

FOCUS ON INVESTMENT CONDITIONS

Capital Still Flows Into Commercial Sector as Investors Become More Discriminating

BY KENNETH P. RIGGS, CRE

COMMERCIAL REAL ESTATE continues to be an attractive investment relative to stocks and bonds for many reasons. Today, however, the appeal of commercial real estate is in its extremely high realized total returns in the absence of very little perceived downside risk.

The level of capital that continues to flow into the market indicates that commercial real estate is clearly coming of age. This sustained level of capital in the public and private real estate markets has created a very competitive environment for investment product. With this continued influx of retail and institutional capital, commercial real estate investments will push the envelope by taking on riskier investment strategies and, as a result, pricing parameters for commercial real estate continues at heightened levels.

Observers are seeing upward pricing pressure and extremely low cap-rate expectations for properties high on the list for institutional investors. However, it appears that investors are exerting upward pressure on cap rates for properties that are more interest-rate sensitive and in more marginal locations. The market is not fickle, but reflective of investors becoming more discriminating.

Commercial real estate performance has easily outpaced other investments and continues today to far exceed investor expectations. This success can be measured by a comparison of realized vs. expected returns, which has been a very good barometer of the relative strength of the market.

Institutional commercial real estate investors sense that they have had it too good for too long in the traditional core real estate arena. They realize it is an appropriate time to look outside the defined core property types and change their traditional views of real estate investments. As Table 1 shows, commercial real estate has been in an over-performance phase—with realized returns exceeding expected returns—since the second quarter of 2004.

Comparing these expected returns with realized returns shows a market that has been over-delivering—promises



About the Columnist

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made were promises kept. This performance is a contrast to the relationship observed in the past. The NCREIF Property Index, or NPI, exemplifies this phenomenon with annual total property returns of more than 19 percent for the 12 months ending second quarter 2006 and more than 15 percent over a three-year period for

largely core-type investments. Investors have lowered overall return expectations as the sluggish stock market shows flat capital growth year-to-date, and low interest rates have permitted a high degree of positive leverage.

For much of the 1990s, strong returns for alternative investments, including stocks, led to the promise of overly aggressive acquisition returns. NPI returns were negative to 7.5 percent from 1990 through 1995, and did not exceed 9 percent from 2001 through 2003. As shown in Table 2, commercial real estate has done well and clearly has earned its rank among stocks and bonds.

The maturing of the industry and expanding view of what is considered an appropriate commercial real estate play is coming at a very challenging time in our world. Common concerns include inflation, increasing interest rates, geopolitical tensions in the Middle East, a slowing in the housing market, a reduction in discretionary consumer spending and higher commodity prices, especially oil. Despite continued strong consumer confidence, the lower end of the market is showing some signs of consumer stress.

Real estate investors are evaluating what the changing economic, financial and political environments mean to

Table 1
RERC All Properties
Investment Performance Cycle



Table 2
What Do The Financial Markets Tell Us?

Compounded Annual Rates of Return as of 6/30/2006

MARKET INDICES	1-YEAR	3-YEAR	5-YEAR	10-YEAR	15-YEAR
Consumer Price Index	3.18%	2.63%	2.70%	2.83%	2.92%
10-Year Treasury Bond*	4.59%	4.37%	4.41%	5.12%	5.65%
Dow Jones Industrial Average	8.52%	7.46%	1.20%	7.03%	9.38%
NASDAQ Composite	3.06%	9.42%	0.24%	5.90%	10.31%
NYSE Composite	10.31%	12.67%	3.66%	7.74%	9.00%
S&P 500	6.62%	9.24%	0.74%	6.60%	8.55%
NCREIF Index	18.68%	15.85%	12.13%	12.49%	9.01%
NAREIT Index	19.06%	26.14%	19.39%	15.13%	14.70%

*Based on Average End of Month T-Bond Rates
Sources: Economy.com, NCREIF, compiled by RERC

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Table 3: RERC Investment Criteria Chart

RERC Required Return Expectations¹ by Property Type

	OFFICE		INDUSTRIAL		RETAIL			Apartment	Hotel	Avg. All Types	RERC Portfolio Index
	CBD	Suburban	Warehouse	R&D	Regional Mall	Power Center	Neigh/Comm				
PRE-TAX YIELD (IRR) (%)											
Range	7.5-11	7.3-11	7-12	7.5-12	7.5-11	7.3-10.5	7-10.5	7.3-10	9-12	7-12	7-12
Average²	8.8	9.1	8.7	9.4	9.2	8.6	8.5				
Weighted Average³	9		8.7		8.9			8.4	10.8	9.1	8.9
GOING-IN CAP RATE (%)											
Range	6-8.5	6.3-9	5.5-9.5	6.5-9.5	5.8-9	5.5-8.5	5.5-8.3	5-8.1	6.5-10.5	5-10.5	5-10.5
Average²	7.1	7.5	7.2	7.8	7.5	7.1	7				
Weighted Average³	7.3		7.2		7.3			6.5	8.9	7.4	7.2
TERMINAL CAP RATE (%)											
Range	6.3-9.3	6.8-9.5	6.5-10	6.8-10	6.3-10	6-9.5	6-9	5.5-8.6	7.2-11	5.5-11	5.5-11
Average²	7.7	8.1	7.9	8.5	8.2	7.7	7.6				
Weighted Average³	7.9		7.9		8			7.1	9.6	8.1	7.8
RENTAL GROWTH (%)											
Range	0-5	0-4	0-3.5	0-4	1-3.3	0-3.5	0-3.5	0-4.5	2-7	0-7	0-7
Average²	3	2.9	2.6	2.5	2.6	2.5	2.7	3.1	3.4	2.8	2.9
Expense Growth (%)											
Range	2-3.5	2-4	1.5-3.5	2-3.5	2-3.5	2-3.5	2-3.5	2-3.5	3-4	1.5-4	0.5-4
Average²	2.9	2.9	2.8	2.8	3	2.9	2.9	3	3.2	2.9	2.9

¹ This survey was conducted in April, May and June 2006 and reflects expected returns for second quarter 2006 investments.

² Ranges and other data reflect the central tendencies of respondents: unusually high and low responses have been eliminated.

³ Weighting based on 1Q06 NCREIF Portfolio market values.

Source: RERC Investment Survey

returns. In some cases, the best option is investing in a different property sector. In other cases, it is evaluating demographic and industry changes and possibly selecting a different location in which to invest. In still other cases, it is taking a realistic look at costs such as insurance or other expenses, and determining whether it is possible to pass them on to tenants in the form of higher rental rates. We have enjoyed the benefits of a growing economy and will continue to do so. But as the rate of growth moderates, expect adjustments to the changing market.

A CLOSER LOOK AT THE MARKETS

Shifting from the previous two quarters, respondents to RERC's second quarter 2006 institutional survey rated commercial real estate slightly higher than stocks as an investment alternative (stocks were rated more favorably during the previous two quarters). The most recent respondents continue to prefer stocks over cash and

bonds. These institutional survey respondents rated all commercial property types lower than in the previous quarter in terms of investment prospects.

On a scale of 1 to 10, with 1 being the lowest, the industrial warehouse and apartment sectors tied for the highest rating, at an average of 6.3. Of all the primary sectors, retail earned the lowest ratings, and the regional mall subsector received the lowest score—a 4.6 average—of all property types that RERC surveys each quarter.

OFFICE SECTOR

RERC's second quarter 2006 investment conditions ratings for the central business district and suburban office markets are slightly lower than those of the previous quarter. Office market fundamentals have improved slightly on a national basis. Decreasing vacancy rates and an increase in demand because of fewer completions have helped to increase rental rates slightly.

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RERC's required going-in capitalization rates for the CBD and suburban office subsectors increased from last quarter by 10 and 20 basis points, respectively (see second quarter 2006 rates in Table 3), and the terminal capitalization rates for each property type increased as well. Survey responses indicate that expected rental growth, by percentage, in both types of office properties is likely to decline.

However, vacancy rates continue to decline, and supply growth remains constrained.

INDUSTRIAL SECTOR

Respondents gave the industrial warehouse sector one of their highest investment conditions ratings—6.3 out of 10, with 10 being high—tying for the top spot with the apartment sector during second quarter 2006.

However, the 6.3 rating was lower than last quarter's rating of 7.0. Respondents rated the industrial research and development sector at 5.5, down from 5.9 last quarter. Some respondents expect these numbers to improve because of increasing construction costs and land prices, which will limit the amount of development.

RERC's required going-in and terminal capitalization rates for industrial warehouse and R&D space each increased from the previous quarter, though expected rental growth was down for both property types. Expected expense growth for the industrial warehouse sector remained steady at 2.8 percent, and the industrial R&D sector increased slightly to 2.8 percent.

APARTMENT SECTOR

The investment conditions rating for the apartment sector has decreased slightly from the previous quarter, but is still tied, along with the industrial warehouse sector, for the highest rated sector. Second quarter 2006 apartment vacancy decreased to 5.6 percent from 5.8 percent, according to Reis Inc. The decline in occupancy is primarily because of increased absorption.

Some respondents suggest the apartment sector is on the upturn, and performance will improve as increasing interest rates make owning a home less affordable, thereby increasing demand, occupancy and rental rates. RERC's going-in capitalization rate for the apartment sector increased to 6.5 percent from 6.4 percent last quarter, and expected rental rate growth for apartments also is up.

RETAIL SECTOR

Institutional survey respondents placed the retail sector at the bottom of the scale with respect to investment conditions for second quarter 2006. On a scale of 1 to 10, with 1 being the lowest, neighborhood/community centers received a 5.6, power centers received a 5.0, and regional malls received a 4.6—the lowest of all of the property types that RERC surveys each quarter. All these ratings were between 40 and 90 basis points lower than first quarter results.

Respondents gave the industrial warehouse sector one of their highest investment conditions ratings—6.3 out of 10, with 10 being high—tying for the top spot with the apartment sector during second quarter 2006.

The rating is influenced by a number of issues, including increased caution in consumer spending, an already overpriced retail sector with no room for growth, overbuilding, and capitalization rates that are becoming much closer to interest rates. Retail sector availability rates are continuing to increase, with current availability at 8.5 percent, up from last quarter's 7.6 percent, according to Torto Wheaton Research.

In part, this increased availability rate is caused by the slowdown of retail sales in some areas, partially spurred on by increased housing and fuel costs. Because these factors probably won't improve greatly, the retail sector is likely to see continuing availability increases. Research shows that six of the top 10 areas with the lowest availability rates in the retail sector are in the state of California.

HOTEL SECTOR

RERC's investment conditions rating for hotels for second quarter 2006 is 5.6, slightly lower than the previous quarter's rating of 6. Several respondents to the RERC institutional investment survey stated that the hotel industry is facing high demand and will fare well because of limited supply.

According to Torto Wheaton Research, hotel occupancy rates have increased to nearly 72 percent from 66 percent last quarter. Revenue per available room, or RevPAR, is at \$80, an increase of 8 percent since year-end 2005. Some areas with the highest RevPAR include New York City at

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Table 4
RERC Expected Return Estimates

RISK CATEGORY	LEVERAGE	TOTAL EQUITY RETURN
Core (no or low leverage)	0 to 25%	7% to 8%
Core (moderate leverage)	25% to 50%	8% to 10%
Core-Plus	50% to 70%	10% to 13%
Value-Add	65% to 75%	13% to 16%
Opportunistic	70%+	16%+

just over \$175; Washington, D.C., at \$120; and Honolulu at nearly \$120.

RERC's going-in and terminal capitalization rates for the hotel sector increased to 8.9 percent and 9.6 percent, respectively, and expected rental growth for hotels increased 30 basis points compared with last quarter. This increase is the first since third quarter 2005, indicating a possible upturn in the hotel sector. The development of mixed-use facilities that incorporate hotels with condominiums also is increasing, allowing new properties to enter the market while keeping the amount of new offerings in check.

CONCLUSION

Commercial real estate is coming of age in a global environment and, as such, is creating new investment frontiers and strategies. As the industry matures, it continues to take on elements of investment style and attitude like the stock and bond markets. In today's extremely capital competitive world, investors are willing to take on unexplored risk arenas in search of alpha, or higher returns with lower relative risk.

The challenge for the entire industry is to develop more rigorous models to approach risk classification and quantification relative to expected return. Commercial real estate is in a very solid position to get it right this time, and to continue to play a more significant role in the investment portfolios of both retail and institutional investors. Given the still local nature of commercial real estate, there is the opportunity for investment managers to add value and, thus, find true alpha strategies.

RISK AND RETURN INVESTMENT SPECTRUM

Based on RERC's extensive work in the industry, its conclusions, and the general consensus noted in forecasts for recent investment funds, the range of total equity return parameters expected by investors gives an indication of the risk profile of the classifications listed in Table 4.

The yield parameters have changed through the years, with steady declines in the past several years. Most new investment funds that target institutional capital, such as commingled funds sponsored by pension fund advisors, market themselves with monikers expressing their risk profile using the aforementioned labels. ■