FOCUS ON INVESTMENT CONDITIONS

INVESTORS WORK AT SEPARATING THE WHEAT FROM THE CHAFF

by Kenneth Riggs, Jr., CRE

Like much of the rest of the nation, Real Estate Research Corporation (RERC) continues to watch for signs that the economy is strengthening. Unemployment increases seem to be slowing, and the stock market appears to be gaining momentum. Low interest rates continue, keeping the housing industry chugging along while providing the economy with a boost and giving consumers either more housing choices or more dollars to save or spend elsewhere. Most analysts believe that consumer spending will increase and business hiring will increase as the various new tax credits and incentives come into play.

With a more positive outlook for the economy, investors are hoping to see some signs of improvement in the demand, or tenant side of the commercial real estate market equation, too. Investor unease as investment dollars grow and flow into a deteriorating space market would be put to rest if at least the space markets would move in tandem with the capital markets. This easing of the disconnect will not happen quickly through demand fundamentals, as we must remember that real estate lags the economy by 6 to 12 months and it will be some time before definite improvement is seen in this investment class. There are certainly opportunities for well-leased properties with solid fundamentals and in good locations, but in general, total delivered returns have not met expectations.

RERC has noted during the last few quarters, that institutional investors have begun lowering their total return expectations to match the financial markets and the observed signals being sent by investors trying to get deals done in the commercial real estate market. In fact, in the summer *2003 RERC Real Estate Report*, "Separating the Wheat From the Chaff," RERC reported lower expected pre-tax yield rates for all property types than any time during the last two years. Realized returns (returns reported by NCREIF) remain in the single digits as property values are being realigned to reflect the future market prospects.

A comparison of required total returns vs. realized total returns reflects that the two have yet to meet at a market equilibrium point. The confluence of pressures to push required total returns down and realized total returns up is at work, but these dynamics move too slowly in a technology-flush world that desires real-time information popping up on the screens of investors. We are in that frictional period where re-pricing, revaluations, and expectations change relatively slowly in a monolithic industry. The data is showing that slowly, over time, expectations are coming down, but most investors are vocal that they are too high to get deals done.

Over a 10-year average, all property types, except apartments and industrial R&D, show a negative variance between required total returns and realized total returns. Five-year returns look better, with industrial R&D properties, CBD offices, apartments, warehouses and power centers showing a positive variance between required and realized returns. Suburban offices, neighborhood and community centers, regional malls, and hotels, show negative variances between required and realized returns for a five-year time period.

However, a comparison between required total and realized total returns over the past one-year time period demonstrates that real estate expectations clearly are not matching market realities and shows how wide the current disparity is between sellers and buyers among all property types:

CBD office properties are showing a -6.17 percent one-year average variance between required total and realized total returns, and suburban office properties show a -10.04 percent variance over a one-year time period. The space fundamentals in this asset class are getting hammered and driving down rents, returns, and overall performance. Investors have a big pit in their stomach as they hope for space demand to return. If an investor can predict the cash flow performance (i.e., a fully leased building with long-term duration), return expectations are lower, but if it is a spotty asset with risk, expectations are not easily swayed. This asset class will continue to be characterized by fully leased properties that have value vs. properties with risky tenant structures (and who knows their value?). Re-pricing in the asset class has to come about through confidence in predicting where cash flows and values will be over the next several years.

Much like the situation with office properties, the one-year spread between total required returns and total realized returns for R&D properties is -9.25 percent. However, warehouse properties, which are expected to be one of the first property types to see improvement, shows a variance of only -3.88 percent between required and realized returns. For apartments, the property type generally considered to have the least risk, the one-year spread between required returns and realized returns is -2.15 percent. On the other hand, the gap between one-year required returns and realized returns for power centers is 5.63 percent, and 0.74 percent for regional malls, and 0.13 percent for neighborhood/community centers. Retail remains a highly volatile investment, but at least the variance between one-year required returns and realized returns is positive, indicating that many retail assets have already been re-priced and prices have become more centralized. Hotels have the greatest volatility of the major property types, with a spread of -10.61 percent between one-year required returns and realized returns.

Adjusting to the market realities at hand takes time in an industry that is slow to change its ways, but it is becoming clear that in most cases the real estate industry has to lower their expectations if they want to compete in today's low-return environment. This is not easy when market fundamentals are deteriorating at such a fast pace, and doing so requires making some difficult decisions.

The investment world is becoming a place where those properties that have or can unequivocally attract tenants have value, and those that suffer vacancy are being written down or written-off the list to buy. However, the fact that investors are separating the wheat from the chaff is a solid sign that the real estate industry is indeed growing into a credible investment vehicle. As the stock market rebounds, the economy grows, and given the current prices of properties, commercial real estate is less attractive today than it was 6 months ago, at least for those properties directly related to joblessness and it appears this will hold true for the next 6 months.

ABOUT THE AUTHOR

Ken Riggs, Jr., CRE, *is chief executive office 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 40 major U.S. markets through the quarterly RERC Real Estate Report, the annual RERC Industry Outlook, and the RERC DataCenter (E-mail:riggs@rerc.com).*