



THE CHASE IS ON FOR COMMERCIAL REAL ESTATE

Although we have seen many positive signs of recovery over the past year, it is clear that the US economy has a long way to go before anyone declares it 'cured' of all its ills. Foremost is an unemployment rate that is much too high to inspire confidence, a housing market that appears to still be in decline, a deficit that is unsustainable, and more failed banks in 2010 than any year since the savings and loan crisis in 1992.

By Kenneth P. Riggs, CRE®, FRICS

Despite its lingering ailments, from a global perspective the US economy is the most resilient and is still the largest in the world. Economic growth in the US has been positive (albeit sluggish) for more than a year. The Federal Reserve has demonstrated its commitment to keeping interest rates low 'for an extended period' and to purchasing additional treasuries, stock market returns have been increasing, and a new Congress is showing signs it is committed to reining in government spending.

Improving sentiment

There is no doubt that as 2011 gets underway, investment conditions for commercial real estate are much less than ideal.

Vacancy rates are near record highs for most major property types (although we are seeing vacancy rates starting to come down for the apartment and industrial warehouse sectors), demand for commercial space remains generally low, and absorption is nearly non-existent. However, markets are flush with institutional capital, and to the surprise of many, there are multiple examples of record high

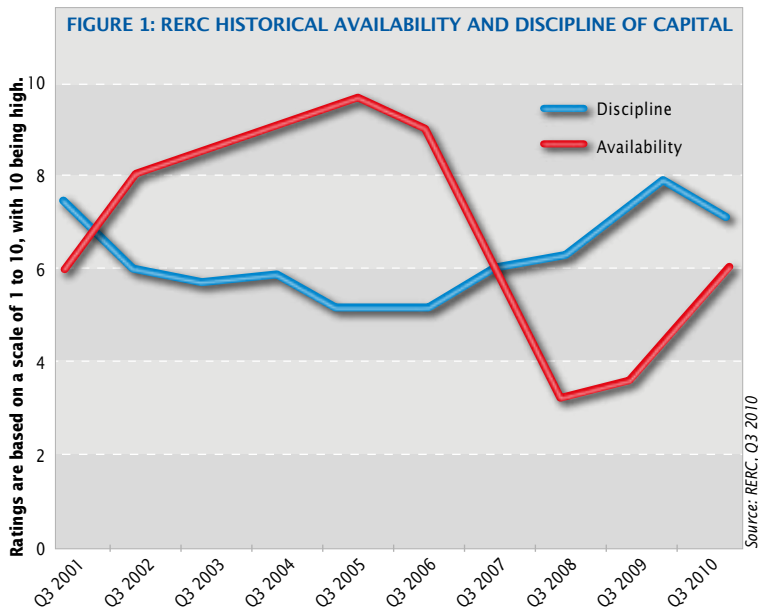
prices being paid for top properties in key locations like New York City, Boston, Chicago, and San Francisco. The market is starting to move from the top down, and more and more investors are signaling their willingness to enter the race, despite their hesitancy about paying high prices. According to results of a survey taken among members of the Association of Foreign Investors in Real Estate (AFIRE) in the fourth quarter 2010, the US commercial real estate market offers a stronger investment opportunity for foreign investors than it has in the past 10 years. For investors with the fortitude to make a move to the 'buy lane,' now looks to be the time. The chase is on!

Economy and capital markets

Real Estate Research Corporation (RERC) issues a quarterly investment survey to the nation's leading institutional investors, which is reported in the *RERC Real Estate Report*. These investors, while noting steady improvement in the economy since mid-2009,



New York.



stepped back during Q3 2010 and lowered their view of the economy to 4.7 on a scale of 1 to 10 (with 10 being high), after rating the economy at 5.3 during the second quarter (however, this is still higher than last year's rating of 4.0). Investors cited lack of job growth as the biggest risk to the US economy, followed by fiscal policy, credit availability and the deficit. Investors have seen the availability of capital for commercial real estate investment increase since hitting its low in Q3 2008. But it wasn't until late 2009, after the recession officially ended in the US, when discipline started to decline and lenders began making capital available for investment, that the gap between the availability and discipline of institutional capital narrowed significantly and deals were finally able to occur. (Figure 1) As a result, investors intend to direct more capital in commercial real estate in the US during 2011 than they invested in 2010. Eventually, demand will extend to core properties in the secondary and tertiary markets.

Commercial real estate investment

RERC's investment survey respondents noted that prices are too high for institutional properties, but with 'everyone seeking cash flow and yield,' commercial real estate retained its first-place rating among the various asset classes during Q3 2010. Investors rated stocks in second place, bonds in third place, and cash in fourth place. Beyond serving as a good choice for investors seeking to balance their portfolios, commercial real estate is generally much less volatile than the stock market, and as values for real estate further stabilize, RERC's required capitalization rates continue to compress, reflecting additional confidence in this asset class. As shown in Figure 2, returns on institutional real estate, as reflected by the annual rate of return for the National Council of Real Estate Investment Fiduciaries (NCREIF) Index, and public real estate investment as reflected by the annual rate of return for National Association of Real Estate Investment Trusts (NAREIT) >>



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Kenneth Riggs has served as president and CEO of Real Estate Research Corporation (RERC) since 1991. Under his leadership, RERC provides research services, valuation management, strategic consulting, independent fiduciary services, litigation support, and Web-based management services for property portfolios.

In addition to leading the firm's business ventures, Riggs serves as publisher of the RERC Real Estate Report and as co-publisher of the annual forecast report, *Expectations & Market Realities in Real Estate*.

Riggs holds an MBA with a concentration in finance and statistics from the University of Chicago Graduate School of Business. He received the CRE designation from The Counselors of Real Estate® in 1995, and was elected first vice chair for 2011. Several years ago, the National Association of REALTORS® named him as one of real estate's 25 most influential thought leaders.

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FIGURE 2: WHAT DO THE FINANCIAL MARKETS TELL US?

COMPOUNDED ANNUAL RATES OF RETURN AS OF 9/30/2010

Market Indices	YTD	1-year	3-year	5-year	10-year	15-year
Consumer Price Index ¹	0.38%	1.20%	1.55%	1.90%	2.32%	2.40%
10-Year Treasury Bond ²	3.33%	3.24%	3.46%	3.97%	4.23%	4.81%
Dow Jones Industrial Average	0.38%	8.51%	-6.96%	2.09%	2.00%	7.52%
NASDAQ Composite ³	4.38%	11.60%	-4.29%	1.94%	-4.29%	5.62%
NYSE Composite ³	1.34%	5.36%	-10.15%	-0.94%	0.38%	5.39%
S&P 500	3.89%	10.16%	-7.16%	0.64%	-0.43%	6.45%
NCREIF Index	8.12%	5.84%	-4.61%	3.67%	7.25%	8.91%
NAREIT Index (Equity REITs)	19.10%	30.28%	-6.06%	1.88%	10.38%	10.31%

¹ Based on the published data from the Bureau of Labor Statistics (Seasonally Adjusted)² Based on Average End of Day T-Bond Rates³ Based on Price Index, and does not include the dividend yield

Sources: BLS, Federal Reserve Board, S&P, Dow Jones, NCREIF, NAREIT, compiled by RERC, Q3 2010

Index, have grown substantially more than those for the other investments on a year-to-date basis as of Sept. 30, 2010.

In addition, according to the cited AFIRE survey, the US is the country providing the best opportunity for capital apprecia-

tion in 2011, with six times as many votes among respondents than for second-place vote getter, China.

FIGURE 3: RERC HISTORICAL RETURN VS. RISK AND VALUE VS. PRICE RATINGS

	Q3 2010	Q2 2010	Q1 2010	Q4 2009	Q3 2009
Return vs. Risk					
Office	5.0	4.7	4.8	4.8	4.6
Industrial	5.9	5.8	5.6	5.1	5.0
Retail	4.9	4.8	4.2	4.3	4.3
Apartment	6.2	6.2	6.0	5.7	5.3
Hotel	5.0	4.7	4.0	3.7	3.0
Overall	5.4	5.1	5.1	4.9	4.3
Value vs. Price					
Office	4.8	5.4	5.4	5.2	4.5
Industrial	5.6	5.7	5.7	5.2	4.6
Retail	4.8	5.3	4.9	5.4	4.2
Apartment	5.2	5.2	5.5	5.7	4.8
Hotel	5.3	5.3	5.1	4.3	3.9
Overall	5.1	5.1	5.4	5.0	4.6

* Ratings are based on a scale of 1 to 10, where 1 is poor and 10 is excellent

Source: RERC, Q3 2010

Return versus risk

Investors have consistently increased their return versus risk ratings for commercial real estate during the past two years, giving the industry as a whole a return versus risk rating of 5.4 on a scale of 1 to 10 in Q3 2010. This is of particular interest to investors who are more risk-averse in general and are finding that commercial real estate better fits their requirements than other types of investments. With respect to the individual property types, investors are becoming increasingly confident in those returns as well. At 6.2, the return versus risk rating for the apartment sector is the highest among all property types, but as shown in Figure 3 the return versus risk rating for the industrial sector closely followed. Even the retail sector is moving closer to the point where the return on investment is equal to the amount of risk involved.

Regarding value versus price, however, ratings declined or remained stagnant during Q3 2010, indicating that many investors feel the value of commercial property overall is losing ground and is barely equal to its price. Among the sectors, the industrial sector earned the highest value versus price rating. However, when compared to Q3 2009, the ratings have all increased.

Property sectors starting to improve

Always the safe haven during recessionary times (and usually the first sector to recover when a recession ends), it is no surprise to see improvement in the apartment sector.

Investors gave the apartment sector an investment conditions

rating of 7.3 on a scale of 1 to 10 during Q3 2010, by far the highest rating among the property types surveyed.

Volume is also up for institutional level apartment properties along with the average price per unit (although there have been suggestions that this property type is becoming overpriced), while RERC's required going-in capitalization rate further compressed to 6.5% (see Figure 4).

In addition, the vacancy rate for the apartment sector dropped significantly during the quarter. According to Reis, Inc., the vacancy rate for apartments dropped to 7.1% from 7.8% in Q2, which was one of the sharpest declines on record, while both asking and effective rents increased.

The industrial warehouse sector is starting to see some improvement as well. Investors gave the industrial warehouse sector an investment conditions rating of 5.8, the second-highest rating among the property types.

In addition, the availability rate for this sector declined slightly during the third quarter of 2010, although it is still near record high levels.

Like the apartment sector, average volume and pricing increased for larger industrial property transactions but was flat or even down slightly for smaller sized transactions; RERC's required going-in capitalization rate declined for institutional industrial properties.

There are mixed signs of improvement in the office, retail, and hotel sectors. >>

FIGURE 4: RERC REQUIRED RETURN EXPECTATIONS BY PROPERTY TYPE

RERC Required Return Expectations¹ by Property Type - Q3 2010

	Office		Industrial			Retail			Apartment	Hotel	Average All Types	RERC Portfolio Index
	CBD	Sub-urban	Ware-house	R&D	Flex	Regional Mall	Power Center	Neigh/Comm				
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 ²	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 ³	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 ²	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 ³	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	6.5-10.0	6.5-11.0
Average ²	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 ³	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	2.1	1.6	2.0	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	2.7	2.7	2.6	2.7	2.6	2.4	2.6	2.6	2.7	2.7	2.6	2.6

¹This survey was conducted in July, August, and September, Q3 2010, and reflects expected returns for Q3 2010 investments. ²Ranges and other data reflect the central tendencies of respondents: unusually high and low responses have been eliminated. ³Weighting based upon Q3 2010, NCREIF Portfolio market values.

Source: RERC Investment Survey, Q3 2010

ADV

With respect to vacancy, the rate increased to 17.6% during Q3 2010 for the office sector and remained unchanged for the retail sector, as noted by Reis, Inc. Hotel occupancy, as well as revenue per available room (RevPAR) and the average daily rate (ADR), increased during Q3.

Institutional office and retail sector volume and prices increased, while RERC's required capitalization rates mostly decreased; however, average prices for office and retail transactions of less than US\$5 million further declined during Q3.

Investment conditions ratings varied for the office, retail and hotel sectors, but all were significantly higher than last year's ratings.

Investors join the chase

The chase for quality properties at good prices is heating up and is expected to intensify throughout 2011. Despite the struggles ahead for the US economy and real estate market, this is the time to look and – if the situation warrants it – make the move and buy.

In doing so, RERC reminds investors:

- US economic growth will continue to be sluggish throughout 2011, and unemployment will remain high.
- The residential real estate market recovery remains weak, and with more foreclosures to work through, we do not expect much improvement for the near term.
- US monetary policy will continue to be very accommodative through most of 2011 at least, with short-term interest rates remaining near zero

'for an extended period,' as the Federal Reserve buys more bonds to stimulate the economy.

- Capital will become more available as the year progresses, as banks continue to work through problem loans and reconcile their balance sheets. We are already seeing some debt capital committed to commercial real estate via publicly-traded REITs and some commercial mortgage-backed securities (CMBS) activity, along with lending increases from life insurance companies and some banks.
- If there are no additional shocks to the economy or markets, it appears that institutional commercial property prices will further stabilize this year.
- Commercial real estate fundamentals will continue to strengthen in 2011, although some sectors will participate in the recovery sooner than others. Recovery in the office market and some retail markets (except for top-tier properties in major markets) appears to be some time away yet.
- Lower your expectations. The basics hold true in this investment environment, and investors should look for good properties in solid locations (relatively low or declining unemployment and a stable housing market), fully or close to fully leased properties with credit-worthy tenants, and with an eye to the long-term future. Look for unleveraged total returns in the range of 8-10% with unleveraged cap rates of 6-8% on a relative basis. Steady as she goes is the key to winning this race! <<

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