FOCUS ON THE INVESTMENT CONDITIONS

Economic Resilience Paves Way to Good Times for Commercial Real Estate

BY KENNETH P.RIGGS, CRE

THE FLEXIBILITY, CREATIVITY AND RESILIENCY OF THE CAPITAL markets and the economy all came into play during 2006 to place the economy in a better year-end position than most pundits had anticipated. With a decreased threat of inflation, substantially lower oil prices, strong employment, signs of improvement in the residential real estate market, huge levels of liquidity and low long-term interest rates in the capital markets, and the stock markets at near-record highs, the economy was in a very healthy condition as the year ended. As such, the economic and capital market landscape for 2007 is starting off with even more positives than 2006.

The economy is operating at a more efficient and effective level than in past cycles; business and consumers are holding strong and investment returns are continuing to gain. Look no further than the markets at year-end 2006: the Dow Jones Industrial Index surpassed the 16 percent mark, the NASDAQ Composite Index rose more than 10 percent, and the S&P 500 Index was up more than 14 percent. And for the seventh straight year, real estate funds were the year's top-performing U.S. stock sector, up more than 34 percent, according to the Lipper average, with 12-month trailing returns of approximately 18 percent as reported by the National Council of Real Estate Investment Fiduciaries Index.

This kind of performance, along with cheap debt and the amount of capital flooding the market, led to a record number of mergers and acquisitions in 2006. Thomson Financial reports a total of $3.79 trillion in M&A activity worldwide and 55 transactions valued at more than $10 billion each. Private equity firms were involved in five of the top 10 largest transactions in the U.S., including the planned sale of Equity Office Properties to Blackstone

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Group for a record-breaking $36 billion. With so much capital available and interest rates remaining relatively low, M&A should continue at this level into 2007 unless public market investors fight back.

Real Estate Research Corp. expects the M&A activity for control of commercial real estate assets to continue between the public and the private real estate markets. As you may recall, during the commercial real estate depression of the 1990s, just a little more than 10 years ago, there was a liquidity crisis with no debt or equity capital to be found, so big real estate companies sought relief in the public capital markets for debt and equity. As a result, most large private real estate holdings went public and formed real estate investment trusts to access capital.

Today, because of the deluge of domestic and global capital across all spectrums—and the inability of public companies to be hamstrung by the use of lower leverage and very watchful shareholders and regulators—private capital sources with huge pocketbooks are buying public companies and REITs. This scenario is especially true for investors who are willing to pay more for commercial real estate assets than the public REIT market is willing to price shares. Even Sam Zell is selling because of these capital market realities. The National Association of Real Estate Investment Trusts reports that REITs were involved in deals worth $117.8 billion in 2006, nearly four times as much as in the previous two years combined.

This backdrop brings a luster to private commercial real estate that hasn't existed in some time. In fact, 2006 may well have been the strongest year for real estate pricing in several decades. The question is, will this cycle of cheap money continue in 2007? Will real estate retain its attractiveness? Is the private market "right," and for how long?

Table 1

RERC Required Return Expectations[1] by Property Type

	Office		Industrial		Retail						
	CBD	Suburban	Warehouse	R&D	Regional Mall	Power Center	Neigh/ Comm	Apartment	Hotel	Average All Types	RER Portfolio Index
Pre-tax Yield (IRR) (%)											
Range	7-10.5	7.3-10.5	7-10.5	7.3-10.5	7-11	7.3-11	6.8-11	7.3-10	9-11.5	6.8-11.5	6.8-11.5
Average[2]	8.5	8.9	8.5	9.1	8.5	8.6	8.5	8.2	10.6	8.9	8.6
Weighted Average[3]	8.7		8.5			8.5					
Going-In Cap Rate (%)											
Range	5.5-8.5	6-8.8	5-8.5	6-8.8	6-9	6.3-9.5	6-9	5-8	6.5-10	5-10	5-10
Average[2]	6.8	7.2	7	7.5	7.1	7.1	7	6.3	8.6	7.2	6.9
Weighted Average[3]	7.0		7.0			7.1					
Terminal Cap Rate (%)											
Range	6-9.1	6.5-9.5	6.5-9	6.8-9.5	6.3-9.5	6.5-9.8	6.5-9.5	5.8-9	7-10.5	5.8-10.5	5.8-10.5
Average[2]	7.5	7.9	7.6	8.1	7.5	7.6	7.5	7	9.3	7.8	7.6
Weighted Average[3]	7.7		7.6			7.5					
Rental Growth (%)											
Range	0-5	0-5	0-4	0-4.5	0-3.5	0-3.5	0-3.5	0-5	0-4.5	0-5	0-5
Average[2]	3.2	3.1	2.7	2.7	2.6	2.7	2.7	3.3	2.8	2.8	3.0
Expense Growth (%)											
Range	0-3.5	0-3.5	0-3.5	0-3.5	0-3	0-3.5	0-3.5	0-3.5	0-3.5	0-3.5	0-3.5
Average[2]	2.8	2.8	2.7	2.7	2.7	2.7	2.8	2.8	2.6	2.7	2.8

[1]*This survey was conducted in July, August, and September 2006 and reflects expected returns for Third 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 upon 2Q06 NCREIF Portfolio market valuesSource: RERC Investment Survey*
Source: RERC, as published in the fall 2006 RERC Real Estate Report.

Table 2

National Transactions by Property Type

	OFFICE	INDUSTRIAL	RETAIL	APARTMENT	HOTEL	TOTAL
Volume ($ million)	$172,132	$44,414%	$65,618	$107,351	$35,866	$425,381
UNIT PRICE						
Average	$172	$84	$177	$109,193	$111,863	—
Median	$139	$67	$126	$87,500	$82,776	—
RERC ESTIMATED CAPITALIZATION RATE (%)						
Range	4.7-10.3	5-10.6	4.7-10.1	3.9-9.5	6.2-12	3.9-12
Average	7.2	7.4	7.0	6.3	8.8	7.4

Unit prices based on data derived from samples of commercial transactions on local, regional, and national levels.
Capitalization rates based upon available transaction information, survey respondents, and NCREIF Index Returns.
Source: RERC, as printed in the first quarter 2007 RERC/CCIM Investment Trends Quarterly *flash report. Content cannot be duplicated or reproduced without expressed written consent of RERC.*

RERC suggests that the private market is *right*—at least for the next few quarters and probably for a few years. Despite the risks—and there are risks, as with any investment—expect interest rates to remain low and capital/credit to be readily available. Employment should remain relatively strong, energy prices should remain reasonable and the residential real estate market should stabilize. Real estate fundamentals should continue to strengthen, and if new construction remains in check, real estate returns should be competitive on a risk-adjusted basis for 2007.

Investors continue to decrease their return requirements (see Table 1). Required pre-tax total yield rates are generally in the mid-8 percent range for the office, industrial, and retail sectors, with required pre-tax total yield rates slightly lower for apartments and 10.6 percent for hotels.

RERC's required capitalization rates inched slightly downward for nearly every property type, bringing investors' required capitalization rates more in line with transaction-based capitalization rates (see Table 2). Even so, these capitalization rates have moved little from the previous quarter, which is primarily a function of continued strong investor demand, availability of capital, and low risk-free rates.

RERC's institutional survey respondents expect office to remain one of the better-performing sectors in the commercial real estate market because of limited new construction and continued job growth. Apartments also are likely to perform well in the short term because of increasing rental rates and a slower housing market. Some survey respondents predict that retail could be the worst performer because of low consumer spending, overpricing and tenant risk. Others say hotels will be the worst-performing sector because of overbuilding and overpricing.

Opinions about the industrial market are mixed. Some respondents believe industrial properties have the best prospects, given that increasing land and construction prices limit building and put constraints on current supply. But others note the slowdown in manufacturing and predict industrial properties eventually will suffer.

The year 2006 was a period when commercial real estate outstripped and exceeded all investor expectations with record deals and prices. 2007 will be another interesting time for commercial real estate, as we adjust to fundamental changes that occurred in the past year and will affect our industry for the foreseeable future. During the coming months, RERC anticipates that:

- Most economic threats related to high oil prices, inflation, a housing bust and the potential of a recession are behind us; 2007 should be balanced with less risk of recession.
- The economy will grow at a pace of around 2.5 to 2.75 percent, more than 1.5 million new jobs will be created and the inflation rate will be low.
- It is more likely that the Federal Reserve System will lower rates in 2007 compared with 2006.
- Capital markets will be flush and will continue to provide money at very favorable rates. Long-term rates should stay low or even fall somewhat in 2007.
- Commercial real estate markets will continue to strengthen, allowing office and industrial properties to gain some rental rate pricing power.
- Retail properties will face the greatest challenge in 2007 among the primary property types, given their spectacular run in rents, prices and transaction volume through the past several years.
- The private market's appetite and ability to leverage commercial real estate will continue to allow it to take assets from the public market.
- Realized or reported/transaction-based returns will come down from unsustainable levels and start to gravitate toward expected or required returns.
- Investors will continue to climb up the risk spectrum in search of higher real estate returns as they venture into smaller markets and broaden their definition of an acceptable real estate investment.

We all have been through cycles before, but somehow this one appears to be different. The outlook for commercial real estate is optimistic in the short- to medium-term because of the sustained period of favorable dynamics. This time we have highly skilled captains at the helm, and they have sophisticated investment tools at their deposal, watchful eyes overseeing their decisions and lifelines—if they need to use them.

There still is a chance that the market could cool because capital has gotten slightly ahead of itself, but we are nowhere near a major commercial real estate price correction. Pricing levels should stabilize, and cap rates should finally stop declining.

Overall, it will be a year for investors to count their booty and assess the strategic position of their real estate portfolios. However, 2007 is not a time to be greedy and, in the long run, the entire industry will be better off if investors