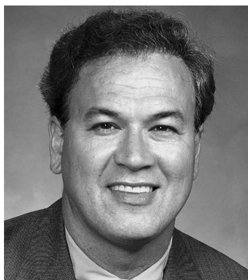
FOCUS ON INVESTMENT CONDITIONS

Managing Expectations in a Riskier World

BY KENNETH P. RIGGS, CRE



HALF WAY INTO THE YEAR, WE ARE ENJOYING A SURPRISINGLY stronger economy than many of us could have imagined only one year earlier. Despite a series of unexpected economic challenges during the past several years—including high deficits, critical terrorist attacks, accounting scandals, wars in Afghanistan and Iraq, high fuel prices, and last summer's hurricane damage to New Orleans and other communities along the Gulf Coast—the U.S. economy has not just survived, it has performed remarkably well. Gross domestic product is growing, job creation is strong, business investment is increasing, Americans are still shopping, and we citizens are wealthier than we have been in the history of this country. Further, some of the wealth lost after the tech bubble burst is finally starting to reappear in the form of improving stock returns. Even the housing market, which has slowed slightly from last year, continues to grow. Despite media reports about an impending housing bubble, home sales are on track for the third largest year on record, according to the National Association of REALTORS®.

Unfortunately, even in such strength, the risk affecting our economic growth—and commercial real estate returns—is growing as well. Long- and short-term interest rates are increasing. Inflation appears to be on the verge of taking hold. High fuel prices have resurfaced and likely will stay with us for a year or more. As a new government begins to take shape in Iraq, geopolitical risk seems to be increasing in Iran, North Korea and other parts of the world.

PREPARE FOR DECLINE IN CAPITAL APPRECIATION

In the commercial real estate arena, capital appreciation remained strong in the first quarter of 2006. However, the chance that the capital or appreciation component will reverse its trend is not merely likely, but inevitable. This risk will continue to mount through 2006 and into 2007 as capitalization rates experience upward pressure from rising rates and improving returns on alternative investments such as stock and bond markets.

This economic climate has prompted the Federal Reserve System to keep a watchful eye on the real estate market for the last year or two. The residential market has cooled in certain areas, but fundamental indicators in the commercial real estate market are generally positive. Demand remains strong, vacancy rates are declining and rents are

About the Columnist

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starting to edge upward. However, speaking to a convention of bankers in early March 2006, Fed Chairman Ben Bernanke expressed concern that the "rapid growth in commercial real estate exposures relative to capital and assets raised the possibility that risk-management practices" may not have kept pace with changes in the economy.

Therein lies the greatest advice for investors: Focus on true risk-management strategies. Heretofore, commercial real estate has done very little in this arena; the Real Estate Research Corporation agrees that investors who focus on competent risk-management strategies will be the winners going forward in commercial real estate.

STOCKS EDGE OUT COMMERCIAL REAL ESTATE

Though real estate returns remain strong, returns on other investments are certainly improving (see Table 1). In fact, RERC's first quarter research survey respondents gave stocks a slight edge over commercial real estate as an investment option. It was the second consecutive quarter that survey respondents rated stocks first, real estate second, cash third and bonds fourth among the major investment alternatives.

RERC's spring 2006 research respondents presented an interesting view of the investment climate for real estate. The majority of respondents stated that nearly all real estate was excessively priced. One respondent noted, "There is no 'best' investment anymore," and another said that investors must look for niche opportunities where they can buy at a price that makes sense. Another respondent suggested looking for long-term credit net lease properties because of low interest rates and an uncertain market.

Among the major property types, the industrial warehouse sector received the highest investment conditions rating (7.0 on a scale of 1 to 10 with 10 being high) for first quarter 2006; retail power centers received the lowest rating (see Table 2). In addition, the investment conditions for all three retail property types declined since the previous quarter.

Research findings indicate that capitalization rates have stopped declining and have stabilized at approximately 7 percent. RERC's first quarter 2006 required going-in capitalization rates are still inching downward for industrial research and development, retail regional malls and suburban office property types; but required going-in capitalization rates have leveled off or are increasing 10 to 20 basis points for the other property types RERC tracks. Further, terminal capitalization rates are stable or increasing for all major property types (see Table 3).

As the capitalization rate compression era comes to an end, a strong space market will become imperative to

Table 1

What Do The Financial Markets Tell Us?

Compounded Annual Rates of Return as of 3/31/2006

MARKET INDICES	1-YEAR	3-YEAR	5-YEAR	10-YEAR
Consumer Price Index	2.73%	2.37%	2.70%	2.79%
10-Year Treasury Bond*	4.36%	4.25%	4.42%	5.16%
Dow Jones Industrial Average	5.77%	11.60%	2.54%	7.11%
NASDAQ Composite	13.29%	19.48%	2.97%	7.73%
NYSE Composite	13.16%	20.34%	5.23%	8.43%
S&P 500	9.68%	15.14%	2.22%	7.21%
NCREIF Index	20.19%	15.15%	11.80%	12.30%

*Based on Average End of Month T-Bond Rates
Sources: Economy.com, NCREIF, compiled by RERC

Table 2

Investment Condition Ratings

Rated on a scale of 1 to 10, with 1 being low and 10 being high.

PROPERTY TYPE	1Q2006 RATING
CBD Office	5.9
Suburban Office	6.0
Industrial Warehouse	7.0
Industrial R&D	5.9
Regional Retail Mall	5.7
Retail Power Center	5.5
Neighborhood/Community Retail	6.0
Apartment	6.4
Hotel	6.0

receive moderate returns. Decreased vacancy rates, increased absorption, restrained new construction and rent increases will be critical.

OFFICE SECTOR REMAINS STRONG

The national office market remains relatively strong overall from a fundamentals perspective. Demand continues to increase, the national vacancy rate continues to decline and new construction has been restrained. Torto Wheaton Research reports that the national CBD office vacancy rate has declined to 11.6 percent and the national suburban office vacancy rate declined to 14.5 percent. The Washington, D.C., New York City, Miami, San Diego and Los Angeles metro markets have some of the lowest office vacancy rates in the country; the highest office vacancy

Table 3

RERC Required Return Expectations[1] by Property Type

	OFFICE		INDUSTRIAL		RETAIL						
	CBD	Suburban	Warehouse	R&D	Regional Mall	Power Center	Neigh/Comm	Apartment	Hotel	Avg. All Types	RERC Portfolio Index
PRE-TAX YIELD (IRR) (%)											
Range	7.3-11	7.3-11.5	7.0-11	7.5-11.5	7.0-11	7.0-11	7.0-11	7.0-10	9.5-12	7.0-12	7.0-12
Average[2]	8.6	8.9	8.6	9.2	8.8	8.5	8.6	8.5	10.8	9	8.7
Weighted Average[3]	8.8		8.6		8.7						
GOING-IN CAP RATE (%)											
Range	5.0-9.0	6.3-9.5	5.8-10	6.5-10	5.5-9	6-8.8	5.0-9.0	5.0-9.0	7.5-10.5	5-10.5	5-10.5
Average[2]	7	7.3	7	7.6	7	6.9	6.9	6.4	8.5	7.2	7
Weighted Average[3]	7.2		7		7						
TERMINAL CAP RATE (%)											
Range	6.5-10	6.8-10	6.5-10.5	7-10.5	6.3-10	6.8-9.5	6.5-9.5	6-9.5	8.0-11	6.0-11	6.0-11
Average[2]	7.6	8	7.8	8.3	7.8	7.6	7.6	7.2	9.4	8	7.7
Weighted Average[3]	7.8		7.8		7.7						
RENTAL GROWTH (%)											
Range	0-6	-6.5	0-6	0-6	2.0-4.0	2.0-4.0	2.0-4.0	0-5	1.5-5	-7.5	-7.5
Average[2]	3.4	3.2	2.8	2.7	2.8	2.9	3	3.1	3.2	2.9	3.1
Expense Growth (%)											
Range	2.0-4.0	2.0-4.0	2-3.5	1.5-3.5	2-3.5	2.0-4.0	2.0-4.0	2.0-4.0	2.0-4.0	1.5-4	0.5-4
Average[2]	3	3.1	2.8	2.7	3	3.1	3.1	3	3	3	3

[1] This survey was conducted in January, February and March 2006 and reflects expected returns for First Quarter 2006 investments.
[2] Ranges and other data reflect the central tendencies of respondents: unusually high and low responses have been eliminated.
[3] Weighting based on 1Q06 NCREIF Portfolio market values.
Source: Spring 2006 RERC Real Estate Report

rate among major metropolitan areas is in Dallas at more than 23 percent.

RERC's first quarter 2006 required going-in and terminal capitalization rates for the CBD office sector increased 20 and 10 basis points, respectively, compared with the previous quarter. However, the required going-in capitalization rate for the suburban office market declined another 10 basis points, and the terminal capitalization rate remained stable.

First quarter 2006 expected rental growth is higher, by percentage, for the office market than for any other property sector RERC tracks. According to RERC's institutional survey respondents, rental growth is expected to increase 3.4 percent for the CBD office market and 3.2 percent for the suburban office sector.

INDUSTRIAL SPACE DEVELOPMENT OFFSETS DEMAND

New development and construction of industrial space is offsetting strong demand, slowing the decline in industrial availability rates. Nonetheless, Torto Wheaton Research reports that the national industrial warehouse availability rate stands at 10.1 percent and the industrial R&D availability rate is 14.4 percent. The port cities and high population growth cities such as Los Angeles, Miami, Tampa and Las Vegas show the lowest industrial availability rates; Pittsburgh, Detroit and Boston have the highest availability rates.

RERC's required going-in and terminal capitalization rates for industrial warehouse space began increasing during first quarter 2006. The required going-in capitalization rate for industrial R&D space declined another 10 basis points from last quarter, and the required terminal capitalization rate remained flat at 8.3 percent.

RETAIL AVAILABILITY BEGINS TO INCREASE

Considered the darling of property types during the past few years, the increase in new retail construction will place upward pressure on the availability rate for this sector in the coming quarters. In fact, on a national level, first quarter 2006 retail availability has already started to increase, partially because of new construction outpacing demand. The Midwest states have the highest retail availability rates; coastal markets have some of the lowest retail availability rates recorded.

A summary of risk factors to determine the best investment strategy:

- *Space markets improving*—Shift to shorter durations of leasing time with pricing power.
- *Capital market pushing capitalization rates and total returns up*—Shift to properties that experienced the least amount of rate compression and have growth potential.
- *Financial market returns increase*—Move out of tactical and cyclical investment arenas.
- *Economic climate increasingly uncertain*—Shift to industries and properties that have pricing power.
- *Overall investments*—Move to more of a value-added-strategy, rather than a core strategy from a risk-adjusted return perspective.

RERC's institutional survey respondents reported mixed results for the retail sector in first quarter 2006. Required going-in capitalization rates for regional retail malls declined 20 basis points from last quarter, remained flat at 6.9 percent for retail power centers and increased 10 basis points for neighborhood/community centers.

APARTMENT CONSTRUCTION SPURS SLIGHT HIKE IN VACANCY RATES

New apartment construction continues, with the majority of new building occurring along the East and West coasts—areas that also have experienced some of the greatest capital appreciation and major condominium conversion. Much of the new apartment development should come online in 2007 and 2008. As such, first quarter 2006 apartment vacancy rates increased to 5.8 percent from 5.7 percent the previous quarter, according to Reis Inc. The slight increase in the overall vacancy rate is the first increase since 2004 for the apartment sector.

RERC's first quarter 2006 required going-in capitalization rate for the apartment sector increased 10 basis points from the previous quarter; the required terminal capitalization rate holds at 7.2 percent.

HOTEL SECTOR EXPERIENCES UPTICK

Though the hotel sector is considered the riskiest of the core property sectors, it has the most pricing power and

upside investment potential in today's market. According to Smith Travel Research, hotel occupancy increased 3.8 percent and revenue per available room, or RevPAR, increased 10.7 percent in early 2006.

RERC's first quarter 2006 required going-in and terminal capitalization rates for hotels increased 10 basis points in last quarter. RERC's expected rental growth for hotels declined to 3.1 percent in first quarter, 70 basis points lower than last quarter and 130 basis points lower than two quarters ago, suggesting that some of the growth momentum will slow for this sector. Expense growth has remained relatively flat during this time period.

CONCLUSIONS

- In this very strong economy, various risk factors—which require appropriate management—will challenge the ability to maintain expected returns on real estate. In the capital market, low capitalization rates are causing real estate prices to climb and are driving up risk. However, investors can still rely on real estate to cushion their portfolios, and should pursue properties with reasonable capitalization rates within low-vacancy areas.
- In today's investment environment, real estate assets with long-term, fixed-rate leases are likely the riskiest investment. Savvy investors are paying premiums for assets with near-term rollover and quality assets with vacancy problems. This investment strategy provides investors with the ability to generate quality returns through increased rents and decreased vacancies, as returns generated from decreasing capitalization rates are rare.
- Double-digit returns should continue through 2006, as commercial real estate likely remains a favorable investment. The retail sector, which served as a leading indicator in the real estate run-up, is now the first sector to begin cooling off, though still recording a strong 18.8 percent return. In the coming months, the total return associated with the retail sector should continue to decrease at a steady and measured pace.
- Overall, the investment demand associated with commercial real estate remains strong and should remain so as the world continues to shrink. The U.S. real estate market has attracted significant investment attention from the global market, which is not surprising given the high prices paid and the low cash-on-cash returns generated in some overseas markets as well as the attractiveness of the U.S. economy and real estate market. ■