FOCUS ON INVESTMENT CONDITIONS

Investment Prospects Still Bleak, but Hope is on the Horizon

by Kenneth P. Riggs, Jr., CRE

If the fall of the tech sector, the September 11 terrorist attacks, and the decline in the stock and bond markets weren't enough, now investors have to deal with doubt associated with the financial scandals accompanying industry giants like Enron, Global Crossing, Arthur Andersen, and Waste Management. It's no wonder that real estate as an investment looks good by comparison, despite the millions of square feet of office and industrial space dumped back into the market. As reported in the winter 2002 issue of the *RERC Real Estate Report*, "at least commercial real estate deals involve tangible assets that are what they are and cannot be masked in accounting mumbo jumbo."

In addition, real estate finds itself in a much stronger position during this slowdown than it was in during the recession of the early 1990s. First, although commercial real estate vacancies are high, the supply vs. demand equation is more balanced than it was 10 years ago. New construction has slowed, and some older and nearly obsolete commercial buildings are being taken out of the market. Secondly, the public market display of real estate equities and debt is being carefully watched by analysts, rating agencies, and investors, offering a level of transparency that was unavailable 10 years ago. Finally, commercial real estate is not over-leveraged, and there is liquidity at a price.

That's not to say that investing in real estate is without risk. While real estate may be positioned better than other investment vehicles to withstand the uncertainty brought on by this economy, there are many factors negatively affecting returns. Safety and security—issues brought to the forefront after the terrorist attacks last fall—are detracting from performance as building owners (at least initially) absorb the expenses associated with securing office ventilation and water systems, setting up electronic surveillance equipment, and/or evaluating mail handling processes. Further, there have been numerous reports of property and casualty risk insurers charging 40 percent to 300 percent more per premium than a year ago. Such increases in expenses, along with a noticeable downward shift in the amount of space that many businesses are requiring in this tenants' market, all factor into reducing values.

Another concern is the fact that 45 of our 50 states are facing budget deficits. Since many states cannot operate at a deficit level and have already been making drastic cuts in services, they will have little choice but to raise taxes (either sales or property taxes, or both). States like Pennsylvania and Illinois are already freezing various growth management initiatives, while Utah and Wisconsin are cutting grants and other funds for open space purchases or preservation. Property owners, however, are lodging their own wars to have real estate taxes reduced in the face of declining property values. This creates

a conundrum for states and property owners which can lead to the eventual decay in the quality of services available in various communities.

Although there are many issues the real estate industry must deal with in 2002, there are also reasons to be optimistic. Foremost is the ongoing consumer need for typical old economy purchases like homes, automobiles and parts, furniture, appliances, and other household goods. Consumers are still spending on these items, albeit modestly. In addition, although new unemployment is still occurring, some industries, like the airlines, are beginning to re-hire some of the workers laid off last fall. Even Congress has entered the picture by passing an economic stimulus package that allows businesses to take a 30 percent tax deduction in the first year on the cost of leasehold tenant improvement projects undertaken during the next three years.

And as reported in the winter 2002 issue of the *RERC Real Estate Report*, there are some solid real estate investment opportunities for the year ahead:

- **Core debt lending.** Underwriters are carefully being watched and monitored, and although real estate returns aren't huge, core debt lending is safe compared to other investments.

- **Leveraged-equity positions.** Risk-adjusted total returns of 15 percent or more are available with leveraged-equity positions for capital-starved property types in some markets.

- **Re-priced class A apartments.** Lower rents and higher vacancies today should lead to opportunities later in the year as these properties are re-priced.

- **Well-located class B apartments.** Current market conditions and the expectation that economic recovery will be slow make class B apartments a safe bet.

- **Leverage equity assets.** Throwing cheap debt on an existing well-leased 100 percent equity asset or portfolio can work to your benefit if you can accept leverage.

- **Class A- office properties.** Class A+ offices will not be offered for sale at bargain prices and class C is not a good deal, but finding something in between, especially in battered markets like San Francisco, Boston, and New York, could prove profitable.

- **Well-leased commercial real estate.** With 10-year treasuries at historical lows, the spread between commercial real estate yields and treasuries makes commercial real estate more attractive today than 10 years ago. Unfortunately, the upside for asset and rent growth is not there as it was in the last recession.

- **Commercial mortgage-backed securities (CMBS).** B pieces and unrated tranches of CMBS offer high risk-adjusted rates of return, although there are only a few players.

Although I anticipate choppy waters ahead for the next few quarters, commercial real estate is poised to weather the storm. An economic recovery is underway, the stock market is beginning to rebound, and the housing market remains strong due to demographics and low interest rates. As the economy continues to strengthen and market fundamentals solidify, those with plenty of capital will be ready to make their move into those areas where demand is increasing, probably in early 2003. Given recent news events, however, it is important to add that the entire U.S. economic recovery can be derailed in an instant and the outlook would change if the violence in the Middle East intensifies, if an oil crisis develops, or if there are additional widespread terrorist attacks—all of which could lead to a global recession. REI

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