FOCUS ON CAPITAL MARKETS

The Capital Markets Outlook Is Good—But What Can Go Wrong?

BY WILLIAM L. RAMSEYER, CRE

Editor's Note: The following commentary was excerpted from remarks made during the Capital Markets Panel at The Counselors of Real Estate Midyear Meetings in Charleston, S.C., in April 2006.

With the NCREIF property index averaging 11–12 percent over the past 10 years, availability of debt through an active commercial mortgage-backed securities market, growing foreign investment and aggressive bidding by pension funds, the capital market view today is euphoric. Real estate continues to generate competitive returns relative to other asset classes. As a result, the river of capital continues to flow. Our firm is active and typifies the major players in the business, having invested more than $1 billion in 2005.

Why is investment interest in real estate so persistent? Without question, we are living in a time of improved fundamentals, however real estate seems to be priced to perfection. Even with prevalent headlines about compressed cap rates, low cash flows and tumultuous world events, we've seen an upward bias in allocations from current institutional investors. Returns are usually in the 7–8 percent range; disappointing relative to the past, but to some institutional or offshore investors, it's a totally acceptable and relatively competitive range. In addition, investors are increasing their risk exposure by moving into value-added and opportunistic investments.

The influx of new investors allocating to real estate most likely is because of enhancements in transparency and disclosure. Historically, the real estate industry has been absolutely abysmal at transparency and disclosure, but when the public real estate investment trust, or REIT, market began its renaissance in 1995, and with the Sarbanes-Oxley Act of 2002, the amount of information available to the public has improved substantially. We can analyze real estate now. There are enough numbers around. Investors are more confident because the investment management industry has matured; it's been through several painful cycles.

If you look at the reasons why people are interested in real estate—returns, strong fundamentals, pricing, confidence, transparency—then you also have to ask yourself: Can the enthusiasm be dampened?

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About the Columnist

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ability to see what's next and adjust your course accordingly, so I offer these cautions:

- *Watch the other sectors*—We need to keep a close watch on what other asset class expectations are and try to anticipate how real estate on a relative basis will perform going forward. There are mounds of historical data, but not many scenario models are actively tracking and anticipating how real estate will play out going forward. What's happening with corporate profits? What's next in the bond market? How are the international global equity markets moving?

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- *Watch the fundamentals and cycles*—Real gross domestic product growth is a fundamental driver of jobs as well as occupancy of space. The last time we had negative real GDP growth, in 1991, is when we saw the beginning of some real problems for the real estate industry. Every year from 1988 to 1990 the industry put 100 million square feet of office space into the market, which led to about five years of vacancies above 18 percent. The NCREIF index had its best year last year at about 20 percent, and that's not sustainable.

- *Watch labor policy*—Liberal U.S. immigration policy has supported impressive growth in our economy. However, our country is struggling with immigration policy that might restrict job growth. This could definitely create some wide-ranging problems with our economy down the line.

- *Watch the balance between supply and demand*—The struggle to balance supply and demand for space has led to trouble in the past. One of the real blessings in our business today, though developers may see it as a curse, is that increased construction costs have exerted a dampening effect on the potential for oversupply. Because of the tremendous amount of capital going into real estate, there is a classic potential for overbuilding. Replacement rents coupled with high construction costs are keeping the volume of new construction down. When you start to see construction costs ease—or if you start to see market rents go up so everyone can start developing again—that could indicate a major problem on the horizon. We also are seeing some excesses in the condo sector that could cause reverberations in the debt markets going forward.

- *Watch operating costs*—Managing operating costs has arguably never been so important as cash flows are on the lower end of an accepted range. Investors go into real estate for good cash flows, and if operating costs rise, decreasing cash flows become a plausible area for concern.

- *Watch for a reduction in long-term investors*—We've been blessed in the past several years with long-term investor mentality. However, as we move into shorter and shorter investment timeframes, a bit of concern likely will arise. Many value-added and opportunistic funds have two-, three- and four-year horizons, which create great initial rates of return but have the potential to be volatile. Today we have the right market conditions, but if we continue shortening the time horizon, it could portend some problems.

- *Watch for reduced liquidity in debt markets*—We also could face challenges if there's reduced liquidity in the debt markets. A substantial number of lenders in the marketplace will lend you a lot of money, but if cash flows start to tighten for any reason, it's going to wreak havoc. Suggestion: Keep an eye on the lending policies and views of the major lenders.

- *Watch interest rates*—As interest rates increase, some money is going to be pulled out of real estate and into

> the fixed-income sector. If you study demographics and look at all the people in 50-something and 60-something age groups, the demand for income is very high. And if interest rates continue to rise, fixed-income investments are going to be increasingly attractive. Rate hikes will result in some investor equity, and eventually some money is going to be pulled out. I don't think we should discount the notion that increased rates may cause some changes in our business.

Euphoria should make us cautious. We have been assuming for too long that there will always be a viable capital market and sustainable liquidity. But be watchful and wary. We've seen this movie before. ■