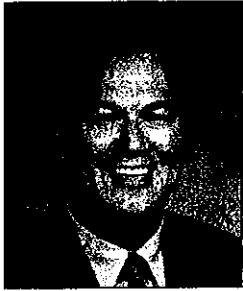


FOCUS ON INVESTMENT CONDITIONS

CLOSING THE CHAPTER ON A CYCLE OF BOOM, BUST, AND SCANDALS

by Kenneth Riggs, Jr., CRE



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The final chapter of the 1990s tech bubble is being written in the financial markets. Companies like Enron, Waste Management, Adelphia, Tyco, WorldCom, and Arthur Andersen have scandalized the investment community, and have fired a deep mistrust among investors about the financial markets. At least the Securities and Exchange Commission (SEC) and various other agencies appear intent on dousing the fire and cleaning house. Real Estate Research Corporation (RERC) recognizes the difficulty for the companies and individuals being prosecuted, but such a stance is necessary for restoring trust in the markets as well as the justice system, and allows investors and businesses to do what they do best — getting on with making money.

In spite of the fact that gross domestic product (GDP) fell to 1.1 percent second quarter from 5 percent first quarter 2002 and consumer confidence dropped to 97.1 from 106.3, there are some key indicators that the economy is moving in a positive direction, however slowly. Latest data show that technology spending rose by 1.2 percent, industrial production increased by 0.2 percent, and the Federal Reserve has thus far decided to leave short-term interest rates at 40-year lows. In addition, labor markets seem to be improving, personal income increased to \$57.0 billion (+0.6 percent), and disposable personal income (DPI) increased to \$55 billion (+0.7 percent) in June. Personal consumption expenditures increased \$35.6 billion (+0.5 percent). This is in the face of declining stock prices, the prosecution of scoundrels on Wall Street, federal government deficits, and the U.S. being in a wartime mode.

Economists have a surprisingly rosy view of the outlook for the economy in the months ahead, but this is all pinned on the consumer. While the consumer has kept the U.S. economy moving, the risk is that the consumer can also halt the economy in its tracks. When the tech companies tanked and triggered a recession and individuals saw 401k and other long-term savings evaporate with the hype, consumers surprisingly shrugged it off and focused on yearly earnings. However, RERC worries that the consumer may pull back as they see their jobs and their paychecks at risk.

RERC believes that the consumer will see the economy through these difficult times, as long as the deceitful business practices that some companies and individuals have been exercising is quickly and decisively dealt with. Otherwise, this cancer that is undermining the confidence in the stock market will unfortunately transfer itself to the consumer and put us back into a recession. Given household buying power, the pent-up demand for housing, positive demographics, and a historically low interest rate, RERC has confidence that the consumer has staying power.

Even so, it will be some time before we see a recovery in the physical (space) markets. As we continue to compile and analyze second quarter survey results provided by the institutional and regional respondents for the Summer 2002 *RERC Real Estate Report*, it appears that space markets may still be in decline. Vacancy continues to increase in most property sectors and in most of the 31 metro areas we cover due to increasing unemployment. In many areas, absorption is already negative while new space continues to come online. Clearly, demand has dropped, and until businesses expand their appetite for space, we can expect further contraction and deterioration in demand for industrial and office space.

On a national basis, the space markets for commercial real estate are weak, and most likely will remain so for the next several quarters. Most properties are past their peak where sustainable prices are above long-term fundamental values. Capital availability, both for debt and equity, remains at all-time highs and most money sources have been chomping at the bit to chase down deals that can withstand scrutiny from investment boards. Deal junkies have grappled with the conundrum on timing the market for each property type. This has resulted in a bid-ask spread that dried up investment activity late last year. The juggernaut has passed and deal flow is beginning as buyers and sellers are gaining better clarity on the direction of the market, albeit at substantially reduced expectations for property earnings.

Investment prospects for commercial real estate are nowhere near the levels seen during the tech craze that drove demand to unsustainable levels. However, RERC's quarterly investment survey results demonstrated overall improvement in the second quarter 2002 over the prior quarter for investment prospects. CBD office, retail power center, and hotel reflected the strongest gains. Relative to other property types, these categories had been hovering around the bottom. RERC is starting to unearth a fundamental element that investors are taking to heart—the greatest attribute that real estate possesses today is extremely favorable risk-adjusted returns. RERC predicts that the transaction market will lead the space market recovery. We will see deals increasing significantly by first quarter 2003.

Expected yields and overall capitalization rates are reported at historical highs relative to equal term government issues. Overall expected total yields for all commercial real estate in the first quarter 2002 was 11.8 percent versus 10-year treasuries at 5.0 percent, which results in a yield spread of 6.8 percent. This spread was one of the highest levels recorded since 1980. Confirming this are our second quarter results, which reflect a narrowing yield spread of 6.5 percent (see Table 1).

The same could be said for the comparison of overall capitalization rates (one-year rate) versus one-year treasuries—the comparisons are done to keep the analysis on an equal-term-structure basis.

Table 1

One-Year Expectation Real Estate Vis-a-Vis Capital Market Returns

	2Q2002	1Q2002	2Q2001	2Q2000	2Q1999	2Q1998
Real Estate Yield (%)	11.7	11.8	11.5	11.8	11.5	11.1
Moody's Baa Corporate (%)	8.1	7.9	8.2	8.6	6.9	7.3
Moody's Aaa Corporate (%)	6.8	6.6	7.4	7.8	5.5	5.6
10-Year Treasuries (%)	5.2	5.0	5.5	6.2	5.5	5.5
Yield Spread (percentage points)						
Moody's Baa Corporate (%)	3.6	3.9	3.3	3.2	4.6	3.8
Moody's Aaa Corporate (%)	4.9	5.2	4.1	4.0	6.0	5.5
10-Year Treasuries (%)	6.5	6.8	6.0	5.6	6.0	5.6

Source: RERC Investment Survey, Federal Reserve

Expected rates are ex ante or anticipated rates are different than realized or ex post rates. Comparing expected versus realized yields would suggest that expected yields should be lower today for certain acquisitions, even in the face of the current economic and financial situation. RERC would deem a spread of 5.0 percent above 10-year treasuries for a total real estate yield to be attractive for assets that possess extremely durable income streams, which would put an expected yield at 10.0 to 10.5 percent. This is for extremely solid properties, not run-of-the-mill assets around the corner.

RERC survey respondents are seeing some light at the end of the tunnel as well. The SEC is cleaning up the stock market, the U.S. has taken a firm stance on terrorism, and the consumer is vigilant with his or her purchases, which is a positive sign for the future of the economy. There are also positive markings for commercial real estate, including overall yield requirements that are starting to see downward pressure, more positive investment conditions ratings, and increased investor confidence about future prospects. As the economic recovery solidifies and business shakes off the dol-

drums, watch for hotels and apartments to improve first, and the office market to improve last as businesses adapt to changing needs.

RERC looks at the second quarter as the end (hopefully) of a difficult, although necessary, chapter in U.S. economic and political history. This past year has changed personal and business attitudes forever, but it is also a time that will allow us to move into a new era. When considering our prospects for the future, it is good to remember what Warren Buffet said, "There is nothing dumber than betting against America. It has not worked since 1776." REI

ABOUT OUR FEATURED COLUMNIST

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