

A New Level of INDUSTRY MATURITY

BY KENNETH P. RIGGS JR.

**Commercial real estate has earned its place in the
pantheon of stable and attractive investment classes.**

**While a smaller market than stocks or bonds,
the real estate market has new followers.**

REAL ESTATE AS AN INVESTMENT CLASS has finally come of age and continues to gain the respect of institutional and retail investors.

Having earned its place with Main Street investors over the past several years when it was able to provide the stability and transparency found lacking in the stock and bond markets, real estate continues as a viable and attractive investment choice. Capital continues to pour into the real estate market with the size of the U.S. institutional-quality real estate debt and equity markets now at slightly more than \$3 trillion. While still relatively small compared with investment in the stock and bond markets (\$13 trillion invested in stocks and \$20 trillion in bonds), it is quite likely that investors will look to real estate even more during the coming years due to the retiring baby boomers' need for income-oriented returns, real estate's relatively stable yield characteristics and the continuing need for portfolio diversification.

I see the commercial real estate investment market transitioning to a new era of investor respect and a level of maturity previously afforded to the stock and bond markets. This new, more mature market will focus on risk management as a necessary tool for assisting investors in gaining marginally better returns while minimizing their risk exposure.

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Despite real estate's stability and general attractiveness, it is important for lenders and investors to remember that real estate is not immune to the risks and uncertainties that affect the stock and bond markets. Given the present investment environment, Real Estate Research Corporation (RERC), Chicago, has identified several critical areas that lenders must understand and incorporate in their debt strategies, with an ultimate commitment to risk management, in order to be successful.

The economy and its impact on real estate

We have always paid attention to the economy, and the famous 1990s tag line of "It's the economy, stupid!" still resonates with investors. More recently, however, the broad real estate investment market has clearly made the connection that the economic outlook for real estate boils down to "Jobs, jobs, jobs!"

The commercial real estate market has watched the expanding economy generate more than 2 million net new jobs during the last year and a half. However, there are early signs that the employment picture is strained, as difficulties continue in industries such as information and technology. High-tech markets—those hit hardest as the fall of the dot-coms ushered in the 2001 recession—continue to reflect weak fundamentals, and have yet to reach their trough employment levels.

A year ago, the economy was poised to come roaring back. Consumer spending remained amazingly resilient, low interest rates continued to provide liquidity to a huge and growing economy, and business spending and investing were finally kicking in. As 2004 got under way, it appeared we were finally hitting on all cylinders, with the economy moving forward. Most important, we were transitioning from a jobless recovery into an economy with a solid overall growth pattern fueled by growth in employment—exactly what was needed to feel confident that a full economic recovery was under way. This was especially critical for the commercial real estate markets that ultimately measure success by filling up space and creating strong earnings for their investors.

Today, the economic landscape has changed. The factors that weigh heavily on the economy—interest rates, inflation, political uncertainty, geopolitical issues and energy prices—are beginning to wear at the optimism of a sustained and even recovery.

The biggest concern of watchful investors rests with slower momentum in household spending, a direct result of

higher prices (especially energy prices), rising interest rates and high debt burdens. Similarly, business growth also has begun to decelerate as the economy and the financial markets have lost the updraft created by favorable employment and demographic factors.

The Federal Reserve Board continues to increase short-term rates, and unless there is a significant reduction in global economic growth, inflationary pressures combined with large federal government budget and current account deficits will eventually put upward pressure on long-term interest rates as well. It is quite conceivable that long-term yields could rise another 100 basis points or more over the next 12 to 18 months.

In time, this will mean consumers increasingly will be less able to borrow, and their cost of servicing existing debt will increase. The economy is expected to settle in at a sustainable 3.5 percent to 4 percent gross domestic product (GDP) growth pace, with productivity growth expected to be near 3 percent. Such a scenario suggests stable employment growth.

Even so, there are a number of downside risks that could adversely affect the outlook for a steady and sustained U.S. economic recovery. They include the risk of a significant retrenchment in consumer spending, higher-than-expected inflation that could lead to more aggressive Fed tightening, and continuing geopolitical/terrorism risk.

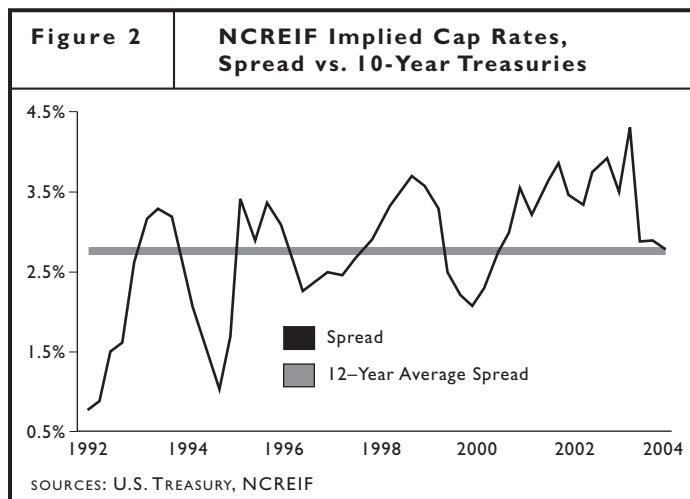
In the near term, we have a sanguine view of the direction of the U.S. economy and a relatively confident view of where monetary policy is headed under the leadership of Federal Reserve Board Chairman Alan Greenspan. (This includes the expectation that interest rates will increase to help control inflation). However, a new Federal Reserve Board chairman will be appointed in 2006, and this, along with the changes in world economies (including the value of the dollar versus other world currencies), could have a dramatic effect on real estate.

From a microeconomic view, corporate profitability and productivity as related to outsourcing/offshoring have a direct effect on the number of new jobs in the market and the real estate required to support them. Further, an understanding of demographics and the economies associated with people—where people work, where they live and where they spend their free time—is still what real estate is all about.

As noted in *Expectations & Market Realities in Real Estate: 2005—Navigating Through the Winds of Change*, which RERC produced in association with Des Moines, Iowa-based Principal Real Estate Investors and Boston-based

RERC Survey Estimate of Required Returns									
RERC Third-Quarter 2004 Required Returns by Property Type									
	Institutional Above-Average			Institutional Average			Institutional Below-Average		
	Pretax Yield (IRR)	Going-In Cap Rate	Terminal Cap Rate	Pretax Yield (IRR)	Going-In Cap Rate	Terminal Cap Rate	Pretax Yield (IRR)	Going-In Cap Rate	Terminal Cap Rate
Office—CBD	8.9	7.6	8.1	9.8	8.1	8.6	10.7	8.6	9.1
Office—Suburban	9.7	8.0	8.6	10.4	8.5	9.1	11.1	9.0	9.6
Industrial—Warehouse	8.6	7.3	7.8	9.6	7.9	8.5	10.6	8.5	9.2
Industrial—R&D	10.0	8.4	9.0	10.6	8.9	9.4	11.2	9.4	9.8
Retail—Regional Mall	8.8	6.9	7.5	9.5	7.4	8.0	10.2	7.9	8.5
Retail—Power Center	9.1	7.9	8.4	10.0	8.3	8.8	10.9	8.7	9.2
Retail—Neighborhood	8.7	7.3	7.8	9.6	7.7	8.2	10.5	8.1	8.6
Apartment	8.4	6.8	7.5	9.3	7.2	7.9	10.2	7.6	8.3
Hotel	12.0	9.9	10.4	12.3	10.3	10.8	12.6	10.7	11.2
All Property Types	9.0	7.3	7.9	10.1	8.2	8.8	11.2	9.1	9.7
	Above-average investment properties are defined as new or newer-quality construction in prime to good locations.			Average investment properties are defined as aging, formerly above-average properties, in good to average locations.			Below-average investment properties are defined as older properties with functional inadequacies or marginal locations.		

SOURCE: RERC



Torto Wheaton Research (TWR), our baseline forecast for the economy calls for everything in moderation. We expect a moderate recovery in spending, moderate inflation and moderate consumer activity.

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Capitalization rates, prices and values

Capitalization rates have continued their downward trend, as reflected in the survey responses of institutional investors in the fall 2004 *RERC Real Estate Report*. Overall required capitalization rates are now at their lowest absolute level in more than 14 years. After experiencing sharp declines over the past two years, capitalization rates for most product types and markets may be bottoming out as investors realize that the downward cyclical pressures of low interest rates abate as the financial environment adjusts to new market realities of higher inflation and interest rates.

However, as demonstrated in Figure 1, required real estate returns on an absolute basis will be lower going forward given the dynamics (secular pressures of lower volatility, lower returns from alternative investments, and need for income vehicles) of the financial world we live in today.

The downward shift in capitalization rates has brought the current spread over risk-free rates near the long-term average, suggesting that the market is acting rationally and with appropriate return expectations. However, given that Treasury rates do adjust more quickly to market factors than capitalization rates, a spread near the average (when rates are near an all-time low) actually places investors at financial risk if interest rates were to begin increasing quickly over the next year. This is of concern to investors

given the political and economic clouds that exist today.

However, many investors are banking on the fact that an environment in which interest rates are rising is indicative of economic growth that is translating into earnings growth for real estate. These factors (the numerator versus denominator effect) need to be carefully weighted for each property type—there will be winners and losers. Figure 2 offers a historical view of Chicago-based National Council of Real Estate Investment Fiduciaries (NCREIF) implied capitalization rate spreads over 10-year Treasury bonds.

Have capitalization rates been pushed too hard by the cyclical pressures of 40-year-low interest rates? This is a realistic question for our industry today, given that capitalization rates are at very low levels while the economy is still not showing adequate strength.

These low capitalization rates (which reflect all-time high prices), as depicted in Figure 3, display the current NCREIF implied capitalization rate spread over 10-year Treasury bonds in relation to the 10-year average spread. It is quite obvious that apartment pricing has been the most aggressive with a current spread of only 120 basis points (nearly 100 basis points below the 10-year average), and apartments will certainly face significant pressure if risk-free rates move upward.

To no one's surprise, office investments reflect the highest spread over their historical levels. In a world where market inflection points are missed, office properties may offer the next opportunity. However, only a rigorous risk-and-

return analysis of each opportunity can present the right investment situation, and in today's mature and competitive lending environment, that is what it takes to be successful on the margin.

Ultimately, an investor's decision to buy or sell is based on the valuation of a given asset versus the price of the asset. The price is the amount that an asset trades for at a given point in time, which may include cyclical influences such as low interest rates or a high level of capital flows embedded into the pricing structure. Value is more of a secular, or long-term, concept. In today's mature investment climate, successful investing depends on understanding cyclical versus secular issues, especially as they relate to capitalization rates, values and prices.

Real estate risk and return

Real estate continues to deliver acceptable risk-adjusted returns relative to alternative investments. As real estate continues to position itself more clearly in the asset allocation mix, many investors are beginning to understand real estate to a greater degree, and are realizing that real estate's income-oriented nature creates a lower risk profile when compared with other asset classes such as stocks and bonds. This, along with the added benefit of portfolio diversification, prompted secular capital to flow into the real estate market in 2003 and 2004.

As shown in Figure 4, which profiles the returns and risks among the property types, the relative return varies among property types. To consider the financial performance of the various property types on an absolute versus a relative basis, RERC has developed a risk-adjusted return (RAR) metric. This risk metric allows investors to see why apartment investments have been and continue to be pursued by most investors.

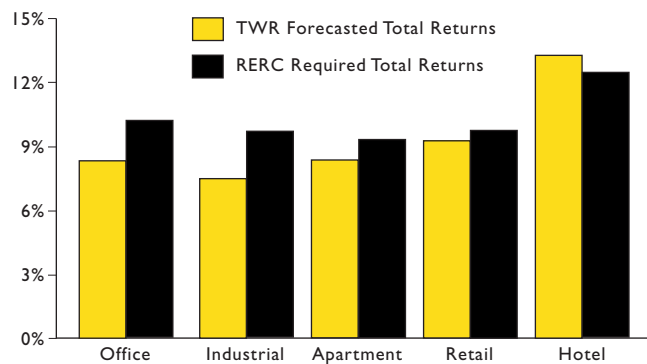
With a RAR of 6.3, apartment investments outpaced the other core property types by a wide margin. Although we expect the risk and return profile for real estate to continue to remain strong, short-term capital coming into the market will likely buy high and sell low—thus earning below-average risk-adjusted returns over the next few years.

Product Type	Historical Spread	Current Spread (Q2 2004)
Office	290 basis points	360 basis points
Apartment	210 basis points	120 basis points
Industrial	300 basis points	290 basis points
Retail	300 basis points	280 basis points

SOURCES: U.S. TREASURY, NCREIF

Property Types	10-Year Average Returns				
	NCREIF Returns	NCREIF St. Dev.	RAR Metric	RERC Returns	NCREIF vs. RERC
Apartment	11.51%	1.82%	6.3	10.80%	0.71%
Industrial-Warehouse	11.55%	2.42%	4.8	10.90%	0.65%
Power Center (9-Year)	12.55%	3.71%	3.4	11.43%	1.12%
All Property Types	10.65%	3.27%	3.3	11.35%	-0.69%
Neighborhood/Community	11.07%	3.62%	3.1	11.15%	-0.08%
Office-CBD	10.76%	4.97%	2.2	11.30%	-0.54%
Office-Suburban	11.25%	6.77%	1.7	11.47%	-0.21%
Industrial-R&D	12.74%	8.23%	1.6	11.55%	1.19%
Regional Mall	9.91%	6.53%	1.5	11.11%	-1.20%
Hotel	13.31%	10.40%	1.3	12.98%	0.32%

SOURCES: RERC, NCREIF

Figure 5**TWR 10-Year Forecasted Total Returns vs. RERC Required Total Returns**

SOURCES: RERC, TWR

Transitioning to an intensive risk-management environment

Effective risk identification, risk pricing and risk management are critical to earning acceptable returns on one's real estate investment. Furthermore, RERC believes that risk management, like modern portfolio theory (MPT) and cash-flow analysis before it, must take center stage as one of the mainstream tools needed to help quantify and earn acceptable risk-adjusted returns.

One area of focus for the industry is to develop a more formal approach to forecasting total returns for real estate, such as that shown in Figure 5. Lenders, investors and their advisers are put in the position of trying to beat some type of real estate index and attempting to outperform the market, thus creating a positive alpha or above-market return given a certain level of risk.

Despite the projection that future real estate total returns are generally unlikely to outperform returns relative to the last decade, specific investor portfolios have the potential to outperform the broader market. While market and property-type selection are clearly important elements of a successful investment strategy, significant value can be added at the individual property management and leasing level.

In addition, it is likely that future real estate valuation swings will be less severe than historical levels. This shows that commercial real estate markets are maturing and that the amplitude of future cycles likely will be reduced. As such, it can be argued that real estate's risk-adjusted return outlook remains quite solid.

As reflected in Figure 5, which compares forecasted returns versus required returns, a lender or investor can see that the hotel sector offers not only the highest absolute return, but is forecasted to provide a higher return than currently required by investors. Conversely, the office sector reflects a relatively low absolute return and does not meet the targeted required return. This analysis allows lenders and investors to perform a risk assessment not previously done on an explicit basis.

Commercial real estate investment has truly come of age—a thought that's worth repeating. Increasing numbers of institutional and retail investors have found that real estate is an excellent match with their increasingly demographically driven need for current income and capital preservation, as well as diversification away from the risks of the stock and bond market. And therein lies the increasing appeal of real estate—despite the likelihood that future real estate total returns will be somewhat lower than in the past.

Whether one is looking at real estate from a debt or equity position, answering the following questions is critical to determining whether one should invest in any given property: What absolute returns can one expect to receive from commercial real estate? Are these levels of returns sufficient on a risk-adjusted basis and comparable to the performance of other investment alternatives? How does leveraging the assets in the portfolio affect the amount of risk? How does movement in capitalization rates and discount rates affect returns? In separating market risk from active risk, how will increasing interest rates affect values?

Today, the industry finds itself at the crossroads for maximizing return and minimizing risk. To accomplish that balance the industry must address the questions just posed. Only by understanding and applying appropriate risk-management analysis can answers be found to these important questions. Fortunately, the industry is well-positioned to step up and address these challenges in order to achieve the highest level of risk-adjusted returns. **MB**

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