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MIDYEAR FORECAST

Press Pause

Despite strong market fundamentals, investors may want to sit back and review their options.

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Although commercial real estate reached unexpected heights in 2006 and continued its solid performance in the first half of 2007, the remainder of the year may very well be the time for investors to pause, take a few breaths, and allow this stellar performance to settle before missteps occur.

So far, the commercial real estate market remains on solid footing. Fundamentals are strong, and demand, especially among private equity investors, remains high. As a result, property pricing continues to increase as capitalization rates stabilize — and even decrease in some situations — and net income continues to rise.

In addition, the availability and demand for capital within the market is abundant, and interest rates remain relatively low. All of these factors, along with the stability of this asset class, have contributed to commercial real estate's favorable outlook versus the mixed signals other investment alternatives are sending. However, recent favorable shifts indicate the stock market may offer better returns as time goes on.

Even as economic growth slows and more risk seems to be present, commercial real estate remains a strong investment alternative. High prices and low capitalization rates appear to be justified, as long as market fundamentals continue to improve and new construction remains relatively restrained. Building should hold off, given today's extremely high construction costs, which not only govern new development, but also make current market prices seem reasonable. However, the industry must take a lesson from past experience: An oversupply of capital can cause space fundamentals to disconnect from market realities.

Economic Foundations

The U.S. economy remains resilient, but economic growth is slowing this year, as forecast. Real gross domestic product growth is 0.6 percent (per revised 1Q07 estimates), and the majority of economists expect GDP growth to continue with a slight dip expected during 4Q07.

Strong employment growth continues. In March, the unemployment rate was 4.4 percent, falling to a six-year low. The jobless rate is expected to remain low throughout the remainder of the year. Consumer confidence and spending should remain fairly steady, and consumer prices (except for food and fuel) are expected to decrease over the remainder of this year.

The fear of inflation is subsiding, and short-term interest rates, which were undergoing somewhat consistent increases, have remained steady during recent months. While still watchful of inflation, the Federal Reserve Board is expected to hold the target federal funds rate fairly constant throughout the remainder of the year, keeping the cost of capital relatively inexpensive for those investors using financing to acquire large amounts of real estate.

Property Types in Perspective

So far this year, all of the major property types continue to experience strong prices and low capitalization rates. In addition, in a 1Q07 Real Estate Research Corp. survey, CCIM designees and candidates gave all property sectors an investment conditions rating of 6.5 or above on a

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scale of 1 to 10, with 10 being high. At 7.1, the apartment sector received the highest rating, as well as the highest number of transactions from April 1, 2006, to March 31, 2007. Not surprisingly, the office sector saw the greatest dollar volume of transactions during the same period, and sales in the East Coast office market comprised the highest percentage of this volume.

During the past several years, cap rate compression has propelled the commercial real estate market to its present-day performance. Although many investors expected cap rate compression to end as interest rates increased, improving space market fundamentals have taken hold and now are fueling low cap rates. In some sectors and against all odds, cap rates have continued to compress further. Even though this trend was unexpected, it indicates the unabated demand for commercial properties.

However, to sustain these low cap rates, space market fundamentals for the major property types must continue to strengthen throughout the remainder of the year. Otherwise, the lack of improving rental rates driven by healthy demand versus supply could lead to potential overpricing in many markets for many of the property sectors.

A recent institutional investor survey showed that fundamentals are expected to continue to improve in the form of increased rental growth in the retail and hotel sectors, while office and industrial rents are expected to remain fairly stable. Rental growth for apartments is expected to decline slightly. And, although rental growth is expected to be fairly minimal, anticipated expense growth for office and industrial properties remains constant, while anticipated expense growth for retail, apartment, and hotel properties appears to be increasing slightly. Required pre-tax yield rates for commercial real estate sectors averaged 8.4 percent during 1Q07. Although this rate was 60 basis points lower than that of the previous year and much lower than other earlier years, it still remains well above the performance of other investment alternatives such as stocks and bonds over the past several years.

Even the slowing housing market seems to be benefiting the commercial real estate market. With some subprime lenders failing and the difficulties from risky home mortgages beginning to shake out, investors wanting to buy some type of real estate are moving from direct and/or indirect housing investments to commercial real estate opportunities. At present, the commercial real estate market remains one of the safest alternatives for long-term investment and serves as a counter to other more inflation-sensitive options. In addition, commercial real estate's low risk and return correlation with other popular investment alternatives allows investors to diversify their portfolio and enhance their return versus risk profile.

Average Return on Investment Expectations, 1Q07 (in percentages)

Property	IRR	Going-in cap rate	Terminal cap rate	Rental growth	Expense growth
CBD office	8.0	6.5	7.3	3.5	2.9
Suburban office	8.4	6.9	7.7	3.3	2.7
Warehouse	8.0	6.7	7.4	2.8	2.7
R&D	8.5	7.3	8.0	2.7	2.7
Flex	8.6	7.4	7.9	2.6	2.7
Regional mall	8.3	6.7	7.4	3.1	2.8
Power center	8.1	6.7	7.3	2.8	2.9
Neighborhood center	8.1	6.7	7.3	2.9	2.9
Apartment*	7.8	5.9	6.7	3.4	2.9
Hospitality*	10.0	8.0	8.8	3.4	2.8
All types*	8.4	6.9	7.6	3.1	2.8

*Weighted averages based upon 4Q06 NCREIF portfolio market values
Source: Real Estate Research Corp. Investment Survey

Capital Spending Questions
A dramatic slowdown in capital spending poses the biggest threat to the national economy's positive strength. At the end of 2006, capital spending fell for the first time in nearly three years, and early reports this year have noted some weakness. This would restrain job growth and payrolls, and as payrolls fall, so too would consumer spending.

Despite the slight slowdown in capital spending, 1Q07 corporate profits are strong and the availability of capital remains quite high. According to RERC's 1Q07 investment survey, institutional real estate investors rated the capital availability within the market at 8.7 on a scale of 1 to 10, with 10 being high, indicating a still-positive view of abundant capital within the market. The same survey showed a slightly below-average amount of discipline, indicating that the market is concerned that the available capital for commercial real estate is getting ahead of the fundamentals, which has been the case for the past several years as the market has heated up. However, this time there is more persistent concern that investment capital should take a slight breather from the torrid pace set last year.

These views on the capital market helped set the stage for commercial real estate's 2006 record-setting transaction volume. As capital is expected to remain available, strong acquisition activity should continue through year-end.

Investment Activity
At 46 percent of the market at year-end 2006, private equity comprises nearly half of the market's total investor composition. Highly leveraged, private, local investors have reduced the velocity of new acquisitions due to increasing interest rates and a flat-to-inverted yield curve. Despite completing fewer transactions, private investors still are willing to pay increasing prices for the assets. This demand trend continues to put upward pressure on the average price for commercial real estate assets, which likely will continue through year-end.

Notwithstanding the strength of the private investors in the commercial market, the pricing of publicly traded real estate investment trusts also reached record highs in 2006. During the first two months of this year alone, real estate mutual fund values increased slightly more than 5 percent, according to Morningstar. The move from the public sector to private equity firms, such as the record-setting sale of Equity Office Properties Trust to the Blackstone Group, also is fueling the public market's success.

The following forecast should hold for the remainder of the year, barring any unforeseen major shocks to the economy.

- Gross domestic product will grow in the neighborhood of 2.5 percent.
- The Federal Funds rate will remain at 5.25 percent for most of the year. If inflation becomes more problematic, the Federal Reserve may reduce short-term rates.
- With low unemployment, strong job growth, and constrained construction activity, space market fundamentals will continue to improve in most of the major markets.
- Capital should continue to flow into the commercial real estate market, as long as interest rates remain low and alternative investments such as stocks and bonds keep moving in a mostly lateral direction. With corporate profits and personal incomes up, investment dollars continue to search for a home.
- Pricing of commercial properties should increase approximately 4 percent on average. Cap rates are expected to remain low. Transaction velocity will slow.

Overall, space market fundamentals and rents are improving at a time when it is needed for sustainable valuations. The market is nearing the end of cap rate compression, which was providing the basis for large value gains over the past several years. Long-term borrowing rates remain very favorable to an asset class such as commercial real estate. The level of investment appetite for commercial real estate will continue to grow and fulfill an investment need in the market among alternatives, although we are starting to see some investment shift in favor of the stock market.

The industry has reached new heights and has exceeded expectations that never were anticipated prior to last year. Patient investors should keep a watchful eye on investment decisions. Otherwise, a continuation of the price increases seen in 2006 will create an investment environment in 2008 and beyond that carries unnecessary risks of having prices exceed the intrinsic valuations of the assets.

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