affected? How will a reportedly slowing housing market affect apartment returns? Will business hiring continue and will rents for office and industrial space increase? With capitalization rates so low, what will drive returns? And more importantly, will real estate returns in 2006 be significant enough to take on the risk associated with this asset class? Given these imbalances, it seems that something has to give—but does it?

ECONOMIC STRENGTHS AND WEAKNESSES HEADING INTO 2006

Despite the uncertainty, the broader economy continues to strengthen. The impact of Hurricane Katrina, the costliest natural disaster in U.S. history, has been about what many forecasters expected. There was a short-term negative impact to the national economy, but as clean-up and rebuilding got underway, the economy began to respond positively. In fact, third quarter real gross domestic product (GDP) grew at an upwardly revised annual rate of 4.3% in third quarter 2005. Surprising most experts, this half-percentage point increase over the seasonally adjusted annual rate released a month ago is the best showing since the first quarter of 2004.

About our Featured Columnist

Kenneth Riggs, Jr., CRE, 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. *(E-mail: riggs@rerc.com)*

This growth was supported by strong spending during third quarter 2005 by consumers and by businesses. Consumer spending rose 4.2%, with purchases of durable goods increasing by 10.5% and nondurable goods spending increasing by 3.6%. Business spending increased 8.8%, with spending on equipment and software rising 10.8%.

Table 1—What Do The Financial Markets Tell Us?

Total Return % as of 9/30/2005 Market Indices	YTD	1-Year	3-Year	5-Year	10-Year
Consumer Price Index	3.21%	3.42%	2.76%	2.49%	2.52%
10-Year Treasury Bond[1]	4.19%	4.20%	4.15%	4.46%	5.20%
Dow Jones Industrial Average	-0.34%	7.23%	14.19%	1.91%	10.33%
NASDAQ Composite	-1.09%	13.44%	22.45%	-10.14%	7.50%
NYSE Composite	5.28%	16.17%	17.46%	1.72%	8.71%
S&P 500	2.77%	12.25%	16.71%	-1.49%	9.48%
NCREIF Index	13.93%	19.25%	13.19%	11.06%	11.68%
NAREIT Index	6.94%	22.63%	24.90%	19.43%	14.24%

1 Based on Average End of Month T-Bond Rates
Sources: Morningstar, NCREIF, NAREIT

As one of the strongest indicators of the health of the economy, the U.S. deficit fell to $319 billion for fiscal year 2005, down $94 billion from the previous year's record, reports the Treasury Department. This is due to a surge in tax revenues, with receipts for the year totaling $2.154 trillion, up from $1.880 trillion a year ago.

However, the housing market has been showing signs of slowing down during the last few months. A recent report from the National Association of Realtors indicated that their index of pending home sales for October 2005 declined 3.2% from September and was down 3.3% from a year earlier. A slowdown in consumer spending is expected, although it appears holiday sales have been strong thus far this season.

And although new productivity numbers are strong (4.7% during third quarter 2005, the largest gain in productivity since mid-2003), corporate profits after taxes fell by 3.7% during third quarter. Even so, year-over-year profits increased 9.4% as compared to third quarter 2004. Employment remains strong, although predicted job losses by Ford and General Motors will have a huge impact in those regions where the affected plants exist.

In addition, the U.S. trade imbalance continues to be a drain on the economy. Imports increased nearly 2 ½ times the rate of exports.

HOW DOES THIS AFFECT REAL ESTATE?

Despite the pressure on real estate values, Real Estate Research Corporation's (RERC's) third quarter survey respondents continued to rate real estate as a better investment option than stocks, bonds, or cash. Third quarter 2005 returns (shown in Table 1) reflect the wisdom of their recommendation, with NCREIF year-to-date returns at 13.93% and NAREIT returns at 6.94%, while the Dow Jones and NASDAQ returns were in negative territory and the NYSE composite and S&P 500 positive but less than the two real estate indices. Up-to-date scores are reported in the RERC Real Estate Report each quarter. (Table 1)

Required capitalization rates and discount rates across the board have declined by approximately 200 basis points (a decline of over 20%) since first quarter 2001. This level of compression is unlike anything RERC has seen in the past, and is what has allowed commercial real estate values and prices to increase to their current levels.

Going forward, strong positive leverage, similar to that realized during the past few years, will be difficult to achieve on properties where capitalization rates have been driven down to levels near interest rates. Even so, RERC expects capital to continue to flow to real estate during 2006, although returns are expected to come down to a more sustainable level on both a capitalization rate and total return basis.

OFFICE

The key demand drivers of the office market recovery—employment growth and business spending—continue at a steady pace, and as a result, office space market fundamentals are improving at a reasonably steady pace in most markets. We expect office demand to continue to increase during the next several years, and as a result, vacancy will continue to decline, assuming new supply stays relatively constrained.

As shown in Table 2, required capitalization rates for all property types are lower than they have been since RERC began reporting them 15 years ago. With further significant capitalization rate compression unlikely, upside in the

Table 2—RERC Required Return Expectations[1] by Property Type

	OFFICE		INDUSTRIAL		RETAIL			APARTMENT	HOTEL	AVERAGE ALL TYPES	RERC PORTFOLIO INDEX
	CBD	Suburban	Warehouse	R&D	Regional Mall	Power Center	Neighbor/ Comm.				
Pre-tax Yield (IRR) (%)											
Range	7.3-10	7.5-10	7-10	7.5-11	7.5-9	7-10	7-10	7-10	11-12	7-12	7-12
Average*	8.4	8.9	8.5	9.4	8.3	8.8	8.6	8.3	11.3	8.9	8.6
Going-In Cap Rate (%)											
Range	6-8	6.5-8.5	6-8.5	6.5-9.5	6-7.5	6.3-8	6-8	5.5-7.5	8-10	5.5-10	5.5-10
Average*	6.9	7.4	7	7.8	6.7	7	6.9	6.4	8.7	7.2	7
Terminal Cap Rate (%)											
Range	6.5-9	7.3-9	6.5-9.5	7.3-10.5	6.5-8	6.5-9	6.5-9	6-8	8.5-10.5	6-10.5	6-10.5
Average*	7.6	8.1	7.7	8.5	7.3	7.6	7.6	7.2	9.4	7.9	7.7
Rental Growth (%)											
Range	0-4	0-4	0-4	0-4	2-4	0-3	0-3	0-4	3-6	0-6	0-6
Average*	2.7	2.8	2.4	2.3	2.9	2.4	2.4	2.7	4.4	2.8	2.7
Expense Growth (%)											
Range	2-3.5	2-3.5	2-3.5	2-3.5	2-3.5	2-3.5	2-3.5	2-3.5	2.5-3.5	2-3.5	2-3.5
Average*	2.9	2.9	2.8	2.8	2.9	2.8	2.8	2.9	3	2.9	2.9

[1]This survey was conducted in April, May, and June 2005 and reflects expected returns for Second Quarter 2005 investments.
*Ranges and other data reflect the central tendencies of respondents: unusually high and low responses have been eliminated.
Source: RERC Investment Survey

office market will occur primarily from space market fundamentals including rental growth, which is beginning to improve from previous quarters (Table 2).

INDUSTRIAL

Having reached a turning point in third quarter 2004, space market fundamentals for the industrial property sector have continued to strengthen throughout 2005. RERC expects occupancy to continue to improve throughout 2006, but it will be a gradual rather than a robust recovery due to elevated levels of new construction and continued productivity gains in transportation logistics. Landlord pricing power and rents are increasing, but it will be gradual, especially given the negotiating strength of large users.

While required capitalization rates for the industrial sector have fallen to levels lower than what RERC expected, further compression is a thing of the past and the driver of investment performance growth going forward will depend on net operating income (NOI). The outlook for warehouse valuation and pricing levels remains bifurcated, with larger and high-quality properties experiencing the greatest user demand and properties in secondary markets or those with few supply constraints finding it challenging to achieve sustained upside.

RETAIL

Having spent most of the 1990s as an investment performance underachiever, the retail sector has been the "darling" of the current decade. Retail fundamentals are quite strong and consumer spending has had more strength and longevity than expected due to low interest rates, improving personal income and job growth, relatively low vacancy rates, consistent rental growth, and significant capitalization rate compression. As a result, retail property total returns have been outpacing those for all other property types.

However, the risk of a slowdown in consumer spending due to elevated energy prices, higher interest rates, and a slowdown in the housing market is very real, and increasing retail performance is expected to slow. RERC's outlook is for retail to return to a more sustainable investment performance level, with realized returns closely matching investor return expectations.

APARTMENTS

Apartment fundamentals have continued to improve during 2005, with net absorption outpacing new supply for the second consecutive year. In addition, rents have been increasing as vacancy rates and rental concessions declined, which is due in part to condominium conversions removing apartments from the rental market.

Apartment investment performance is expected to remain strong with declining home affordability, rising long-term interest rates, and strong population growth. However, given how low apartment capitalization rates are, apartments will likely need to rely even more heavily on landlord pricing power going forward than will the other property types.

HOTELS

Hotels are well positioned to outperform the other property types over the next few years. Pricing power is allowing room rates to move upward, and business travel should increase as corporations increase business spending. But risks still exist, including high energy prices that could reduce discretionary travel. Compared to other property types, however, hotels are not as fully priced and thus have a somewhat higher margin for investment error.

CONCLUSIONS

■ Real estate has come of age, fully regaining its credibility as an asset class and re-establishing itself as an integral part of asset allocation models. Returns are at historical highs, space market fundamentals are improving, and capital continues to pour in.

■ In an era of post capitalization rate compression, real estate appreciation will be a function of income growth, which will be tied to improvements in space market fundamentals. However, improvement in fundamentals will not be uniform across property types or markets. Unevenness exists across markets in terms of demographics, employment growth, and supply constraints, resulting in heterogeneity of landlord pricing power and investment performance.

■ Given high real estate prices and low current capitalization rate and cash flow yields, recent double-digit returns are unsustainable and will revert to the single-digit level for core real estate on an unleveraged basis. Despite expectations of lower returns going forward, real estate continues to demonstrate strong relative value compared to stocks and bonds.

■ Real estate increasingly appears to be priced for perfection, but is faced with significant global and domestic imbalances and the inherent challenges of accurately assessing the nature, timing, and magnitude of eventual corrections. As such, investors should keep absolute return expectations low and risk awareness levels high.■