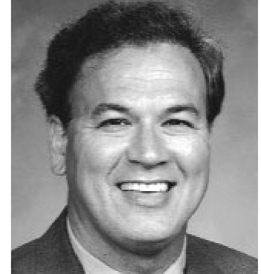
FOCUS ON INVESTMENT CONDITIONS



Value Risk Management Key in this Economic Landscape

BY KEN RIGGS, JR., CRE

TO HEAR THE ELECTION-YEAR RHETORIC, ONE WOULD THINK the U.S. is mired in double-digit unemployment and that all our jobs are on the verge of being shipped offshore to workers in China or India for less than half of what U.S. workers are being paid. While we know that picture is inaccurate, it is true that the U.S. has lost over 2 million jobs since the recession began in 2001. However, we've cut that number in half during the last few months, and expect this trend to continue.

And to quote Paul Harvey, "the rest of the story" shows that at 5.6 percent, America's long-term unemployment rate remains the lowest among all the Western countries. In fact, our near-95 percent employment rate, along with continued strong GDP growth, rising manufacturing activity and business investment, a recovering stock market, record home sales, and other positive indicators show that the economic recovery is well-underway. In addition, an accommodative Federal Reserve has kept the federal funds rate low and the President has signed a series of tax cuts and refunds designed to stimulate consumer and business spending. Now that we've seen the successes of these stimuli, along with the fortitude of U.S. business, are joblessness and a slow economy only bad memories? Or is the job situation and economic risk, especially as they relate to real estate returns and values, still tenuous?

WHAT'S DIFFERENT IN THIS ECONOMIC CYCLE?

Some lingering joblessness and economic risk is to be expected after any recessionary period. However, there are a number of key factors affecting jobs in this economic recovery that did not impact previous recessionary cycles. The most critical factor among these is exceptionally strong productivity. As noted last fall in our forecast report, *Expectations & Market Realities in Real Estate: 2004*, produced by Real Estate Research Corporation (RERC), Torto Wheaton Research, and Principal Real Estate Investors, we saw a significant likelihood that strong productivity would continue throughout 2004, resulting in low to moderate job growth. With productivity averaging 4.5 to 5 percent annually, and with each percentage point of productivity growth estimated to eliminate up to 1.3 million jobs, as outlined by the Bureau of Labor Statistics (BLS) and Forrester Research, Inc., some have commented that we were being too productive for our own good. We believe productivity increases will continue at this rate, as technology is further applied to business processes, additional jobs are outsourced, and corporate mergers continue.

Secondly, it is likely that there have been more jobs being created in this economy than were being reflected by the U.S. Census Bureau payroll/establishment survey. U.S. Treasury Secretary John Snow pointed out that a recent BLS household survey showed a gain of 2.4 million jobs since January 2002, although the BLS payroll/establishment survey showed a cumulative decline of 341,000 jobs over the same period. The household survey factors in critical employment characteristics not included in the establishment survey, such as self-employment, individuals on unpaid leave, and the development of new small businesses. Small business guru David Birch says that "the gazelles" (small businesses) create significantly more jobs than large businesses, noting that for the period 1994 to 1998, the largest firms lost 2 million jobs while during the

same time, small companies created 10 million jobs. Birch believes small business drives the nation's economic growth even more today.

In addition, having been burned by recent corporate and accounting scandals and falling stock prices, companies are more cautious and focused on the bottom line. Besides further streamlining processes and avoiding geopolitical and economic risk, they are seeking to minimize their biggest expense—labor—along with the associated overhead costs of healthcare benefits and pension contributions. According to the U.S. Department of Commerce, such measures are holding down price increases while boosting corporate profits by $223 billion in 2003. This means that companies that have already gained all they can from internal efficiencies may look to outsource some labor costs to further maximize profit, but this creates opportunities for more small business growth.

Contrary to the political clamor, shipping certain types of jobs overseas actually benefits the economy, and adopting reactionary isolationist policies now would likely hamper U.S. job growth. Management expert Peter Drucker reminds us that the U.S. imports two to three times as many jobs as it exports. Often referred to as the "second wave of NAFTA," the U.S. is importing primarily high-skill, high-paying jobs, such as German or Japanese automobile manufacturing, drug research, and banking, while exporting basic manufacturing, clerical, simple programming, or routine service jobs. According to the Organization for International Investment, even the states complaining the loudest about outsourcing are benefiting from importing jobs. Ohio imported 242,000 jobs, Michigan brought in 244,000 jobs, and Pennsylvania imported 267,000 jobs, comprising approximately 6 percent of their respective workforces. In fact, new foreign direct investment in the U.S. increased by a record $82 billion in 2003.

INVESTMENT FORECASTING NOT FOR THE FAINT OF HEART

So how will job growth affect commercial real estate investment throughout 2004? At present, space market fundamentals are finally bottoming out, and commercial real estate is still delivering a reasonable level of total return as compared to stocks, which recently caught up to their pre-2000 levels. But with no home runs in sight, it is more important than ever to incorporate sound risk management as it relates to value preservation to successfully navigate the markets.

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Looking ahead, no industry is demonstrating the kind of growth that requires significant new property outlays, although some industries such as energy, biotech, nanotech, telecom, and security are showing potential. For present, however, returns on office investment remain depressed, and yields on industrial properties are challenged. Apartments are oversupplied, but returns are expected to improve as jobs trickle in and interest rates begin to move up. Retail returns look good right now, but their sustainability is uncertain, especially if consumer purchases and retail sales are reduced due to the high cost of energy and other commodities.

It appears that secular capital will remain committed to the industry, while cyclical capital will move out of commercial real estate. This will relieve some unwanted capital

About our Featured Columnist

Kenneth Riggs, Jr., CRE, is chief executive officer of Real Estate Research Corporation (RERC). RERC offers research, valuation, independent fiduciary services, portfolio services, corporate advisory services, litigation support, and other real estate-related consulting services. RERC also provides research, analysis, and investment criteria (cap rates, yield rates, expense and growth expectations, recommendations, etc.) for nine property types on a national and regional level and for 40 major U.S. markets through the quarterly RERC Real Estate Report*, the annual* Expectations & Market Realities in Real Estate*, and the* RERC DataCenter.

pressures, however it will also create downward pressure on prices and increase the probability of write-downs.

As the stock market rebounds from the losses of a few years ago, household wealth has hit a new peak of $45 trillion, due primarily to the strength of the housing market and low interest rates. Consumers have stood firm during the slow economy, but the question is, are they durable enough to continue doing so as interest rates kick in, inflation occurs, and energy prices go up? Will retail sales begin to suffer, along with returns on retail property investment? And assuming that jobs continue to increase, how does one manage the risk on office, industrial, apartment, and hotel property investment?

Based on RERC's required risk-adjusted returns for real estate, investors should:

- **Steer clear of speculative office investment.** U.S. office vacancy rates will remain relatively high in most areas. As a result, NOI will continue at or below current levels.
- **Expect downward pressure on rents, as industrial vacancy rates will remain relatively high.**
- **Expect office and industrial space to be utilized in smaller portions, often in secondary markets or suburban areas, since most new jobs are created by small business.**
- **Rents will begin improving later in the year as jobs continue to grow and demand increases.** As job growth continues, apartments will be the property type most likely to stand out.
- **Keep an eye out for signs that consumers might be unable to sustain their current purchasing power.** Retail continues to offer the best returns for the near term, with average retail rents stable to increasing as consumers continue to buy.
- **Watch for hotels to rebound strongly as business travel picks up and safety fears subside.**
- **Anticipate that certain property types will be exposed to greater value and risk, given the economic, space, and capital markets forecasts.** ■