

Adjusting to New Realities

Commercial and multifamily real estate is working through a market transition against the backdrop of a wobbly economy, rising inflation and a global credit crunch. All in all, the asset class is holding up pretty well despite challenging conditions.

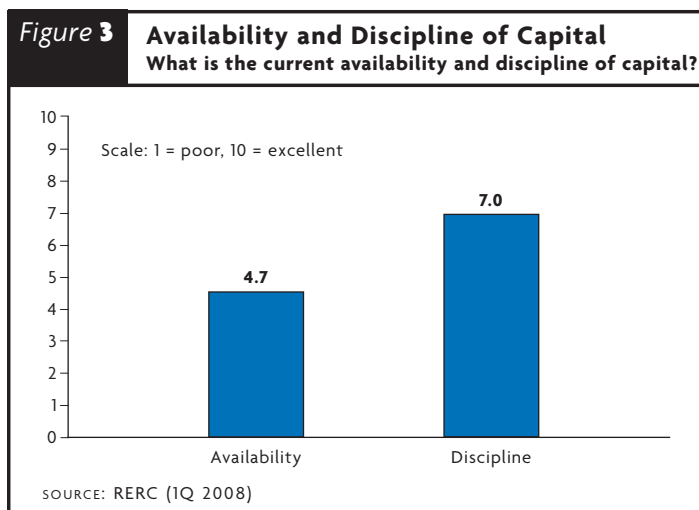
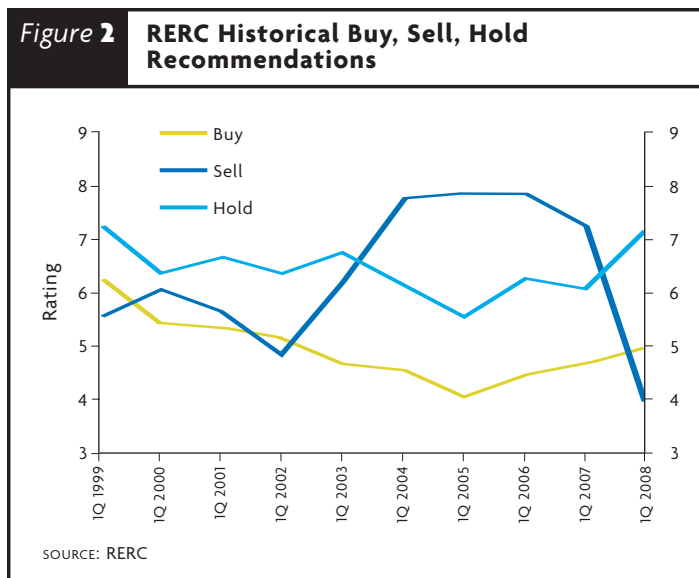
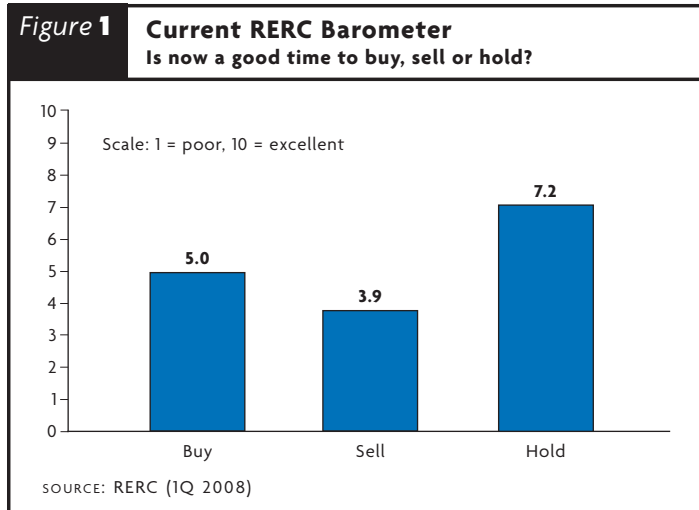
BY KENNETH P. RIGGS JR.



The year 2007 will be remembered for the many difficulties in the U.S. economy—slow growth and the fear of a recession, the subprime lending imbroglio and the bursting of the U.S. housing market bubble—along with difficulties in the global financial markets. Although these issues have continued into this year, 2008 has brought its own set of problems to the mix—record-high gasoline prices, climbing food prices and slow employment growth, to name a few. ■ This is the environment in which commercial real estate finds itself, and the fear remains that what has happened to the residential market may also happen in the commercial market. ■ Real Estate Research Corporation (RERC) expects continued repricing to occur in the commercial property market (as it has in the residential market). And while the credit crisis has affected the debt markets for commercial real estate (as it has with the residential market), the commercial real estate (low-leverage) equity market has not been impacted to the degree anticipated by investors, and we do not expect it to go the way of the residential market. However, we still have some tough realities to face before the market stabilizes.

This is important to keep in mind when we examine the financial side of the commercial real estate market versus the asset side.

The inability of investors to sort through the financial instruments that were created over the past decade has caused them to become more risk-averse. That has brought



established underwriting and investment criteria back to appropriate standards that focus on the fundamental value of the asset. Getting back to basics is not a bad thing, but one should not over-react to this situation out of fear.

Investors are seeing a bifurcation relative to repricing issues in commercial real estate between top-quality, low-leveraged assets versus average-quality, high-leveraged assets (75-plus percent), although each set of assets is facing some level of repricing.

RERC's first-quarter 2008 investor survey shows that currently there is a wait-and-see attitude with a "hold" recommendation of 7.2 based on a scale of 1 to 10 (see Figure 1) for investment sentiment. Further, given the first-quarter disarray and disappointment seen in the economy and financial markets, the "buy" recommendation of 5.0 versus a "sell" recommendation of 3.9 disputes the view that investors are totally out of sorts with commercial real estate.

(NOTE: It is important to point out that the RERC investor survey reflects the view of large institutional buyers for high-quality properties.)

It is no surprise that we are continuing to see the bid/ask

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spread widen, as sellers are not willing to sell at a discount, and buyers are not willing to buy at the ask price, given the uncertainty in the economy and financial markets.

The profound shift in the sell sentiment can be found in the historical buy, sell or hold recommendations shown in Figure 2. The sell recommendation during first-quarter 2003 through first-quarter 2007 hovered around 8.0 on a scale of 1 to 10, indicating that it was a good time to sell (prices were viewed as strong relative to value). In first-quarter 2008, however, the sell recommendation was 3.9—about half that level—indicating that it fell quickly when credit market concerns entered the picture, and now is not a good time to sell (properties are viewed as underpriced relative to what buyers will pay).

This dramatic reversal in sentiment occurred right after The Blackstone Group purchased Equity Office Properties Trust—the nation's largest publicly held office building owner and manager, with a total office portfolio consisting of interests in 580 office buildings in 16 states and the District of Columbia—for approximately \$36 billion. The deal will go down in history as a pricing-velocity watermark.

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survey found a slightly-below-average current capital availability rating of 4.7 on a scale of 1 to 10, while the discipline score registers at 7.0, which is very high on a relative basis (see Figure 3). Commercial real estate has not seen this crossover of the discipline of capital versus the availability of capital since early 2001, when we were in the last recession (see Figure 4).

If the industry had continued with the levels of first-quarter 2007 commercial mortgage-backed securities (CMBS) underwriting that possessed aggressive pricing of high loan-to-

value (LTV) ratios and high valuations, commercial real estate would have undergone a fate similar to that of the subprime market. But because it didn't, the current situation is better for long-term investment prospects for commercial real estate, and provides us with a more solid investment foundation without having to suffer a broad-based market failure like the residential securitized market.

However, we also know there will be more casualties before everything is sorted out. In fact, while discipline is currently very high and there is less aggressively postured capital, discipline could change if capital—particularly debt capital—becomes more available and aggressively priced. We do not see this happening for at least a year, however.

Despite the difficulties with commercial real estate, RERC's institutional investment survey respondents rated commercial real estate at 5.6 on a scale of 1 to 10, indicating it is a better investment relative to the alternatives of stocks, bonds and cash (see Figure 5). This does not come as a surprise to investors in commercial real estate, but they have always been an optimistic group.

In fact, in this world of downside volatility, the only positive realized returns during first-quarter 2008 were those reflected by the National Council of Real Estate Investment Fiduciaries (NCREIF), Chicago, and the National Association of Real Estate Investment Trusts (NAREIT), Washington, D.C., as shown in Figure 6. (The 10-year Treasury bonds reflect expected returns versus realized returns.)

NCREIF and NAREIT show almost no capital (appreciation) return, indicating that values flattened in first-quarter 2008, and further value adjustments or repricing of the underlying assets are likely. However, while commercial real estate is not performing at a level witnessed a year ago, it is still delivering positive returns at present.

Despite the challenges, commercial property deals are still occurring. In the largest commercial real estate acquisition thus far this year, Boston-based Boston Properties Inc. reportedly is buying a portfolio of four New York City office properties, including the General Motors Building, from New York-based Macklowe Properties Inc. for a price approaching \$4 billion. Financing includes about \$1.5 billion in cash and about

Figure 4 Historical Availability and Discipline of Capital

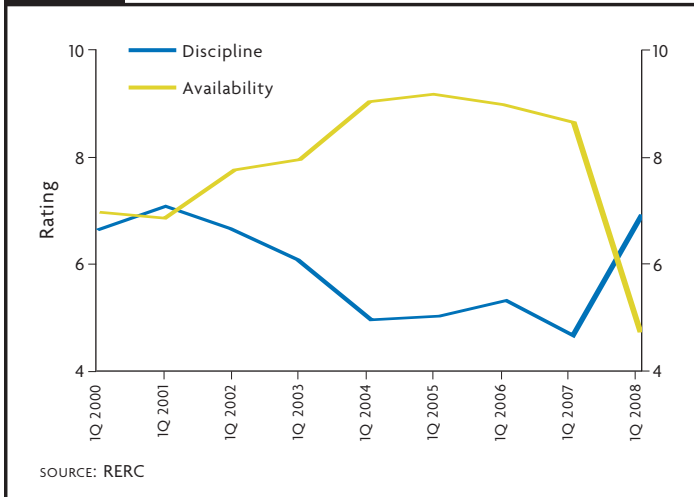


Figure 5 Investment Ratings

	1Q 2008	4Q 2007
Stocks	4.0	5.1
Bonds	4.6	5.2
Commercial Real Estate	5.6	5.4
Cash	5.0	6.1

SOURCE: RERC INSTITUTIONAL INVESTMENT SURVEY (1Q 2008)

Figure 6 What Do the Financial Markets Tell Us?

Market Indexes	Compounded Annual Rates of Return as of 4/1/2008					
	1Q 2008	1-Year	3-Year	5-Year	10-Year	15-Year
Consumer Price Index	1.16%	3.98%	3.37%	3.00%	2.79%	2.68%
10-Year Treasury Bond*	3.66%	4.38%	4.52%	4.39%	4.81%	5.34%
Dow Jones Industrial Average	-3.06%	-0.74%	5.30%	8.94%	3.37%	8.85%
NASDAQ Composite	-6.75%	-6.11%	3.56%	10.83%	2.39%	8.27%
NYSE Composite	-3.60%	-5.02%	7.07%	13.21%	3.80%	8.36%
S&P 500	-4.05%	-6.91%	3.86%	9.29%	1.84%	7.43%
NCREIF Index	1.60%	13.56%	16.84%	15.17%	12.70%	11.29%
NAREIT Index**	1.40%	-17.37%	11.69%	18.34%	10.69%	11.66%

* Based on average end-of-month Treasury Bond rates
 ** Based on FTSE NAREIT US Real Estate Index equity real estate investment trusts (REITs), total return
 SOURCES: MOODY'S ECONOMY.COM, FEDERAL RESERVE BOARD, BUREAU OF LABOR STATISTICS, NEW YORK STOCK EXCHANGE (NYSE), NATIONAL COUNCIL OF REAL ESTATE INVESTMENT FIDUCIARIES (NCREIF), NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS (NAREIT) [COMPILED BY RERC]

\$2.5 billion in fixed-rate debt. New York-based JP Morgan's equity real estate investment trust (REIT) research group estimates that the price for the GM building is about \$2.8 billion, or \$1,400 per square foot, with a capitalization rate of about 4.5 percent.

Figure 7 RERC Yield Rates vs. 10-Year Treasuries

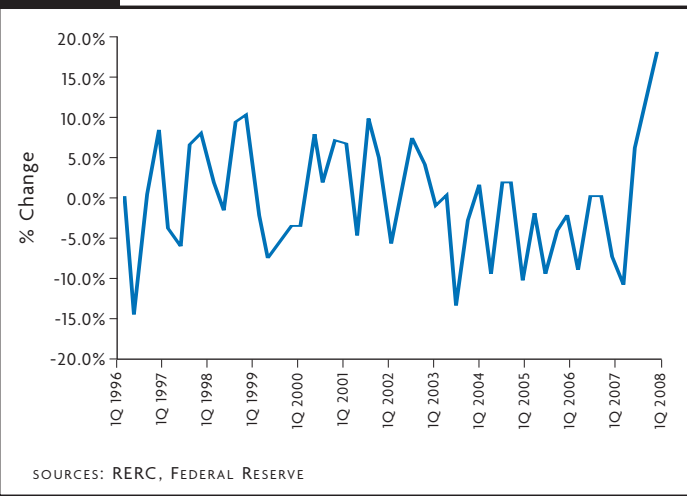


Figure 8 RERC Going-In Cap Rates vs. Five-Year Treasuries

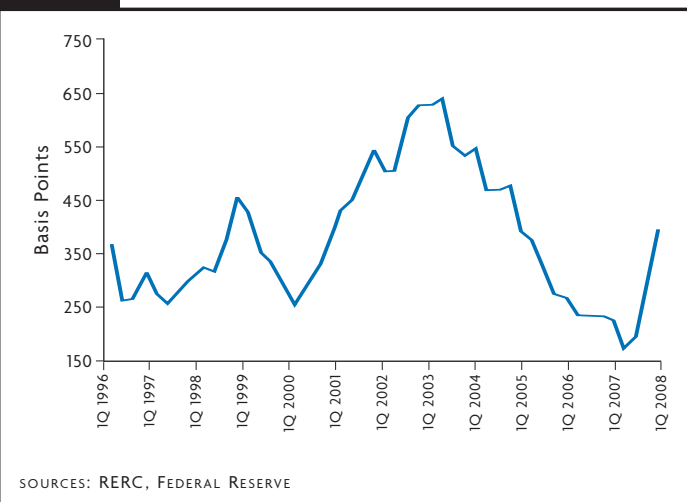
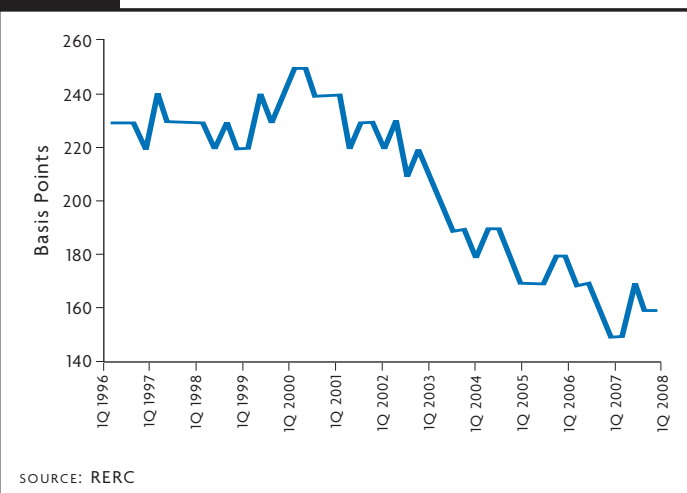


Figure 9 RERC Yield Rates vs. Going-In Cap Rates



Real estate cap rate and yield rate expectations

As a starting point in examining return expectations, it is important to focus on the spreads of commercial real estate yields (total returns) versus 10-year and five-year Treasuries rather than reviewing these returns strictly on a nominal basis. In our evaluation, we are using both 10-year and five-year durations, because the holding periods for commercial real estate have shortened from the traditional 10-year holding periods, and the durations of average leases that create these cash flows are probably something between that of five-year and 10-year bonds.

The spreads between commercial real estate yields and 10-year and five-year Treasuries in 2003 were huge, which meant that commercial real estate was a very attractive risk-adjusted investment and that capital was bound to flow into this arena. Then the market started to aggressively bid up real estate prices to bring this spread down to its lowest level in 10 years in the first quarter of 2007. Since then, we have seen yield spreads for commercial real estate reach around 450 basis points over 10-year Treasuries, and 550 basis points over five-year Treasuries. (We recognize that spreads for other financial instruments have widened much more, and at a more rapid pace, during this credit crisis.)

Since second-quarter 2007, the market has been repricing commercial real estate risk relative to Treasuries. On historical terms and given the dynamics of commercial real estate today, the spread is at least recognizing market risk vagaries. This shift in attitude is demonstrated in Figure 7, showing the significant upward percentage change in commercial real estate yield expectations during the second quarter of 2007 from a 10 percent decline to a net upward shift of more than 25 percent (-10 percent versus 15 percent).

Are we there yet? Probably not across the board—but for the low-leverage, high-quality deals, we are getting close. From our vantage point, the biggest question that the market is wrestling with today is: How do you price risk for commercial real estate when there are fewer transactions to measure investor behavior?

The market tends to talk about pricing in terms of capitalization rates on a nominal basis. Cap rates are a simple performance measure and an easy metric to extract from actual transactions; however, a cap rate does not give you the full picture like a yield rate or internal rate of return (IRR) can provide.

During the last few years, RERC and others have commented on this “era of cap-rate compression.” Since 2004, cap rates have declined by 200 basis points, much of which is attributable to spreads over Treasuries (see Figure 8). Cap-rate compression has been reflecting the attractiveness of commercial real estate from an overall investment-appeal perspective, a world with lower-return expectations and significantly improved transparency. Although cap rates increased by only around 25 basis points during first-quarter 2008, the spreads over Treasuries have increased significantly and have incorporated more upward repricing for the asset class than most market observers are recognizing.

Yields (total returns, or IRRs/discount rates) also have increased slightly more than cap rates since second-quarter 2007. The spread between yields and cap rates, as shown in

Figure 9, spiked during the latter part of 2007, but settled down to a 160-basis-point spread in first-quarter 2008. As with cap-rate compression, we see a 200-basis-point decline in yield expectations over the past three years until first-quarter 2007 and an increase in yield expectations from that point in time—also reflecting the attractiveness of commercial real estate at a time of lower-return expectations.

What can we expect from commercial real estate?

In this time of doubt and uncertainty, it is becoming more and more difficult to find return on investment. The credit crisis continues, and the International Monetary Fund (IMF) predicts that before it is over, an overwhelming \$945 billion of credit-related losses will have occurred. Oil prices have

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topped \$130 per barrel, which exacts a heavy toll on consumers and businesses. The labor markets are succumbing to the pressure of rising costs, and job growth is slowing.

The one-year expected inflation readings are approaching 5 percent, up from the prior month's (April 2008) level of about 4.5 percent, according to published reports. However burdened, our financial system and the economy have remained relatively resilient. But many wonder: How long can they continue?

RERC maintains that as the economy, financial markets and capital markets continue to go through troubled times, commercial real estate will remain a relatively strong investment option, given the nature of the asset and where it has been over the past year when compared with other investment prospects. Here is a brief property-specific outlook:

Office—Although the vacancy rate for the office sector increased slightly, sales volume decreased, and average prices declined during first-quarter 2008, investment conditions remained steady to improving for the office market. RERC expects vacancy rates to increase slightly throughout 2008 as the economy continues to struggle and unemployment increases, especially in the financial sector. RERC's required going-in capitalization rates are increasing, but asking rental rates for office properties remain stable.

Industrial—Fundamentals for the industrial sector declined during first-quarter 2008. The availability rate increased, and net absorption of industrial space was the lowest it has been in about five years. However, average prices remained relatively steady, while required going-in capitalization rates increased. Even so, RERC's investment conditions for the industrial warehouse sector increased slightly, and expected rental growth is up.

Retail—Faced with a sluggish economy, the retail sector

will likely prove to be the most challenged of the core property types. Retail sales have been declining as consumers scale back, and as a result, the retail property sector is seeing less demand and increased availability. However, after a notable decline during fourth-quarter 2007, RERC's investment conditions rating for the retail sector reversed direction and increased slightly during first-quarter 2008, along with average prices.

Apartments—The declining housing market and record numbers of home foreclosures have helped to sustain the apartment market. In addition, this sector earned the highest investment conditions rating when compared with the other property types tracked by RERC. Although vacancy rates increased during first-quarter 2008 (due in part to the seasonality of the apartment cycles), rental growth is expected to increase as required going-in capitalization rates declined. Given that there is less volatility in this sector than the other major property types, apartment investors are poised to reap the rewards of an expanding economy in 12 to 15 months.

Hotels—With consumer confidence down and gasoline costs up, hotel occupancy declined slightly during first-quarter 2008. However, RERC's investment conditions rating for hotels increased from fourth-quarter 2007, and with the summer vacation season under way, occupancy is expected to increase slightly in the near term, despite still-high gasoline prices and new hotel supply. Required going-in capitalization rates for the hotel sector are down from the previous quarter, and we are seeing some fluctuation in pricing of hotel units.

Working through uncertainty

RERC's expectations reflect much more of a risky undercurrent than one would surmise by looking at nominal returns for commercial real estate. Although some pundits would argue there has not been enough adjustment in these return expectations, given the global credit crisis and particularly in the CMBS debt market, RERC believes that the market is working through this uncertainty—but there is not enough clarity to make a confident adjustment.

Low-leverage, high-quality commercial real estate is in a relatively positive position compared with investment alternatives, and the message we offer from the equity commercial real estate market is that of selectivity, caution and the need to keep a watchful eye on the rest of the financial markets. The highly leveraged commercial real estate investments and those properties located in soft economies with vacancy challenges will take the brunt of the write-downs, and we will see relatively fewer transactions in this arena over the coming 12 months. **MB**

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