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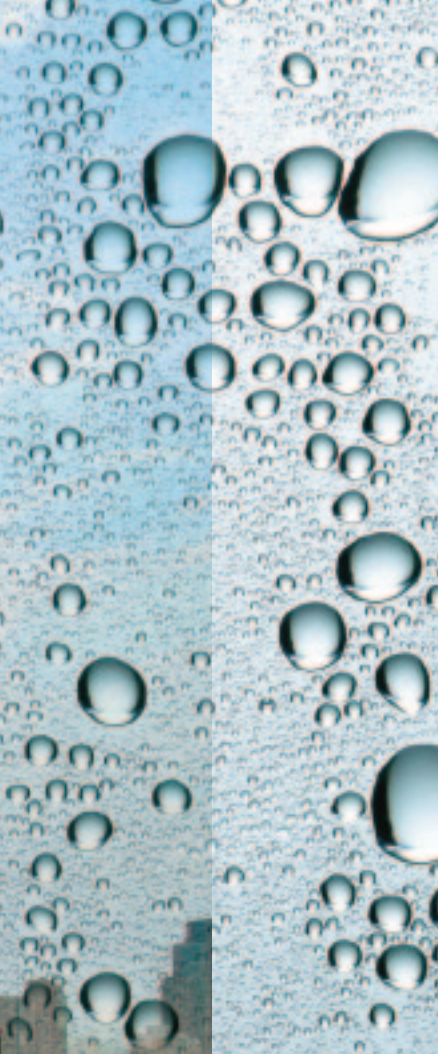
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Shelter

From the Storm





Commercial real estate offers investors refuge amid economic uncertainty.

by Kenneth P. Riggs,
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Now that we are several years past the credit crisis of 2008, the world is still in turmoil. The European debt crisis and unrest in the Middle East — these global circumstances set the tenor for U.S. economic concerns. Gross domestic product grew 2.0 percent in 3Q11, but the federal debt grew to \$15 trillion in 4Q11. Unemployment remains at 9.0 percent, home prices are still declining, and although the nation has dealt with many of its financial issues, the political climate is the worst we have seen in recent history as attested by Standard & Poor's downgrading of U.S. credit to AA+.

Not surprisingly, businesses and consumers lack confidence, market volatility has increased, and investors are tentative. It seems the only certainty is that uncertainty will prevail throughout 2012, at least until the fall elections. The year 2012 will serve as a foundation for new business growth, more deals, and getting our ducks in a row for what is to come. Then we can finally turn the page to 2013, when it's time for commercial real estate to come clean.

Ballast in the Storm

Although the uncertainty is dragging on, investors can take heart in the fact that commercial real estate has been able to more than hold its own in this environment.

Commercial real estate has held varying degrees of value throughout history, but compared to the banking industry and other investment alternatives, it has always been tangible, mostly transparent, and has served as a secure investment to which we have retreated when times were tough. Given the uncertainty we are experiencing, this security is a very appealing place to be — an investment foundation that is relatively stable fits our needs quite well and, from an investment perspective, will continue to for the next decade. Commercial real estate is

able to deliver what cannot be delivered by the alternatives.

As shown in Table 1, the returns for commercial real estate for private institutional equity investors are up strongly and exceed all other investments on a year-to-date basis through 3Q11, according to the National Council for Real Estate Investment Fiduciaries Index. Public equity investors are down on a YTD basis following a strong bull run in the prior two years, according to the National Association of Real Estate Investment Trusts Index. In addition, much of the loss we are seeing in the NAREIT Index is due to the inherent volatility in the stock market. In fact, as of 3Q11, institutional real estate investors are still seeing a YTD annual rate of return of 10.97 percent according to the NCREIF Index, despite the increasing risk. Most investors consider these returns quite good on a relative or risk-adjusted basis.

Investors are fed up with the volatile stock market, which can fluctuate 3.0 percent or more a day based on news from overseas. Further, according to some estimates, 80 percent of daily trading volume comes from high-frequency traders that are careless about the fundamental value of the companies they are trading. Much of 2012 will be spent cleaning up the volatility created by traders versus investors. The bond market is a risky bet too, with interest rates at historical lows. As rates rise — and they will one day — values will go down accordingly. The year 2012 will be a pivotal time for the financial markets, as investors separate the wheat from the chaff.

As for commercial real estate returns, we are already seeing moves toward stabilization among the core property types, according to Real Estate Research Corp.'s institutional investment survey respondents. As shown in Table 2, RERC's required pre-tax yield rates and required going-in and terminal capitalization rates increased or decreased only

slightly, if at all, for the office, industrial, retail, and apartment sectors. In contrast, required returns for the hotel sector decreased somewhat significantly from the previous quarter.

It does not take much brain power to connect the dots when commercial real estate is providing extremely attractive risk-adjusted returns versus Treasuries (Table 3). Analyses of RERC's required pre-tax yield rate (discount rate) and cap rates demonstrate returns with spreads of 600 basis points and 450 basis points respectively, which are above the long-term averages. Although Treasuries are at all-time lows, these low rates are anticipated to continue for the next several years.

U.S. commercial real estate continues to provide the ballast needed in this global financial storm that remains fraught with moral hazard, lacks honesty and transparency, and has turned the world on its head. It will take several years to deal with many of these systemic issues in a world that operates between greed and fear, but if commercial real estate does not come clean by 2013, it will be a lost relic of the Great Recession.

Fundamentals Hold Their Own

Commercial real estate's saving grace is that it was not significantly overbuilt nor did it

have a huge construction pipeline when the recession began. As a result, property fundamentals continue to improve, despite sluggish and downright dismal employment growth. The interaction between demand and supply for commercial properties has translated into stabilizing fundamentals relative to the dislocation felt throughout most industries. Commercial space absorption is now positive, and new construction remained at record lows in 2011. As a result, vacancy rates and rents posted slow but steady improvements. This is what needs to continue for property prices to inch up.

Office vacancy declined to 17.4 percent in 3Q11, while asking and effective rents increased 0.4 percent and 0.6 percent respectively, according to Reis. RERC's transaction analysis indicated that total volume increased 20.0 percent, as the size-weighted average price per square foot increased approximately 5.0 percent.

The availability rate for industrial properties declined to 13.0 percent in 3Q11, according to Grubb & Ellis, as new supply and rents increased slightly. Industrial property volume increased about 10.0 percent on a 12-month trailing basis, but the overall size-weighted average price per square foot declined slightly, according to RERC's analysis.

Despite a weak economy and slow consumer spending, the retail sector vacancy rate remained at 11.0 percent during 3Q11, according to Reis. However, net absorption remained negative, and rents remained flat. Transaction volume increased nearly 10.0 percent on a 12-month trailing basis, and the size-weighted average price psf of retail property space increased slightly, according to RERC's analysis.

With a vacancy rate of only 5.6 percent during 3Q11, according to Reis, increasing rents, and positive net absorption, it is easy to see that the multifamily sector poses minimal risk nationally, regionally, and in most metro areas. Apartment sector volume increased 15.0 percent on a 12-month trailing basis, although the size-weighted average price per unit declined slightly, according to RERC.

Hotel occupancy rose to 62.8 percent in 3Q11, according to Smith Travel Research. The average daily rate and revenue per available room also increased. RERC's transaction analysis showed that total volume for the hotel sector rose 10.0 percent, but the overall size-weighted average price per unit decreased about 5.0 percent.

All in all, we should be thankful for the fundamentals we see today on the heels of

Table 1:
Financial Markets vs. Commercial Real Estate Performance

COMPOUNDED ANNUAL RATES OF RETURN AS OF 9/30/2011						
Market Indices	YTD ⁴	1-Year	3-Year	5-Year	10-Year	15-Year
Consumer Price Index ¹	3.05%	3.93%	1.23%	2.27%	2.45%	2.46%
10-Year Treasury Bond ²	3.02%	2.98%	3.14%	3.62%	4.01%	4.59%
Dow Jones Industrial Avg.	-3.90%	9.21%	3.15%	1.37%	4.67%	6.52%
NASDAQ Composite ³	-8.95%	1.97%	4.91%	1.35%	4.89%	4.62%
NYSE Composite ³	-14.72%	-6.72%	-3.39%	-4.32%	1.68%	3.80%
S&P 500	-8.67%	1.14%	1.22%	-1.18%	2.81%	5.23%
NCREIF Index	10.97%	16.10%	-1.45%	3.40%	7.82%	9.39%
NAREIT Index (Equity REITs)	-6.05%	0.93%	-1.99%	-2.43%	9.18%	9.14%

¹ Based on the published data from the Bureau of Labor Statistics (seasonally adjusted)

² Based on Average End of Day T-Bond Rates

³ Based on Price Index, and does not include the dividend yield

⁴ Year-to-date (YTD) averages are not compounded annually

Source: BLS, Federal Reserve Board, S&P, Dow Jones, NCREIF, compiled by RERC

Table 2: RERC Required Return Expectations¹ by Property Type

COMPOUNDED ANNUAL RATES OF RETURN AS OF 9/30/2011												
	Office		Industrial			Retail			Apartment	Hotel	Average All Types	RERC Portfolio Index
	CBD	Suburban	Warehouse	R&D	Flex	Regional Mall	Power Center	Neigh/Comm				
Pre-tax Yield (IRR) (%)												
Range	7.0-10.0	7.5-11.0	7.0-11.0	8.0-11.5	8.0-12.0	6.5-11.5	6.0-11.0	7.0-12.0	6.0-11.0	8.0-15.0	6.0-15.0	6.0-15.0
Average ²	8.1	9.1	8.6	9.1	9.5	8.1	8.7	8.6	7.9	10.4	8.8	8.5
Weighted Average ³	8.7		8.7			8.4						
BPS Change ⁴	20	0	10	0	10	10	-10	-30	10	-30	0	10
	10		0			0						
Going-in Cap Rate (%)												
Range	5.0-8.5	6.3-9.5	6.0-8.0	7.0-9.0	7.0-9.0	5.0-8.0	6.5-8.0	6.0-9.0	5.0-8.0	6.0-10.0	5.0-10.0	5.0-10.0
Average ²	6.4	7.4	7.1	7.7	7.9	6.4	7.4	7.1	5.9	8.3	7.2	6.7
Weighted Average ³	6.9		7.2			6.8						
BPS Change ⁴	0	-10	10	0	10	-20	-10	0	-10	-50	0	-10
	-10		10			-10						
Terminal Cap Rate (%)												
Range	6.0-8.5	6.8-9.5	6.5-8.5	7.5-9.0	7.0-10.0	6.0-8.5	7.0-9.8	6.3-10.5	5.5-8.5	8.0-11.0	5.5-11.0	5.5-11.0
Average ²	7	8	7.6	8.2	8.4	7	7.8	7.8	6.5	8.9	7.7	7.3
Weighted Average ³	7.5		7.7			7.4						
BPS Change ⁴	0	-10	0	0	0	0	-30	0	-10	-40	-10	-10
	-20		0			-10						

¹ This survey was conducted in July, August, and September 2011 and reflects expected returns for third quarter 2011 investments.

² Ranges and other data reflect the central tendencies of respondents: Unusually high and low responses have been eliminated.

³ Weighting is based upon 3Q11 NCREIF Portfolio market values.

⁴ Change (+/-) in basis points (BPS) are from quarter immediately preceding current rate.

Source: RERC Investment Survey

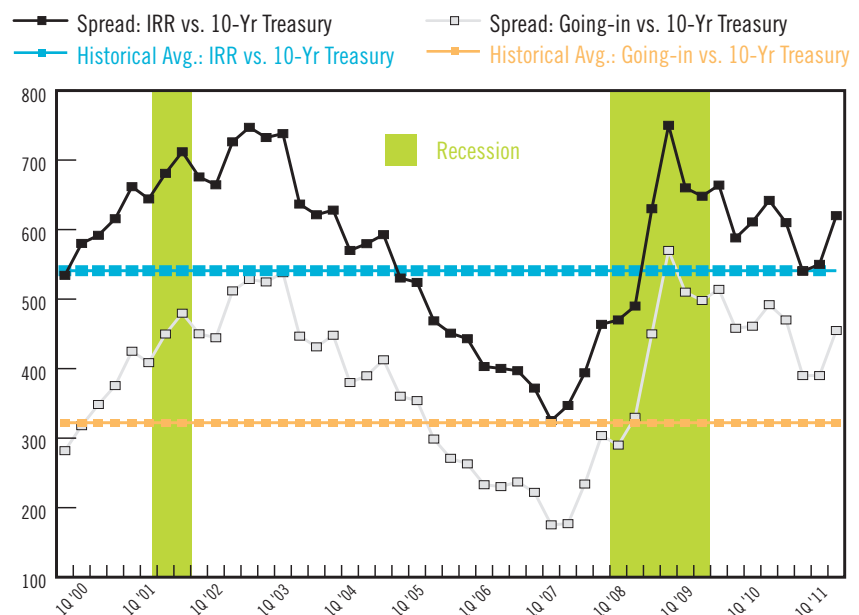
the Great Recession. As 2012 unfolds and we see increased financial stability, the need for companies to hire and the confidence of businesses to spend the \$2 trillion in cash hoarded over the past several years should increase. That said, commercial real estate market fundamentals are poised to see strong rent increases.

Class B and C Improve

Class B and C markets generally are not seeing the kind of returns realized in the institutional market or with class A properties in top markets, but investors have been expanding their search into tertiary markets and smaller cities looking for higher returns and lower-priced assets. There is plenty of capital in search of the right deal at the right price, as the issue is not liquidity, but pricing.

Class B and C properties are starting to show improving fundamentals, with class A properties tending to see peak pricing and

Table 3: RERC Rates vs. 10-Year Treasuries



Source: RERC, Federal Reserve, and NBER 3Q11 data

Table 4: Historical Value vs. Price and Return vs. Risk Ratings

Historical Return/Risk and Value/Price Ratings					
	3Q 2011	2Q 2011	1Q 2011	4Q 2010	3Q 2010
Return vs. Risk					
Overall	5.1	5.3	5.6	5.4	4.9
Office	4.4	4.4	4.5	4.5	4.1
Industrial	5.1	5.1	5.5	5.2	4.8
Retail	4.4	4.7	4.8	4.9	4.2
Apartment	6.8	6.7	6.7	6.7	6.2
Hotel	4.7	4.8	4.8	4.7	4.1
Value vs. Price					
Overall	5.4	5.4	5.5	5.5	5.1
Office	5.1	5.0	5.1	4.8	4.7
Industrial	5.5	5.4	5.7	5.2	5.1
Retail	5.0	5.0	5.3	4.9	4.8
Apartment	5.5	5.2	5.4	5.3	5.4
Hotel	5.1	4.9	5.3	4.7	4.5

Ratings are based on a scale of 1 to 10, where 1 is poor and 10 is excellent.
Source: RERC/CCIM Investment Trends Quarterly Survey, 3Q 2011

rents, according to Reis. For example, B and C office properties experienced rental growth and positive absorption in 2011, although vacancy rates have yet to decline. Tertiary markets are also beginning to show growth, given that volume doubled in the first half of 2011 as compared to a year earlier. In addition, office, apartment, and retail property transactions of less than \$5 million showed larger increases in volume than transactions greater than \$5 million during 3Q11 on a 12-month trailing basis, according to RERC.

CCIM members are seeing this trend and believe that commercial real estate's overall value is holding its own as well, giving the asset a value versus price rating of 5.4 on a scale of 1 to 10, with 10 being high, during 3Q11. As for the individual property types, CCIM members rated the value of each sector equal to or higher than the property price. As shown in Table 4, the apartment and industrial property sectors have the highest value versus price ratings.

Despite the relative stability of commercial real estate, there is risk with any investment, particularly in periods of great uncertainty. As a result, we are seeing investors turn to

cash as the stock market turns stomachs and bonds are priced for perfection. In fact, according to RERC's 3Q11 *Investment Trends Quarterly* survey of CCIM members, cash is the only investment type where the ratings have consistently increased during the past year. As we saw with the NCREIF and NAREIT Index readings in Table 1, commercial real estate is not immune from economic risk — particularly when the rest of the market is going haywire. It is difficult to quantify the amount of risk associated with commercial real estate, but according to CCIM members, the return for commercial real estate continued to outweigh its investment risk in 2011, even though the amount of risk associated with commercial real estate continued to increase throughout the year. By 3Q11, the return versus risk rating for this asset type overall was 5.1 on a scale of 1 to 10, with 10 being high, indicating that the return for commercial real estate was only slightly more than the risk.

Further, the apartment sector was the only property type where the return versus risk rating increased in 2011, while investment risk increased and outweighed the return for

the office, retail, and hotel sectors, as detailed in Table 4. The industrial sector had a return versus risk rating of 5.1 in 3Q11, indicating a slightly higher return than risk, but this return rating was down from 5.5 earlier in the year. With a healthy score of 6.8, the apartment sector's investment return easily outweighed the risk.

The Outlook for Values

RERC forecasts aggregate private commercial real estate values to continue to increase over the next few years. RERC's expectation is bracketed by upside and downside scenarios that reflect a projected value change between -1.0 percent and 6.0 percent in 2012, with the current investment climate suggesting a higher probability to achieving the upside scenario versus the downside scenario. Adding an income return of 6.0 percent, total returns in 2012 are expected to range from 5.0 percent to 12.0 percent, with the base-case scenario near 9.0 percent on an unleveraged basis. It is important to note that RERC's estimates are unleveraged, and the use of debt has a compounding impact on value increases going forward. Thus, if positive leverage is added to these estimates, one can see that commercial real estate offers very attractive risk-adjusted returns for a core strategy.

Commercial real estate entered this recession in better shape than in past recessions and did not need to come clean on as many facets as other investments. In light of the turmoil we see in the stock and bond markets, this forecast reflects the fact that commercial real estate is delivering what investors thought they would get from the asset class some 40 years ago — a hard asset that holds up in chaotic times, an income stream that is relatively predictable when you truly analyze leases that are in place, diversification when times are bad in the other investment arenas, and some equity kicker with values increasing, especially when you add some debt into the equation.

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