

FOCUS ON MARKET RETURNS

WHAT RETURNS WILL THE MARKET DELIVER?

by Raymond G. Torto, Ph.D, CRE



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In 2003 capital market positives and space market fundamentals negatives combined to lower real estate investor return expectations. Today, investors face both the challenge of sustaining net income and understanding the future pricing multiple on that income. Together these elements will determine future returns.

One question we have been asking at Torto Wheaton Research is what will be the average market returns that investors can expect. Certainly, looking back we know that these investors did well. But, as they say on Wall Street, past performance is not a guarantee of future performance.

CONTRIBUTIONS TO HISTORIC AND FUTURE RETURNS

One way to look at this question of what the market will return in the future is to not only look at total returns but to study the components of that return - going in yield, NOI growth, and cap rate changes.

Using the Torto Wheaton Research Investment Database, we have combined the four major "food groups" of retail, office, industrial, and multi-housing properties to examine historic information and to forecast what the market will deliver over the next five years as shown in Figure 1.

Historically, total return over the last five years averaged 13.5%. Looking at the components, lower capitalization rates accounted for 131 basis points of the total of 13500 basis points return, and we are sure that much of the contribution from capitalization rates came in the last two years. Importantly, yield and NOI growth (rents and occupancy increases) were the major contributors to the strong returns over the last five years.

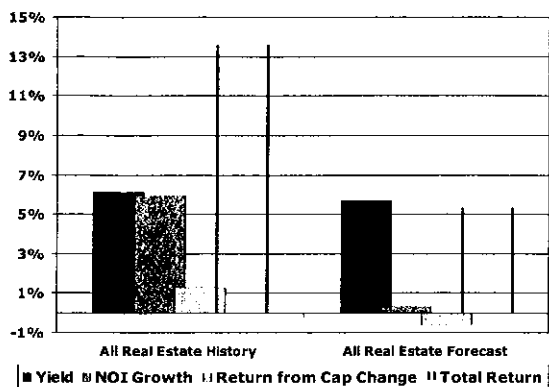
Over the next five years, investors should consider whether they expect to see NOI growth and capitalization rate compression repeat their performance of the last five years. We think not, and therefore our fundamentals forecasts and capitalization rate forecasts combine to give us a five-year return of just 5.3%.

It is the going in yield that contributes the most to the future return, with NOI growth flat and our capitalization rate forecast rising slightly and hence subtracting from return.

More important is the components to the historic and forecasted returns. Historically, we see that over the last five years there was tremendous run-up in NOI due to rent and occupancy increases. Additionally, there was about a

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Figure 1. Five Year Returns for Commercial Real Estate



100 basis point contribution to returns due to cap rates falling.

For the future our market return estimates are all provided by the going in yield. We have little hope of NOI growth from the market as we expect some roll down of NOI due to above market leases in place. And unlike the last five years we would expect some small rise in cap rates which will also reduce total return.

This market expectation is, again, for the real estate equivalent of the Russell 3000. However, better return estimates can be achieved for other portfolios and not one that reflects the overall market. For instance we get 9% returns for office investments which are positioning to ride up the market rents that are expected in future years rather than a ride down in NOI due to lease rollover. Essentially the difference between paying for income-in-place vs. buying vacancy as the bet!

The TWR analysis is based on a real estate portfolio that is akin to the Wilshire 3000. It is not an investment grade portfolio, or a NCREIF portfolio, which may be akin to the S&P 500. In other words, it is what the wider market will deliver. We are sure that real estate investment managers are making a difference in the outcomes. Remember, in real estate, alpha matters.

Figure 2. Total Returns for Office on Five Year Holds

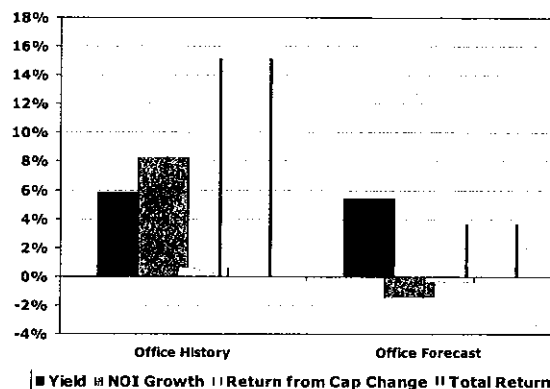


Figure 2 shows the historic and forecast total returns for a five year hold and also the components of that return for office space which is one property type that has certainly turned the corner on fundamentals as of the end of 2003. Based on the Torto Wheaton Research Investment Database we estimate the five year historic total return to be about 15%.

Again, the geographic and property mix in this portfolio is not the same as NCREIF. Going forward, if this office portfolio was assembled and purchased today at today's prices and on today's income in place, we would expect the market portfolio to return only about 4%.

The bottom line: real estate investors had a tail wind during the last five years, but are facing a headwind today! But the message is be careful, not chicken!

ABOUT OUR FEATURED COLUMNIST

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