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The Good,

Working through these unprecedented times has generated a search for new terms. Although Real Estate Research Corp. noted the commercial real estate market's bifurcation in 2010, this new year brings further division in the economy and the commercial real estate industry.

The 2011 market can best be described as "trifurcated," with three clear divisions. The good: Quality properties are selling at high prices in the best markets; The bad: Distressed properties are selling at a fraction of prices fetched in 2007; And the unknown: The rest of the properties seem to attract no interest, are not being re-priced, and are not seeing any urgency from lenders or investors.

The unknown has the market on edge: Only time will unveil how the rest of the market plays out — and even that process makes investors nervous. But there is no other solution: It is going to take time for the market to reach broad stabilization, and the process will be painful.

Life in a Three-Way Mirror

The trifurcation is not only in the real estate market; it is palpable in many areas of life. The economy is divided among the Federal Reserve Board and its monetary policy decisions, the government and various fiscal policies, and the rest of us as businesses and consumers trying to operate in the midst of these policies and decisions. Even the employment situation is divided among those who have a great deal of confidence in their jobs, those workers who have jobs but have a great deal of uncertainty about them, and those who do not have a job or much confidence in acquiring one.

The investment world also is trifurcated. Wall Street and the investment banks are mostly past the financial crisis, the regional and community banks are working their way through their troubled loans, but the remaining banks on Main Street have yet to face the market's brutal realities. Investors themselves also are separated into

three distinct groups: those with ready access to capital who can and will pay any price for properties, those with access to capital but with limitations, and those for whom credit is not yet available.

And then there is the trifurcation of commercial real estate quality. Those top-tier properties in the best locations command the highest prices and the highest rents. The distressed properties in overbuilt markets see little demand except at rock-bottom prices. Finally, there is a wide range of average properties in small-town America where buyers, sellers, and lenders are finding it nearly impossible to get deals done.

Unfortunately, this third category is where the majority of properties exist and where much is unknown about their investment status. So much depends on the strength of the banks for those properties that are economically paying their way but technically are in default. It will take discipline to avoid rushing through this purgatory, but over the long run, giving the market time to correct itself may be the best way to gain the transparency that investors find lacking.

The Bad,

by Kenneth P. Riggs Jr., CCIM, CRE, MAI

National Trends by Sector

Most of us are happy to put 2010 behind us, but it was good to see the commercial real estate market take the first steps to right itself last year. Total investment volume increased 60 percent from 4Q09 to 3Q10 and the size-weighted average prices increased for all property types except the industrial sector, where prices remained stable.

However, the majority of these increases were based on the improving institutional property market and transactions of more than \$5 million each. Unfortunately, as noted in the *RERC/CCIM Investment Trends Quarterly*, the volume and price of smaller transactions are still declining for most property types. Among the major property types, there are clear divisions among the good, the bad, and the unknown.

The good: apartments. The apartment market is easily the safest sector for investors with little appetite for risk. RERC's 3Q10



and the Unknown

Investors search for clarity in a divided market.

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TRIFURCATED MARKETS

Some metropolitan areas are seeing generally positive growth in the commercial real estate market while others see much distress. Then there is the great unknown—those tertiary cities where the commercial real estate markets are mixed, investors are uncertain, and lending status and much else remains in question. The markets listed below are representative of good, bad, and unknown markets. The markets selected for the good, the bad, and the unknown are based on RERC’s investment models that look at the relative value to price relationship and identify investor views of markets and properties where values equal or exceed the prices required to have a transaction take place (or where there is a meeting of minds between a buyer and seller).

The Good: Positive Growth	The Bad: Much Distress	The Great Unknown
Washington, D.C.	Toledo, Ohio	Hartford, Conn.
New York	Detroit	Milwaukee
Los Angeles	Las Vegas	Fresno, Calif.
San Francisco	Sacramento, Calif.	Tallahassee, Fla.
Seattle	Memphis, Tenn.	Albuquerque, N.M.

Source: RERC

institutional investment survey respondents rated the investment conditions for the apartment sector at 7.3 on a scale of 1 to 10, with 10 being high. This is significantly higher than the ratings for the other property types, and is among the highest apartment sector investment conditions ratings since RERC began measuring this criterion in 1991. Demand for this property type has been increasing for several quarters, with the vacancy rate dropping to 7.1 percent in 3Q10 and expected to decline to 6.6 percent in 2011, according to Reis. This is no surprise, given that apartment demand may further increase as single-family home foreclosures mount.

The 12-month trailing size-weighted average price per apartment unit increased to \$90,621 per unit, or approximately 20 percent, in 3Q10 from a year earlier for all transactions, *ITQ* reported. Total sales volume for the apartment sector increased 50 percent over the past year. Top-tier, institutional apartments have seen capitalization rates fall and prices significantly increase in the Northeast and West Coast markets. However, even for this top-rated property type, prices

have seen downward price adjustments for the more-distressed markets and smaller apartments on a 12-month trailing basis for transactions of less than \$5 million.

Prices and volume should continue to hold firm or even increase for top-tier apartment properties in primary locations in 2011. In addition, broad apartment transaction volume and pricing should begin to stabilize in the secondary markets, although the stabilization period could be drawn out, especially in regions plagued by significant economic deterioration.

At 6.5 percent, the apartment sector continues to have the lowest expected going-in institutional cap rate on a national level among the various property types, further adding to the attractiveness of this sector. (See “Required Return Expectations.”) On a regional basis, expected going-in cap rates

for this sector are lower in the West and East, while rates in the South and Midwest are somewhat higher.

The bad: office, hospitality. The office and hotel sectors seem to be competing for weakest property sector, although for different reasons. Unemployment among office-using industries is expected to remain high for some time, and as a result, the office sector may take longer than other sectors to recover from a demand side.

The hotel sector always has been a risky investment, and while both leisure and business travel are increasing slightly, neither businesses nor individual consumers are expected to return to their broad-based, unsustainable spending habits anytime soon.

With respect to the office sector, the investment conditions rating for the central business district office sector is 5.8 on a scale of 1 to 10, and 4.1 for the suburban office sector, the lowest rating among all property types. However, each of these ratings is higher than those for the past two years, so investor sentiment for these sectors is improving, although demand is not, due to weak fundamentals that reflect a weak economy. In fact, vacancy in the office sector has been increasing throughout the year, jumping to 17.6 percent in 3Q10, the highest since 1993, according to Reis. Office vacancy is expected to finally start declining in 2011; Reis projects office vacancy to be about 17.2 percent by year end.

Nationally, the size-weighted average price per square foot of all office property increased to \$189 psf, an increase of approximately 15 percent in 3Q10 from a year earlier, while total volume nearly doubled, as reported on a 12-month trailing basis. However, for office transactions of less than \$5 million, both price and volume are still declining. Unfortunately, this trend will continue until job numbers increase, particularly in those markets where unemployment in office-using industries remains high.



The strengthening of prices is the result of cap rate compression resurrecting itself. Undoubtedly, it is for different reasons in this new era of less, but still, office cap rate expectations are declining. The expected going-in cap rate for the national CBD office sector is 7.2 percent, while the expected cap rate for the suburban office sector is 8.0 percent, 20 basis points less for each of these sectors than expected in the previous quarter. The going-in cap rates are highest in the Midwest and South, where the recovery has been slower.

Examination of the hotel sector data shows similar results, with an overall investment conditions rating of 4.9 on a scale of 1 to 10. While this rating is much higher than the ratings for the past two years, it still reflects the inherent risk associated with lodging due to its heavy reliance on business and consumer travel, both of which, while improving, remain weak. However, Smith Travel Research projects the various hotel sector metrics to increase slightly over the next year, estimating that occupancy will increase to 57.9 percent in 2011, the average daily rate to \$101.55, and revenue per available room to \$58.75.

Unlike most of the other property types, however, the hotel sector is showing improved pricing for transactions of less than \$5 million, as reported on a 12-month trailing basis in the *ITQ*. This property category has taken its lumps to get most assets, even the small deals, re-priced and in line with buyer expectations. The size-weighted average price per hotel unit increased to \$23,690 per unit, or approximately 20 percent, in 3Q10 from a year earlier for transactions of less than \$2 million, while transactions of \$2 million to \$5 million remained stable at \$35,286 per unit. For transactions greater than \$5 million, the size-weighted average price per unit increased to \$131,348, or approximately 30 percent, from the price a year ago, while volume more than doubled.

But beware the risk in putting too much stock in these increases; in comparison to the other major property types, volume is still quite small on a relative basis for the hotel sector. On a national basis, the expected going-in cap rate for the hotel sector is 9.0 percent, 50 basis points lower than the previous quarter, while among the regions, the going-in cap rate was lowest in the East and highest in the Midwest.

The unknown: retail, industrial. The retail and industrial warehouse sectors are waiting for consumers to take back the reins to this

economy. While we expect this to happen eventually, it continues to be a gradual and painful process for most in the economy. A cheaper dollar and rising exports offer some hope for industrial. Also, retail sales and business spending are growing slightly, but demand for either of these property types will not increase significantly until wages grow, the unemployment rate declines, and confidence in the U.S. economy and our nation's leadership is restored.

The regional retail mall sector received an investment conditions rating of 4.8 on a scale of 1 to 10, more than two points higher than last year's ratings. The neighborhood/community retail sector received a rating of 5.1, which, while higher than a year ago, was down slightly from the previous quarter. The retail sector has been overbuilt for some time, and with increased completions and inventory, vacancy for the retail property sector is expected to increase from its current rate of 10.9 percent to 11.5 percent in 2011 and to remain at that level through 2012, despite positive absorption, according to Reis.

The size-weighted average price psf of retail space declined to \$124 psf, or 5 percent, on a 12-month trailing basis over the past year for transactions of \$2 million to \$5 million. However, the sales price of property transactions of more than \$5 million increased to only \$160 psf from \$154 psf a year ago, although the volume of properties sold at this level increased 50 percent from a year ago.

INVESTMENT CONDITIONS RATINGS

1 = poor; 10 = excellent

	3Q2010	3Q2009	3Q2008
CBD office	5.8	4.6	4.9
Suburban office	4.1	3.8	3.8
Industrial warehouse	5.8	4.6	5.1
Regional mall	4.8	2.7	3.9
Neighborhood/community center	5.1	4.4	4.1
Apartments	7.3	5.6	5.9
Hotels	4.9	2.6	3.9

Source: RERC, 3q 2010

Cap rate expectations are mixed for the retail sector. The expected going-in cap rate for the national regional mall sector is 8.0 percent, up 40 basis points from the previous quarter, while the neighborhood/community retail sector rate is 7.4 percent, 60 basis points lower than the previous quarter. In general, retail going-in cap rates are lowest in the West and East and highest in the Midwest.

Institutional investors sense that demand for industrial warehouse space is increasing, making it a good property type in which to invest. As such, the investment conditions rating for this property type is 5.8 on a scale of 1 to 10, the second-highest rating among the property types. However, the availability rate for industrial

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properties on a nationwide basis is currently 11.6 percent, the highest it has been since Reis began collecting this data. The availability rate for the industrial sector is expected to decline to 11.4 percent in 2011.

In addition, industrial's size-weighted average price psf decreased slightly for all transaction levels on a 12-month trailing basis during 2010, with the average price psf declining to \$53 psf from \$55 psf a year ago. Total volume increased by approximately 30 percent from a year ago, although the entire increase was based on property transactions of more than \$5 million.

Expected going-in cap rates for the industrial warehouse sector continue to compress. During 3Q10 it was 7.8 percent, 30 basis points less than the previous quarter. The going-in cap rate is lowest in the West and highest in the Midwest.

Hit the Reset Button

Incorporating the National Council of Real Estate Investment Fiduciaries Value Index, the "Commercial Real Estate Value Outlook" shows the commercial real estate downturn in the 1990s versus the downturn that started in 2Q08. (The NCREIF Value Index emphasizes the change in institutional property values only.) From 1Q90 until 4Q95, institutional commercial real estate declined in value by approximately 32 percent. During the recent peak to trough (2Q08 to 1Q10), values declined by approximately 31 percent, very comparable to the 1990s downturn. However, the current decline was much more drastic, taking place over a two-year period versus the six-year decline that occurred in the 1990s. This bodes well for recovery this time around: a hard fast drop versus a decline that played out for a half-decade.

Over the past two quarters, the NCREIF Value Index has been increasing, which is great news for institutional investors. RERC's forecast sees institutional property values increasing further by an estimated 27 percent from the trough (1Q10) over the next four years, putting property values close to where they were before the market collapsed. However, such a forecast could be knocked off course by major negative shocks almost anywhere in the world.

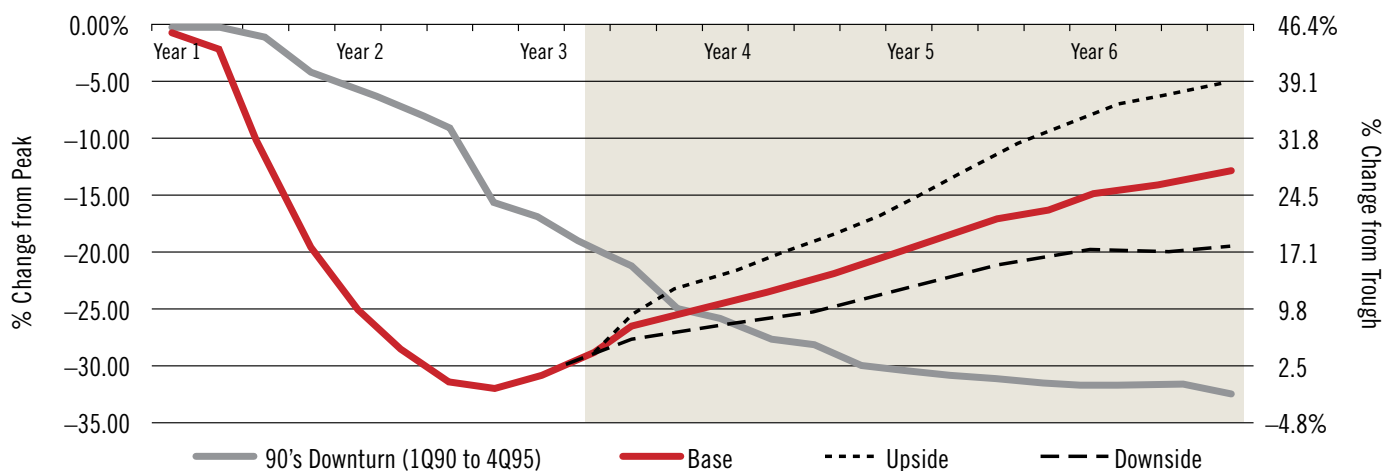
Although the projected increase in property values is for institutional properties only, the fact that we are starting to see some positive growth is encouraging for second- and third-tier property investors, too. In other downturns, institutional properties served as a leading indicator of the broader market overall. Unfortunately, even the changes in institutional property values are starting out slowly, and there has been some speculation that the increase in institutional prices is unsustainable.

For property transactions of less than \$5 million, prices are still declining among all property types. Before we can see improvement in second- and third-tier property prices or in tertiary markets, the bleeding has to stop. This unknown will continue to play out in 2011 and 2012. Sam Zell said a year ago: "Come clean by 2013," and that mantra seems to be holding for the unknown spectrum of the commercial real estate market.

Whether you are involved with the good, the bad, or the unknown in this trifurcated market, or a little of each, you no doubt experienced a great deal of pain when the market collapsed. Unfortunately, there is more pain ahead before we see a broad-based recovery in the economy or in the real estate market.

Even so, the U.S. economy has many positive things going for it, including its resilience, which is easy to forget when we have been used

COMMERCIAL REAL ESTATE VALUE OUTLOOK



Source: NCREIF, RERC

Note: Shaded area reflects RERC's outlook for the Base, Upside, and Downside Scenarios, from 4Q10 to 1Q14.

RERC Required Return Expectations by Property Type

	Office		Industrial			Retail						
	CBD	Suburban	Ware-house	R&D	Flex	Regional mall	Power center	Neigh/comm center	Apartment	Hotel	Average all types	RERC portfolio index
Pre-tax Yield (IRR) (%)												
Range	7.5 – 10.0	8.0 – 12.0	7.5 – 10.5	8.0 – 11.0	7.8 – 12.0	8.0 – 10.0	7.8 – 10.0	7.5 – 13.0	7.5 – 10.0	10.0 – 12.0	7.5 – 13.0	7.5 – 13.0
Average	8.6	9.5	9.0	9.5	9.7	9.1	9.1	9.3	8.5	10.8	9.3	9.0
Weighted Average	9.1	9.1	9.2									
Going-In Cap Rate (%)												
Range	6.0 – 8.5	7.0 – 10.0	6.3 – 10.0	7.0 – 10.0	7.0 – 9.0	6.5 – 10.0	6.5 – 10.0	6.0 – 8.5	5.5 – 8.0	8.0 – 10.0	5.5 – 10.0	5.5 – 10.0
Average	7.2	8.0	7.8	8.3	8.2	8.0	7.9	7.4	6.5	9.0	7.8	7.4
Weighted Average	7.6	7.9	7.7									
Terminal Cap Rate (%)												
Range	6.5 – 8.5	7.5 – 9.0	7.0 – 10.0	7.5 – 9.5	7.5 – 10.0	7.0 – 9.0	7.0 – 9.3	7.0 – 11.0	6.5 – 9.0	8.5 – 10.0	6.5 – 11.0	6.5 – 11.0
Average	7.8	8.4	8.3	8.7	8.7	8.0	8.3	8.3	7.2	9.4	8.3	8.0
Weighted Average	8.1	8.4	8.1									
Rental Growth (%)												
Range	0.0 – 5.0	-2.0 – 4.0	-1.0 – 6.0	-2.0 – 5.0	-2.0 – 4.5	-1.0 – 3.1	-1.0 – 4.0	-1.0 – 3.5	0.0 – 7.0	-2.0 – 5.0	-2.0 – 7.0	-2.0 – 7.0
Average	2.1	1.6	2	1.7	1.7	1.6	1.6	1.8	2.9	2.1	1.9	2.1
Expense Growth (%)												
Range	1.5 – 3.5	1.5 – 3.5	1.5 – 3.5	1.5 – 3.5	1.5 – 3.5	1.5 – 3.0	1.5 – 3.5	1.5 – 3.5	1.5 – 3.5	2.0 – 4.0	1.5 – 4.0	1.5 – 4.0
Average	2.7	2.7	2.6	2.7	2.6	2.4	2.6	2.6	2.7	2.7	2.6	2.6

This survey was conducted in July, August, and September 2010 and reflects expected returns for third quarter 2010 investments. Ranges and other data reflect the central tendencies of respondents: Unusually high and low responses have been eliminated. Weighting is based upon 3Q10 NCREIF portfolio market values.

Source: RERC Investment Survey

to more vigorous growth. In addition, monetary policies have been very accommodating, and with the guiding or meddling hand of the government (depending on your economic persuasion), there is liquidity for doing business and getting deals done, if there is a re-pricing of expectations. Further, business optimism has been increasing slightly, according to the National Federation of Independent Business' Small Business Economic Trends report, although at 91.7 at the time of this writing, the Optimism Index remained in recession territory.

Keeping this in mind, the key to successfully getting through this painful period is resetting our expectations according to today's trifurcated investment environment, and realizing that for the foreseeable future, there will be good elements, bad elements, and many, many unknown elements that will contribute to investment uncertainty.

Much more time and stamina are required as we work through the most severe economic crisis since the Great Depression and the worst real estate crisis since the commercial real estate debacle of the 1990s. But as we reset our expectations to align with the investment environment we have today, we urge you to be patient, keep your ear to the ground regarding the economic and employment conditions in your region, and know the real estate fundamentals in your area. That, and the relationships you have built over time with your clients and the new relationships you are building today, will keep you in good stead as the recovery evolves.

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