

Various commercial property types will fare much differently given different economic scenarios. Here's the outlook from the Real Estate Research Corporation on how to prepare for the changing market conditions ahead.

BY KENNETH P. RIGGS JR.

STORM Watch

CONSUMERS, HOMEBUYERS, LENDERS AND COMMERCIAL REAL ESTATE INVESTORS ARE COMING TO TERMS with the market reality that the honeymoon will soon be over for 46-year-low interest rates. During the recent period of high commercial vacancies, low demand and deteriorating values, most pundits concluded we could thank low interest rates for keeping commercial real estate performance positive and creating a broad market investment appeal for those reeling from the dot-com crash of the late 1990s. Without low interest rates to prop up poor fundamentals, will real estate performance go the way of other investments that have been providing declining or even negative returns, and lose its relative attractiveness? ● With job growth strong, retail sales up and commodity prices booming, it is only a matter of time before the Federal Reserve Board raises the funds rate in order to control inflation, and interest rates will begin their climb. In fact, the odds are close to 9 to 1 that as you read this article, the Fed already will have begun to act. ● What do higher rates mean for the economy? ● The current generation of thinking maintains that even though higher interest rates make capital more costly and negatively impact corporate earnings, the fact that the Fed finds it

necessary to increase rates is a good indication of its confidence in the recovery. The facts bear this out.

Gross domestic product (GDP) growth has accelerated year over year for the last quarter. Jobs are back. Retail sales and durable-goods orders are strong. In addition, while demand is such that companies can pass along some increase in costs to consumers, pricing power is not likely to turn into inflation until wages increase significantly. (According to most economists, wages will not increase until unemployment declines at least 1.5 percentage points further, or to approximately 4 percent.) While we all wish for continued job growth and lower unemployment, it is most likely this will take place over a period of time, and will allow the Fed to adjust rates gradually to better control inflation.

The other school of thought, however, for those of us old

enough to have been in business 25 or more years ago, is more affected by flashbacks of double-digit interest rates, skyrocketing inflation and Jimmy Carter-era fuel shortages. Those memories remind us that despite the best efforts of the Fed, monetary policy is not always able to harness inflation (i.e., inflation was 7.6 percent in 1978 and by 1980 it had risen to 13.5 percent).

Investors and money managers too young to have witnessed firsthand the difficulties of the 1970s should take note that an economy saddled with a \$500 billion deficit, combined with growing federal spending for homeland security and defense, Social Security, Medicare and other outlays, cannot continue to spend without increasing taxes, borrowing further or printing more money. And doing any one of those things can fuel higher prices and increase inflation.

Figure 1		Required Real Estate Yields vis-a-vis Capital Market Returns					
	1Q 2004	4Q 2003	1Q 2003	1Q 2002	1Q 2001	1Q 2000	
Real Estate Yield (%)	10.3	10.5	11.3	11.8	11.5	11.7	
Moody's Baa Corporate (%)	6.4	6.7	7.2	7.9	7.9	8.3	
Moody's Aaa Corporate (%)	5.5	5.7	6.0	6.6	7.1	7.7	
10-Year Treasuries (%)	4.1	4.3	3.9	5.0	5.1	6.5	
Yield Spread (Percentage Points)							
Moody's Baa Corporate (%)	3.9	3.8	4.1	3.9	3.6	3.4	
Moody's Aaa Corporate (%)	4.8	4.8	5.3	5.2	4.4	4.0	
10-Year Treasuries (%)	6.2	6.2	7.4	6.8	6.4	5.2	

SOURCES: RERC INVESTMENT SURVEY, FEDERAL RESERVE

Figure 2		RERC Required Return Expectations by Property Type								
	Industrial		Retail			Office		Apartment	Hotel	Average
	Warehouse	R&D	Regional Mall	Power Center	Neighbor/Comm.	CBD	Suburban	Apartment	Hotel	All Types
Pre-Tax Yield (IRR) (%)										
Range	8.3-12.0	9.5-12.0	9.0-10.5	8.0-12.0	8.5-12.0	8.5-12.0	9.0-12.0	8.0-12.0	12.0-13.0	8.0-13.0
Average*	9.7	10.7	9.8	10.4	10.0	9.9	10.4	9.4	12.6	10.3
Going-In Cap Rate (%)										
Range	7.3-9.5	8.0-10.0	7.0-8.3	7.0-9.0	7.0-9.0	7.3-10.0	7.8-9.5	6.0-8.0	10.0-11.0	6.0-11.0
Average*	8.1	9.0	7.7	8.4	8.0	8.3	8.8	7.4	10.7	8.5
Terminal Cap Rate (%)										
Range	7.5-10.5	8.5-10.5	7.5-8.8	7.5-9.5	7.5-9.5	7.8-11.0	8.5-10.5	6.5-9.0	10.6-12.0	6.5-12.0
Average*	8.6	9.6	8.4	9.0	8.6	8.8	9.3	8.0	11.3	9.1
Rental Growth (%)										
Range	-2.0-4.0	-2.0-5.0	1.0-4.0	0.0-3.5	-1.0-3.0	0.0-4.0	-2.0-5.0	-2.0-4.0	0.0-4.0	-2.0-5.0
Average*	1.7	1.4	2.5	2.4	2.3	1.8	1.5	1.9	2.4	2.0
Expense Growth (%)										
Range	0.0-3.5	1.0-3.5	2.0-3.5	1.5-3.5	2.0-3.5	2.0-3.5	2.0-3.5	1.5-4.0	2.0-3.5	0.0-4.0
Average*	2.6	2.5	2.8	2.7	2.8	2.8	2.7	2.8	2.8	2.7

NOTE: This survey was conducted in January, February and March 2004 and reflects expected returns for first-quarter 2004 investments.
* Ranges and other data reflect the central tendencies of respondents: Unusually high and low responses have been eliminated.

SOURCE: RERC INVESTMENT SURVEY

This is not Real Estate Research Corporation's (RERC's) view of the world to come, but thinking about the possibilities is always sound investment advice. We have certainly learned that it is the unexpected that catches us flat-footed—after all, life and investing are all about matching expectations to market realities, and being prepared to execute your strategies and plans.

Effect of higher rates on the broader market

All markets will be affected to some extent by increasing interest rates and higher inflation. Bonds, except for Treasury inflation-protected securities (TIPS), lose value as rates rise and are expected to continue to offer low realized returns through 2005. The relative impact of rising interest rates is dependent on the duration, or term, of the fixed-income instrument.

As interest rates move up, the challenge for this investment arena is, "Did investors anticipate the moves of the Fed relative to how the markets would react to the realities of inflation and the economy in general?" We note that the 10-year Treasury bond yield rate was at 4.7 percent on June 1, down from 4.8 percent a week earlier but up from 3.7 percent just two months earlier.

Based on our forecast, 10-year Treasuries are expected to increase over the next 12 months to the low to mid-5 percent range. Therefore, if you are an investor in fixed-income instruments, you should be on the short end of the duration or term range. Conversely, if you are borrowing money, you want to lock these low rates in for as long as you can.

The stock market outlook has many dimensions to it when looking through the interest rate prism. As interest rates climb, the cost of capital clearly increases. In addition, the earnings and values—especially those for consumer-oriented, interest-rate-driven stocks such as automobiles, durable goods, building supplies and home furnishings—will likely decline for the near term, while stocks associated with non-interest-rate-affected industries will hold their own and even demonstrate growth. As will be discussed later in this article, for real estate prices and values to hold or grow, earnings have to outstrip the increase in your cost of capital.

Beyond the direct impact of increasing interest rates, such psychological factors as high oil prices, terrorist activities in the oil-producing countries and increasing threats to the United States and the upcoming presidential election are also causing some uncertainty in the stock market. Although there are no hard, fast answers as to how stocks will perform in a period of increasing interest rates, according to Ned Davis Research Inc., Venice, Florida, historically, stocks have fallen 1.3 percent in the two months after the first in a series of Fed rate boosts. But stocks have risen 5.1 percent the two months after that and then have kept going up.

Credited with keeping the economy afloat during the recent recession and recovery, consumers have taken advantage of low interest rates to refinance existing home loans and to build or buy new homes. In so doing, consumers have put trillions of dollars into the economy, but as interest rates increase, this contribution will stop. While it is too early to

determine the ripple effect of consumers via the residential real estate market, the effect of not having those contributions to the economy is expected to be profound.

As for the effect of increasing interest rates on commercial real estate, RERC notes that first-quarter 2004 required yield rate expectations, yield spread and capitalization rates continue downward, as shown in the spring 2004 issue of the *RERC Real Estate Report—Bracing for the Storm* (see Figures 1 and 2).

There is still a lot of money chasing real estate, but with increasing interest rates, the end is in sight for cyclical or short-term capital players—although there may be a mad rush to finalize deals before the upward climb begins. Further, just the expectation of increasing interest rates has many long-term players heaving a sigh of relief that some of the "hot" money will finally be drained off the top so they can exercise their investment and direct long-term committed dollars to commercial real estate.



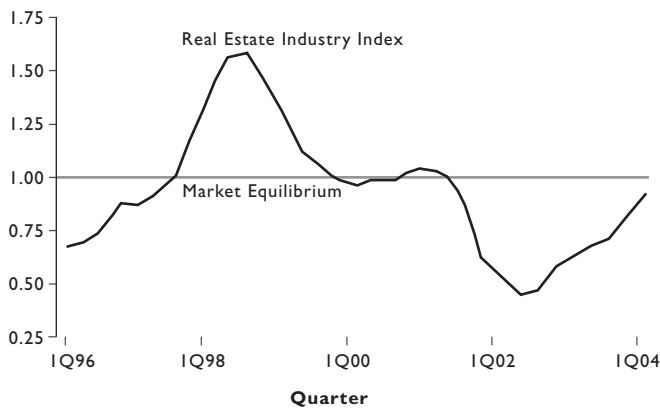
Real estate capital markets

Given the relatively consistent income returns for real estate as compared with the recent volatility of the stock markets, real estate is an increasingly desirable investment for pension funds. In fact, some funds are reported to be increasing their real estate allocation to 5 percent. And because most pension funds typically do not leverage their assets, rising interest rates will have little effect on existing properties in the portfolio.

RERC also has seen an increase of foreign capital directed to the U.S. real estate market, and we expect this to continue as long as the dollar remains weak. Further, the United States continues to drive the world economy. As long as the U.S. economy is in a position of growth, and unless interest rates increase dramatically, foreign investors will continue to look to the United States. Local leverage buyers will continue to find real estate investment an attractive investment compared with the risk involved with stocks.

As interest rates increase, it is important for managers to use a disciplined risk-management process for weighing risk versus return for the various property types and locations. This is necessary in order to more quickly react should interest rates be raised sooner than the Fed anticipates (they may be raised more dramatically if the economy grows faster or inflation accelerates quicker than expected).

RERC's *Risk and Return Analysis* offers some insight into required returns for the various property types and classifications. Overall real estate performance began declining during the 2001 recession, but since third-quarter 2002 has been improving and is now close to reaching the point of equilibrium (see Figure 3).

Figure 3**RERC Core Property Investment Performance Cycle**

SOURCE: RERC INVESTMENT SURVEY

Values to hold steady or decline?

In looking at valuation and pricing going forward, it is important to remember the basics. The basic value formula for income-producing properties equates net operating income (NOI) or earnings divided by overall capitalization rate, which includes an implicit amount for your cost of capital. Remember, this direct capitalization method for real estate is a shorthand method for a discounted cash-flow analysis.

For commercial investment, increased vacancies, eroding rent levels and lack of demand have created weak operating statements and lower NOIs. Even though the numerator (or NOI portion) of this simple value equation has been decreasing, the denominator (or interest rates) has been decreasing at a proportionately higher level, so values remained strong.

Value or pricing = net operating income / overall capitalization rate.

However, this may all be about to change. With interest rates set to increase, the precarious balance between NOI versus the overall capitalization rate will tip unless NOI increases more than the increase in the overall capitalization rate, which includes your cost of capital and NOI growth expectations. It is the numerator versus the denominator effect. As new jobs increase, renters move to where the new jobs are, consumers continue to buy and workers, apartment dwellers and shoppers demand more commercial space. With this sequence of events occurring, NOI should eventually begin to increase.

Let us explore this relationship given RERC's forecast for the space markets and interest rates, keeping in mind the

need for today's real estate lenders and investors to focus on risk management.

RERC forecast for rate increases

In a special study conducted by RERC and analyzed in the spring 2004 *RERC Real Estate Report*, RERC offers three different scenarios for increasing interest rates. In each case, as interest rates increase, some property values are put at risk. This type of analysis is value-at-risk (VaR). RERC's forecast as to how the various property types will perform, generally, in each of the different increasing interest scenarios is summarized as follows.

Gradual Increase (60 percent probability)

Given solid U.S. job growth, RERC believes that a gradual increase in interest rates, beginning in mid- to late 2004 and increasing incrementally 100 to 200 basis points over the next year or two, is the most likely roadmap for the Fed to follow. In this case, consumer spending will start to slow as prices for nondiscretionary items increase, and inflation increases to a targeted level of 2 percent to 3 percent.

With a gradual increase in interest rates, apartments, hotels and industrial warehouses are expected to perform relatively well. RERC believes apartment performance improvement is just around the corner, as current reported returns are nearing investors' required returns. Hotels also are expected to perform well, as business travel has already begun to increase and vacation season is under way; RERC forecasts that combining hotel income returns close to 2003's 8 percent with appreciation near inflation will yield double-digit returns overall.

As for industrial warehouses, although capitalization rates increasingly will begin to show signs of trending upward and will put pressure on values and prices, decreasing vacancies and stable-to-increasing rents will offset those increasing capitalization rates, and eventually prices and values will increase accordingly.

If interest rates increase gradually, office, industrial research and development (R&D) and retail properties are not expected to perform well. In this scenario, office prices appear to have peaked and values are expected to deteriorate quickly, despite lower vacancies due to job growth. Although sales are at record levels, consumer spending is expected to slow as prices for consumer products increase. RERC believes current return levels for retail properties are unsustainable in this environment, and will begin to deteriorate.

WITH A GRADUAL INCREASE IN INTEREST RATES, APARTMENTS, HOTELS AND INDUSTRIAL WAREHOUSES ARE EXPECTED TO PERFORM RELATIVELY WELL.

Tepid Increase (25 percent probability)

If job growth begins to slow dramatically, the Fed may elect to leave interest rates where they are for the next year or so, and then raise interest rates by less than 100 basis points in mid-2005 through 2006. In this scenario, consumer spending continues, and concerns about deflation are more worrisome than threats of inflation.

If interest rates remain stable and consumers continue to spend, retail and industrial warehouse properties will continue to perform. Unfortunately, the sustainability of the consumer,

as well as the current reported total National Council of Real Estate Investment Fiduciaries (NCREIF) returns of 17 percent for retail, remain in question, and RERC sees retail performance eventually beginning to deteriorate. Warehouse investments have shown their resiliency, and RERC suggests investors can expect near-term returns to remain around the current reported NCREIF total returns of 8.5 percent.

If job growth slows and interest rates stay low, apartment, hotel and office performance will continue to suffer. Renters by choice cannot offset the attraction of low interest rates for homebuyers and builders, and apartment vacancy will continue around 7 percent to 8 percent. Hotels are not expected to perform well in this environment either, with sluggish job growth limiting corporate and leisure travel. Regarding office performance, capitalization rates are near their all-time lows and prices have peaked. Office values will begin to fall slowly, and the current NCREIF return of 6 percent is in danger of slipping further.

Steep Increase (15 percent probability)

The least likely scenario will be if there is very robust job growth, and the Fed keeps interest rates low through 2004 and then hikes them dramatically. In this environment, rising inflation becomes a real threat and consumer spending suffers. Recent price increases for food, gasoline, clothing, furniture and hotels seem to suggest that inflation may be taking off, but thus far these price increases have been marginal.

Interestingly, robust job growth and a steep increase in interest rates could bode well for returns on most commercial properties. Hotels, apartments, industrial R&D properties and offices could all perform well in this environment. RERC expects that total investment returns could reach the low teens for hotels due to high job growth and travel. Significant demand for apartments would be created by renters of necessity as job growth expands, and although increasing interest rates will affect capitalization rates, prices and values will not be affected as lower vacancies and higher rents will more than offset increased interest rates.

Industrial R&D properties with their current NCREIF-reported total returns of 4 percent have the most to gain in this scenario, although they will feel some pressure from large increases in interest rates and there is still a great deal of risk involved with this property type. Robust job growth is also expected to finally increase demand for office properties, and although value declines will occur with a substantial increase in rates, demand will quickly bring values to a more stabilized level.

Although the increase in job growth will keep consumers spending, this may not be enough to offset the effect of increasing interest rates on retail properties, as average retail capitalization rates are around 7 percent to 8 percent. RERC forecasts that retail returns will deteriorate from current levels, but will still provide a fair return to investors. Industrial warehouse prices and values will begin to feel some heat from the large increase in interest rates, and lower vacancies and higher rent levels won't be enough to withstand the increase in capitalization rates.

The outlook

In addition to the forecast information for various property types in the three increasing interest rate scenarios, RERC expects the following in terms of the overall outlook:

The economy will continue to fulfill expectations, grow and add new jobs. Interest rates will rise, but RERC views these rate increases as part of a healthy recovery (rather than a negative effect).

There will be a period of adjustment in dealing with increasing interest rates as they move up from what are now exceptionally low levels.

All investments will be affected to some degree by higher interest rates, although some invest-

ments are more interest rate-sensitive than others. For the short

term, bonds will be negatively impacted, certain stocks will be negatively affected and some real estate also will be negatively affected.

There is a need to gain perspective and develop a solid risk-management approach to increasing interest rates.

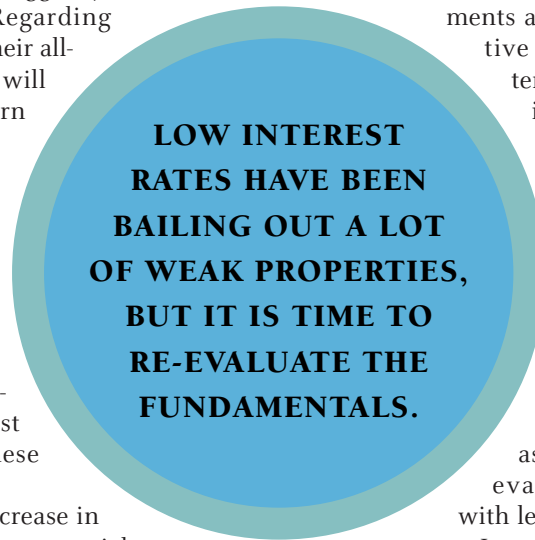
Borrowers will want to lock in low rates for as long as they can. Lenders need to evaluate the risk associated with lending at today's low rates.

Low interest rates have been

bailing out a lot of weak properties, but it is time to re-evaluate the fundamentals. For example, with deteriorating NOIs, office property owners will have trouble paying their debts, resulting in more defaults. Fortunately, underwriting generally has been quite disciplined, and RERC does not anticipate the number of defaults to be as high as those that occurred in the early 1990s.

Lenders need to focus on the numerator-versus-denominator effect. Look for properties with increasing capitalization rates. Apartments and hotels will do best. Office properties (which have benefited greatly from low interest rates) and retail properties (which have good fundamentals now but are expected to suffer if the consumer begins to weaken) involve more risk.

In the long term, commercial real estate will remain a solid arena. However, for the next 12 to 18 months, there will be a period of adjustment as the cyclical effect of low interest rates works itself out of the economy and financial markets. **MB**



Kenneth P. Riggs Jr. is chief executive officer and managing principal of Chicago-based Real Estate Research Corporation (RERC). RERC provides research, valuation, independent fiduciary services and general consulting to clients throughout the United States. It publishes the quarterly *RERC Real Estate Report*; the online RERC DataCenter, which provides independent national, regional and metropolitan-level investment criteria; and the annual *Expectations & Market Realities in Real Estate*, which offers annual forecast information for real estate. Riggs can be reached at riggs@rerc.com.