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Atlanta suburban office properties are a good example of current trends...

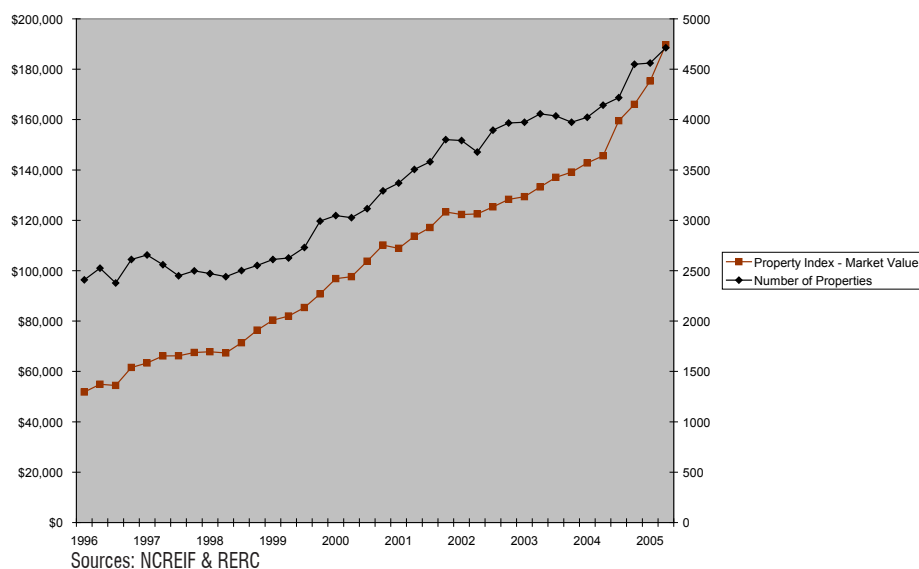
Priced for Perfection – Where Do We Go from Here?

By RERC Principal and co-Director Don Burns, CRE, MAI

“Industrial Strength Recovery.” “Big Expectations for Denver.” “Anything Goes.” “Let’s Make a Deal.” “Las Vegas Market Heats Up.” “Seattle Opens Doors to Skyscrapers.” “CMBS Growth Off-the-Chart.” With headlines like these, even non-real estate investors are aware that this asset class has been enjoying strong returns.

As demonstrated in the accompanying chart, real estate has performed very well over the past several years with historically high transaction volumes and steadily increasing asset values. Recent levels of real estate investor activity are clearly demonstrated by the increase in the size of the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index.

Interestingly, some aspects of real estate’s recent strong performance have contradicted traditional norms. Historically considered a hedge against inflation, real estate also has done well in a non-inflationary environment. The average annual inflation rate for the period 2000 through 2005 was only 2.56 percent, yet the market value of the NCREIF Property Index increased by approximately 89 percent.



In addition, the high transaction volumes and increases in asset values occurred against a backdrop of generally weak property market fundamentals including imbalances in supply and demand, which resulted in flat to declining rental rates, and in many cases, falling property income.

We expect that despite concerns over inflation and interest rates, real estate will continue to be a desirable investment vehicle as long as there is continued liquidity and improvement in property market fundamentals.

While this disconnect is not limited to suburban office properties or the Atlanta market, an examination of the Atlanta suburban office market shows capitalization rates declining steadily during a period when supply and demand market fundamentals were relatively weak.

Atlanta Suburban Office Market		
Year	Cap Rate	Vacancy Rate
2001	9.1%	17.3%
2002	9.1%	21.5%
2003	8.9%	22.9%
2004	8.5%	19.6%
2005	7.7%	17.0%

Sources: Torto Wheaton Research & RERC

The unprecedented levels of capital flowing into real estate has generated significant capitalization rate compression, resulting in the previously mentioned high transaction prices and asset values. As a result of the disconnect between the capital and spatial markets, a disproportionate amount of the recent capital appreciation enjoyed by

investors stems from capitalization rate compression rather than asset performance. With pricing appearing quite full for many property types and markets, there is the danger that real estate is currently priced for perfection and that the margin for error is very low.

With interest rates moving up and signs that higher inflation may be eminent, it is expected that some upward pressure will be exerted on capitalization rates. It appears that the end to the capitalization rate compression era may be at hand as yields are stabilizing and beginning to show signs of increasing. As presented in this issue of the *RERC Real Estate Report*, RERC's first quarter 2006 survey respondents indicated that required going-in capitalization rates are increasing over the prior quarter for five of the nine property types surveyed, while rates from the other property types are still slipping slightly or have stabilized and remain flat.

We expect that despite concerns over inflation and interest rates, real estate will continue to be a desirable investment vehicle as long as there is continued liquidity and improvement in property market fundamentals. While changes in the market have the potential to reduce capital flows as investors look to alternative investments, it is anticipated that there will continue to be an ample flow of capital for the foreseeable future. The current cycle has witnessed capital pouring into real estate from a broad spectrum of sources including traditional investors such as pension funds

and public and private real estate investment trusts (REITs), as well as new vehicles such as such as tenant-in-common (TIC) syndicates. Consequently, capital sources for real estate are more abundant than ever before.

Increasing capitalization rates and the possibility of diminishing capital flows will necessarily result in some repricing of assets unless there are corresponding increases in net operating income (NOI). Investments in markets and sectors where an abundance of capital has possibly driven prices too high face greater risks of value declines and diminished returns. Future value increases and investment performance will not be a function of capitalization rates, but of property performance and the ability to increase NOI. Investors who acquired properties in the current cycle must ask themselves two questions: "What is my exit strategy?" and "With pricing based on historically low yields, is there room for appreciation?"

In a post capitalization rate compression era, investment success will, to a large degree, depend on constraints on new construction and continued improvement in property market fundamentals. Clearly, the primary driver of future upside performance will be growth in NOI. As such, investors would be well-served to critically assess the magnitude and sustainability of landlord pricing power in their existing real estate holdings and proposed acquisitions. With capitalization rates expected to increase over current levels, the best possible scenario would be slowly increasing capitalization rates combined with improving property market fundamentals and commensurate increases in NOI.

In an environment where more and more real estate assets are priced for perfection, investors are advised to keep return expectations low and risk awareness levels high.

