Focus on Investment Conditions

Real Estate Deals with a World in Transition

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The world has always been an uncertain place, but the confidence of even the most sure-footed among us has been shaken during the last few years. The tech fall-out of the late 1990s, a recession, and a tumbling stock market were just the beginning. Then there was the loss of life on September 11, which has forever changed us as security against additional threats of terrorism takes center stage. With last year's accounting scandals, we lost trust in the financial markets as well as the review mechanisms charged with corporate oversight. And for the last 6 months, concerns about a war with Iraq and other geopolitical risks have disturbed us all.

It is clear that this uncertainty has had a serious effect on the U.S. economy. Poor corporate outlooks have prevented business from spending, and unemployment, while still relatively low, has been increasing. Although consumers continue to invest in housing, they remain cautious about other spending. There is fear that the uncertain economy will continue its malaise, even though the situation with Iraq has been addressed.

It is expected that the Federal Reserve will lower interest rates again in an effort to get the economy moving and that some version of the President's fiscal stimulus package eventually will be approved by Congress. For present, however, the slow economy continues its chokehold on the commercial real estate market, and until profit and loss statements begin improving and businesses begin hiring, hotels, office, apartment, and industrial properties will bear the brunt of low demand.

Office vacancies are already 20 percent or higher in certain areas, including central Florida, Dallas-Fort Worth, Memphis, Phoenix, Salt Lake City, San Francisco, and Boston. Real Estate Research Corporation (RERC) expects further cuts in rental rates and more concessions in 2003, with little or no growth for the near-term as companies continue to contract.

The stress of the space markets is showing up in commercial real estate's realized reported returns (NCREIF) that are single digit, at best, as the broad market takes value write-downs. Ironically, RERC's recent independent research shows expected return requirements for institutional grade commercial real estate continue lower. In fact, as detailed in the Winter 2003 *RERC Real Estate Report, A World in Transition*, this is the third consecutive quarter that RERC's expected one-year pre-tax yield rates have been flat to down for warehouses, R&D properties, CBD offices, suburban offices, regional malls, power centers, neighborhood/community centers, and apartments. Expected yield rates for hotels are up slightly over last quarter. The message here is that return prospects for all types of investments are not very promising and return requirements are being lowered and compressed as we enter a new economic and political era.

RERC strongly believes prices have peaked for most property types and it may

be time to take a more contrarian approach by looking for investment potential among those properties that have been beaten down and out of favor. Surprisingly, the places to look for re-priced assets are where delinquencies are the highest. Despite low interest rates, reports show that hotel loan delinquencies, especially among older, poorly located hotels, are the highest they've been since the early 1990s. Besides hotels, retail and suburban office properties in distressed areas have been taking a beating, and greater pressure can be applied for repricing. Apartments and industrial properties may still be overpriced, but can offer greater income stability for the future.

With respect to demand, RERC believes that the worst is yet to come since real estate lags the economy by up to 12 months, as demonstrated by the decline in profits for real estate investment trusts (REITs) last quarter—the first yearly decline in profits since 1993. This was led by multifamily REITs that had an average decline of 9.8 percent in the fourth quarter 2002, with an average of 1 percent for all REITs.

Rent and value growth expectations have dropped for all of the property types RERC tracks each quarter. One-year expected rental growth, after increasing last quarter, dropped 1.0 percent for suburban **office** and 0.9 percent for CBD office. Investors have lowered their required returns for office for those assets that have extremely strong, consistent cash flow. Overall office values are down in most markets, but continue to rise in some areas as investors continue to take advantage of lower interest rates. In fact, a couple CBD office properties in New York and Chicago recently traded at the highest price per square foot ever recorded.

Industrial properties remain high on investors' lists of go-to investments, but due to the contraction of business and the decrease of inventory, revenues will be down for the short run. RERC's current research shows one-year expected rental growth dropped 1.3 percent for R&D properties and 0.7 percent for warehouse properties. Required returns generally are steady or have seen an approximate 0.5 percent decrease due to lower interest rates.

Weak **retail** demand is anticipated for the rest of the year, and expected rental growth dropped 0.9 percent for regional malls, 0.8 percent for neighborhood/community centers, and 0.2 percent for power centers. With the slowdown in consumer spending and increased costs for security and terrorism insurance, expect retail vacancies to rise and more stores to close.

Despite weak demand due to the increase in homeownership and overbuilding during the last five years, investors still tend to look favorably upon the long-term outlook for the **apartment** market. For the present however, occupancy levels are at least 5 to 10 percent lower than a couple years ago. As a result, rental growth expectations for apartments fell 50 basis points.

Demand from the corporate segment is still weak for **hotels,** but rental growth expectations for hotels dropped only 0.1 percent. Luxury and the more independent urban boutique hotels continue to exhibit the greatest risk, as consumers remain conservative with their disposable income. Still, an active market exists for quality full-service properties, and based on revenue and occupancy expectations for 2003, values are expected to increase somewhere near inflation.

RERC sees this as a time of transition for the commercial real estate markets. We are adapting and beginning a period of correction, but unlike past corrections, the current real estate market appears fairly resilient. The year will be a trying time for real estate, but the lack of financial alternatives and the need for diversification makes commercial real estate extremely attractive in the short-term outlook. The long-term outlook will become less appealing as the stock market recovers and the economy gets back on track.

ABOUT OUR FEATURED COLUMNIST

Kenneth Riggs, Jr., CRE, *is chief executive officer of Real Estate Research Corporation (RERC). RERC offers research, valuation, 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 31 major U.S. markets through the quarterly* RERC Real Estate Report, *the annual* RERC Industry Outlook: 2003, *and the RERC DataCenter. (E-mail: riggs@rerc.com)*