Reconciling the spatial market/capital market gap
James R DeLisle
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Reconciling the Spatial Market/Capital Market Gap

by James R. DeLisle, PhD

Commentary

Going into the fourth quarter of 2002, it was becoming increasingly clear that the transitional economy we had been looking forward to six months earlier would not emerge from the doldrums. As the quarter unfolded, the story reverted to the old adage "much the same," with little prospects for renewed growth. Indeed, the specter of further declines lingered in the background with many adopting a defensive stance. While few were projecting another recession, such downside risk remains a distinct possibility. On a positive note, the election results from across the country suggested that the executive branch might have sufficient backing to get new economic stimuli enacted. Despite some partisan politics in the early going, it looks like some pro-business incentives might emerge from the new Congress. Unfortunately, such initiatives will not be sufficient to rekindle the flames of economic growth. This caveat is especially warranted in light of the malaise that pervades the economy, and the renewed threat of terrorist activities, and potential for military conflict with Iraq. Indeed, many observers are wondering out loud whether the government can effectively battle economic and terrorist conflicts, especially since both could be waged on our home field.

Although the outlook for the economy remains guarded, there are some bright spots that suggest the situation is at least stabilizing. First, interest rates remain low with no shortage of capital to fuel economic activity. Second, there is little risk of a spike in inflation, assuming the country is not subjected to a new wave of terrorist attacks and/or drawn into a prolonged military conflict with Iraq. Third, the stock market continues to flirt with a recovery, with various sectors showing some positive activity as the market shows signs of bottoming out. Fourth, the corporate scandals that dominated the press over the past six months appear to have played out, although investors and consumers remain somewhat cynical. Fifth, the new Congress has more of a pro-business bias, suggesting that efforts may be successful to pass a number of economic incentives. Sixth, the president signed the homeland security bill, providing a focal point for security and anti-terrorist investment activities, while increasing government spending. Finally, although business spending remains depressed, investment incentives and the need to replace aging computer systems—with a 4-year replacement life—could encourage companies to increase spending to position themselves for the recovery. In spite of these positives, it should be noted that the specter of military conflict will continue to hang over the economy and could quickly cast a pale over such activities.

On the real estate front, little has changed in recent months. That is, in spite of weakening market fundamentals and the prospects for further erosion, there is no shortage of both debt and equity capital for real estate. This growing investor demand is fairly widespread, cutting across the equity/debt and private/public sectors with investors willingly accepting lower yields. Despite yield declines, real estate returns remain attractive, especially on a risk-adjusted basis compared to the uncertainty and volatility that characterizes alternative investments. In early 2003, this situation should continue, fueling an active, but not frenetic, real estate market. As the economy begins to show signs of life, it is likely that investors will begin to factor rent spikes into their underwriting models, helping to turn the corner on expected yields. As market fundamentals begin to improve, deals that have been shelved or temporarily mothballed can be expected to resurface, leading to an increase in development activity. However, ex-

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cess space exists in virtually all markets—inclusive of sublease space—and the phantom vacancies (underutilized space carried by tenants) must be absorbed. Thus, the pace of new development should remain tempered, with lenders remaining disciplined and analysts pointing out the fragile market balance, although strong investor demand for products could partially offset such inhibitors.

The Economic Environment

Economic Growth

During the first three quarters of 2002, the economy struggled to generate moderate gains. The GDP growth in the third quarter was a disappointing 3.1%, which was below expectations. Unfortunately, the gains were not sustained during the quarter, and weakened toward the end of the period, suggesting that the economy was once again losing steam. Even more ominous was the fact that the few bright spots that had been supporting growth were weakening with few signs of any reversal. Examples of this weakening include automobile sales cannibalized by previous financing incentives, retail sales dampened by eroding consumer confidence, and housing activity, with homebuyers beginning to pay attention to talk of a housing bubble and lower earnings/job prospects. While few are arguing the economy will slip into a double dip recession, the prospects of such declines remain much higher than earlier in 2002, despite a temporary rebound in housing and consumer sales in the pre-holiday period. The general lack of confidence that has tempered GDP prospects this year suggests weakening consumer spending and lagging business investment will continue to dampen GDP growth during 2003.

Employment

The generally sluggish economy extended to the employment sector, with relatively flat to negative results for 2002. While some sectors are increasing employment, others continue to cull their payrolls to maintain margins. Losses were particularly pronounced in the construction, manufacturing, and business services sectors. The weakening housing market and soft commercial market should continue to dampen the construction sector over the near term until economic recovery begins. Within the manufacturing sector, declines have been most pronounced in durable goods, especially the electronics sector, which continues to be plagued by tepid business spending. Thus, while some industries have been adding employees (e.g., finance, real estate, and health services), unless the economy turns the corner such gains will likely be eroded by job losses in other industries. This situation is expected to continue over the near term, with few prospects for a dramatic improvement in employment and significant downside risk of further erosion. In addition to rather bleak prospects for jobs, 820,000 unemployed workers faced the prospect of a cut-off in federal unemployment benefits three days after Christmas. While both the Senate and House tried to avoid the crisis and extend benefit coverage, they could not agree on some of the add-on provisions and failed to resolve the issue going into the Thanksgiving holiday.

In addition to unemployment concerns, many households on the margin are facing another economic crisis in the form of rising health care costs. Rampant increases in health care costs have eroded the budgets of many Americans, especially as companies cut back benefits to focus on their own fiscal problems. Thus, even those households who remain insured are facing significant health-induced budget problems as rising deductibles and reduced coverage force them to pick up more of the share of total health care costs. However, the situation has reached crisis levels for the more than 40 million American families who can no longer access and/or afford health insurance. In addition to the growing ranks of households who cannot afford any coverage, a growing number of households have been forced to ration health coverage, selecting which members within the family unit should be covered. Given the aging profile of American households and with it an increased need for health care, the situation is expected to get much worse. To date, policymakers have been reluctant to make some difficult decisions on how to deal with the fundamental issues of access to adequate health care.

Inflation and Interest Rates

In the fourth quarter of 2002, inflation remained irrelevant, with few signs of upward pressure due to the sluggish economy and weak employment scene. Two major exceptions to this general picture were health care and insurance, both of which were eating into corporate and personal income. With respect to health care, there are few signs that rising costs will subside, with the potential for even more increases.

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This situation is most severe for low-income households, although moderate-income budgets also are being strained by spiraling costs. Many companies are scaling back benefits to try to reign in rising rates, which for many small companies has been in the 30% to 40% range. While some larger companies have been able to lock in lower increases, no one is escaping the upward movement. This will translate into higher matching payments for access to company-sponsored plans, as well as higher deductibles, larger copayments, and more economic pressure to opt for generic drugs.

In its November 2002 meeting, the Fed dropped the federal funds interest rate by 50 basis points to 1.25%, the lowest rate in over 40 years. This action, which was more dramatic than many had anticipated, was taken to stimulate consumer spending and business investment to help jump-start the economy. In its announcement, the Fed suggested that it would not ease rates further in its next meeting, because in part it was running out of options to stimulate economic activity. By playing its hand all at once, the Fed shifted pressure for guiding the economy out of its doldrums to fiscal policy coming out of Washington. It is expected that the Fed will ease interest rates again in early 2003 if the economy does not show signs of a recovery. Once the economy does pick up, the absence of inflationary pressure is likely to allow the Fed to delay rate increases. Thus, interest rates are expected to remain relatively flat over the near term, helping stabilize costs of capital and dampen some of the volatility that can be expected as the economy bounces along the bottom of the cycle.

Business Indicators

As through much of 2002, business indicators remained mixed in the fourth quarter, with few signs of a recovery and few cases of early winners. However, after falling for several months, leading economic indicators flattened out at the end of the third quarter. As they had through much of the year, inventory levels remained low, especially in the retail sector as companies braced for a disappointing holiday season. On the manufacturing front, there was some improvement early on in the third quarter before weakening in the fourth quarter. Unfortunately, deflation in prices—induced in part by falling import prices—hurt the bottom line for many manufacturers. Despite these pressures, an increasing number of sectors appeared to be improving over the prior year, reporting improved production levels. Many of the gains in manufacturing were attributable to increased productivity, with fewer workers producing more goods. While positive for manufacturing companies, productivity gains offered little solace to employees, with many companies opting to do more with fewer employees. This situation should carry into 2003, placing a damper on hiring and additional upward pressure on unemployment rates. Business indicators are expected to continue to increase, with companies benefiting from the low cost of capital and pro-business initiatives coming out of Washington as it seeks to exert its leadership on the economic front. Despite the somewhat upbeat tone of this outlook, it should be noted that businesses continue to face significant downside risk, with the threat of a new round of terrorism or war in the Middle East looming over the recovery.

Stock Market

As expected, toward the end of 2002 the stock market continued to bounce along, with gains quickly giving way to losses. This pattern can be expected to repeat over the near term although there are some signs that the market may be moving off the rocky bottom. For example, the outlook for corporate earnings going into the fourth quarter was relatively healthy, with gains over 2002 levels in the mid-teens. In addition, it looks like the fourth quarter figures could trend up over the third quarter, as investors return to the market in search of returns above those available through low-risk, fixed-income investments. Despite such early indicators, the market remains extremely vulnerable to downward shocks, with a number of such pressure points lurking on the horizon. In addition, companies are expected to continue to temper their public expectations in response to increased scrutiny of investors and to the beating that the market has vented at companies who miss forecasts. This situation will create a vexing dilemma for companies with positive prospects, since investors can be expected to seek out the potential "winners" and start making bets as to who will emerge from the pack.

At the same time, Wall Street investment banking firms continue to struggle to resolve conflicts of interest with the SEC and state securities regulators. In addition to the laundry list of companies facing \$50–\$100 million in fines, some companies are facing fines in the \$250–\$500 million range for past

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errors. Investment bankers still face the wrath of institutional and individual investors, some of whom can be expected to file lawsuits to seek remedies for the losses they bore as a result of relying on biased research reports. In this environment, investment bankers and advisory firms are likely to put more effort into reigning in their analysts to avoid additional charges that can be expected to be dealt with even more harshly. Such voluntary changes will be on top of the structural changes that are being interjected to force a separation of brokerage and research functions. In addition to this separation, it is expected that firms also will be required to provide clients with independent research options. To support this option, firms are being asked to help fund the creation of independent research operations with up to five years of financial support.

Consumer Confidence

Throughout the recent economic cycle, the dependence of the economy on retail sales has focused attention squarely on consumer confidence. Going into the third quarter, there was little good news as the cumulative effects of the economic downturn, the stock market's collapse, and the threat of military action seemed to finally catch up with consumers. Indeed, with the rising level of unemployment and erosion in 401(k)s, consumers were hard-pressed to put on their happy faces and continue to propel the economy along. The end result was a downward spiral in consumer confidence ratings, falling to the lowest point in almost 10 years. Although there was relatively little positive economic news in the fourth quarter, confidence levels did bounce upward in November 2002. Whether this change was more than a temporary blip as consumers latched onto the latest stock market rally or began to believe some of the pro-business rhetoric and initiatives coming out of Washington remains to be seen. This is especially true in light of continued weakness in the job market with more downside risk than upside recovery. At the same time, consumers may become more predisposed to good news as they long for the good times to return. Thus, over the foreseeable future, consumer confidence levels will be more volatile than in the past, an outlook that has not been lost on retailers or the stock market.

Retail Sales

As with the overall economy, retail sales experienced a rocky road in late 2002, with falling consumer confidence and a weakening economy causing consumers to reign in spending plans. In addition to these natural inhibitors, unseasonably warm weather and the lack of compelling trends contributed to a decline in retail sales. The end result in early fall was a pattern of flat sales growth, with actual declines on year-over levels. The leading categories of sales growth were the "usual suspects" including health and personal care and home improvement and gardening. On the other hand, auto sales plummeted in early fall, lending credence to earlier predictions that the incentive programs that permeated the industry over the prior year had cannibalized future sales. Going into the fourth quarter, the outlook for retail sales growth remained guarded, with increases for holiday sales expected to be a disappointing 2% over 2001. In the face of such weakness, promotions and discounts were rampant, beginning with the Thanksgiving sales. Thus, many retailers seemed to throw in the towel early regarding a resurgence of consumer spending, lowering their expectations in response to the economic reality and other pressures that were causing consumers significant angst. To a certain extent, this negative outlook placed a cap on sales potential, as retailers cut inventories in anticipation of weak holiday sales. In addition to setting the stage for weaker sales, retailers' expectations resulted in greater pressure on store margins, with many retailers seeking to aggressively cut costs. These cost cuts were largely concentrated on employee payrolls and advertising budgets, creating additional governors on sales growth. This somber mood should carry into 2003, although consumers can be expected to rally in the face of good news as they seek to rekindle their spirits and return to the cash registers. Despite this natural buoyancy, it is likely that retail sales will be volatile with significant downside risk over the near term until the economy declares itself and international tensions are somewhat relaxed.

On the Internet front, the streak of double-digit increases in Internet sales continued during the fall, and is expected to hold throughout the important holiday period. This outlook was bolstered by the return of "free shipping," with an increasing number of companies offering specials early on to entice buyers to order merchandise. Despite robust growth—especially compared to total retail sales—Internet sales still comprised less than 2% of total retail sales. While this market share has been gradu-

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ally increasing, there are no signs that suggest a major shift in retail sales channels. Thus, the outlook for Internet sales remains strong, but of relatively limited significance compared to the overall retail market. In evaluating the effect of the Internet and other technological advances on retail, it should be noted that "traditional" retailers have dramatically changed over the past several years, with many offering Internet distribution options to increase market potential. In other cases, the use of technology and other innovations were concentrated on achieving greater efficiencies in terms of buying, supply chain, and distribution functions. These trends are expected to continue, providing nimble retailers with the flexibility to flourish in a low-volume, discount environment as well as enabling them to exploit emerging pockets of demand. Despite these advances, the outlook for retail remains guarded, with sagging consumer confidence, a floundering economy, rising health care costs, and the threat of military/terrorist activities hanging over the sector.

Housing Market

Over the past several years, the housing market has been one of the mainstays of economic activity. Indeed, during the first quarter of 2002, housing starts rose dramatically as builders tried to tap into the seemingly insatiable demand for new housing. After a brief respite, housing starts accelerated before tapering off during late summer. In the early fall, there was a significant surge in housing starts, due in part to moderate weather and strong demand, before falling back into line with the pace set at the end of 2001. Much of the decline was attributable to the multifamily sector, with rising vacancy rates and generally softening conditions triggering a contraction in the pipeline of new product. While starts were down toward the end of 2002, permit activity picked up a bit, suggesting that builders had not yet thrown in the towel. During 2003, permit and start activity should closely track the economic recovery, with builders ready to ratchet up volume to meet any increase in demand for new housing.

The combination of ample construction, low mortgage rates, and strong appreciation in housing markets has translated to record-breaking homeownership rates, with slightly over two-thirds of American families owning their own homes. Sales in the existing home market remained brisk in fall 2002, with low interest rates and renewed belief in single-family housing as a safe investment fueling continued activity. Year-over appreciation rates for housing were also robust, pushing the 10% mark for October with median prices continuing to rise. As might be expected, these gains were not experienced across all markets, with a number of Sun-Belt markets showing signs of weakness (e.g., Atlanta, Dallas, Denver). To a great extent, the rise in prices was supported by even further declines in mortgage rates, with traditional financing hovering slightly above the 6% level.

The housing market is beginning to exhibit some signs of falling back into line from the frenetic pace it has exhibited. There has been weakening in some markets due to declining employment. Several other factors suggest a fall back in the housing market. First, the "housing capture ratio" or percentage of income required to support housing has been creeping upward, with a significant number of households allocating over half of their income for housing payments, secondary financing, and operating costs. Unless income growth accelerates unexpectedly, it is unlikely that this over-consumption will continue without some correction. If such a correction occurs, a significant number of homeowners could see themselves trapped in their "American Dreams," with limited exit strategies as potential buyers with similar demand functions see themselves priced out of the market. Second, the mortgage delinquency and default rates are rising in many markets leading to record foreclosure rates as more homebuyers simply cannot afford to continue as homeowners. The end result of this squeeze has been a rise in Chapter 13 bankruptcy filings, with mid-2002 totals about 8% above 2001. While still low relative to total homeownership, these increases are troubling especially in light of the potential for continued weakness in the economy and the likelihood of continued job losses in many sectors. Third, the refinancing trend has begun to play out. To this point, many owners have benefited from falling rates and translated them to lower mortgage payments. However, a significant number of other households have aggressively and fully tapped into equity build-up to consolidate debt and/or finance other purchases. Finally, the existence of a "housing bubble" is receiving more press, with a number of housing observers pointing out that the self-fulfilling prophecy of housing appreciation is more driven by a decline in rates than a rise in income, setting the stage for a

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correction or pause when rates begin to rise and exit opportunities become suppressed. Despite these caveats, the housing market should remain relatively healthy, especially if the economy begins to pick up, fueling additional interest from potential homebuyers and skewing plentiful capital to the housing sector.

Real Estate and Capital Markets

During the fourth quarter, real estate capital flows were relatively stable, with little net change over the prior quarter. As during the balance of the year, there were adequate flows to support an active pace of real estate transactions. This situation continued to baffle some observers because real estate fundamentals—which translate to the net operating income that is used to compensate debt and equity investment—continued to deteriorate. Rather than translating into commensurate losses in value, the levels of price declines were dampened by the lower cost of capital. On the debt side, the lower cost of capital could be attributed to a combination of lower interest rates and strong capital flows for fixed income assets. On the equity side, the lower costs of capital were due to buyers' willingness to accept lower yields on real estate. In the face of declining income and little hope for a quick market recovery, strong pricing suggested that equity investors were being drawn to real estate in part based on their relative perception of risk and expectation for higher risk-adjusted returns than those offered by other asset classes. This situation remains something of an anomaly, with widespread expectations for further erosion in real estate fundamentals. Furthermore, real estate investors undoubtedly have heard the forecast from most prognosticators, who noted the real estate market would lag behind the general economy in terms of recovery. This general perception suggests that recent buyers of commercial real estate are in it for the long haul and can be expected to ride out the downside of the cycle.

As with investors in the broader market, in latter part of 2002 some real estate investors began to soften their risk-aversion, eschewing stable assets with low returns in favor of more "challenging" investments promising higher yields. Unlike past recovery phases, the more aggressive investors were not merely looking for a gradual market recovery or even rent spikes to justify pricing real estate at low multiples on the basis of stabilized net operating income. Rather, these investors were looking to take on inherently riskier investments that would require active management to create value and increase yields to more historically acceptable levels. Despite this trend, for the bulk of real estate investors, core investments with limited downside potential remained most in favor. This appetite was strongest for investors seeking to diversify their investment portfolios, using equity real estate as a stabilizing element of a broader mixed-asset portfolio.

Before exploring the real estate capital markets in more detail, it is useful to discuss some of the potential changes coming out of Washington that could affect real estate capital flows. Two major policy initiatives are noteworthy to the real estate market: tax relief and terrorist insurance relief. With respect to tax relief, the Fed's ability to stimulate the economy through monetary policy by further reducing interest rates has been fully played out. Thus, the government will have to rely more heavily on fiscal approaches, with tax relief being a key tool. A number of tax reforms are being explored by Congress, as well as by various interest groups working on behalf of their respective constituencies. Such reforms range from providing additional relief for households, as achieved in the 2001 tax cuts, to the introduction of business tax cuts and/or the creation of incentive programs to stimulate business spending. These initiatives could include acceleration of depreciation allowances for equipment purchases or the introduction of investment tax credits for new equipment purchases.

A number of tax issues are being discussed that more direct for the real estate industry. First, there is increasing pressure to shorten depreciable lives of buildings from the current 27.5 years for residential properties and 39 years for commercial real estate, bringing them more into line with other assets. Second, there is some support for reducing the recapture rate for straight-line depreciation from the current 25% to a rate of 20%, a figure that would be in line with other assets. Third, there is some pressure to reduce the depreciable life of leasehold improvements to coincide with the term of the lease, or to set it at 10 years. Finally, there is some discussion of extending the deduction for environmental clean-up costs in targeted areas to the clean up costs of all brownfields, regardless of where they are located. While it is unclear if these revisions will be approved, it should be noted that the need for such change is subject to debate in the sense that the real estate

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market is functioning rather fluidly in terms of transactions. This situation is even more revealing in the face of the generalized expectation for further weakening in real estate fundamentals, although there is no shortage of capital chasing real estate. This is not to argue that real estate markets would not benefit from tax reform, however, traditional stimuli might merely create windfalls for current owners, helping bolster already aggressive pricing.

While the case for tax reform to stimulate the real estate market is unclear, the need to intervene with respect to terrorism insurance is much stronger. On a positive note, real estate interests had Washington to thank for passage of the Terrorism Risk Insurance Act around Thanksgiving. In a testament to its importance, the bill was swiftly signed into law by the President the day after Thanksgiving. Several elements of the legislation are particularly interesting in a discussion of real estate capital flows. First, the Act establishes the Terrorism Insurance Program in the Treasury Department to oversee federal contributions for insured losses. Second, the Act employs a broad definition of covered terrorist acts, with covered events ranging from $5 million to $100 billion. Third, the federal government pays 90% of insured losses above a phased-in deductible, while insurance companies cover the remaining costs. Fourth, the government may seek to recover payments by making moderate surcharges to policyholders. Fifth, participation in the program is mandatory for all insurers and extends terrorism coverage to all types of policies. Sixth, the Act voids any commercial property and casualty terrorism exclusions in force at the time the Act is signed into law. Finally, the Act establishes a number of litigation reforms that streamline the process and ban punitive damages. While the Act is a temporary measure that extends through the end of 2005, it should help eliminate the cloud attached to real estate investment, especially the larger, trophy-type buildings that fit the profile of terrorist targets and that were largely uninsurable. This coverage is particularly important to individual and institutional investors who concentrate on such assets as part of a core investment strategy.

Construction Activity

During the first three quarters of 2002, the lagging economy and weak business demand continued to ripple through the real estate market. The end result was further erosion in market fundamentals for most property types and markets. In this environment, opportunities for new development were tempered, with the exception of projects that were targeted for specific tenants or specialized niche opportunities for projects with significant pre-leasing. On the other hand, capital flow was almost nonexistent for purely speculative construction, with activity limited to projects that were already in the pipeline or part of larger development ventures. This situation carried into the fourth quarter, with a number of projects being shelved until the supply-demand equation returns to a more balanced level. These trends were born out in construction statistics, with month-to-month changes in construction levels skewed to the negative side after a brief upturn at the beginning of 2002. In mid-fall, construction activity moved into the positive sphere, although such gains were minor compared to recent declines. Weak construction activity was fairly widespread, affecting residential, commercial, and public sectors. In most cases, the bulk of new products delivered during the year represent the end of the pipeline for projects conceived during the 2000 bull market. As these projects are completed, they are not being replaced at the same rate, creating a lull in commercial construction that will carry into 2003. Given the current state of the economy and significant overcapacity in most property categories, the pace of starts is likely to remain tempered relative to that of the past several years. This caveat is especially warranted in light of the excess capacity that remains in the overall market and the continued surplus of sublet space.

Private Equity Market

On the equity frontier, the trend toward strong equity flows for domestic real estate shows few signs of abating. While investors remained concerned about weakening fundamentals, real estate retained its luster relative to other asset classes. Once again, the search for safer investments attracted additional allocations, with investors willing to accept lower cap rates based on stabilized net operating income. This situation is different than in prior real estate recessions in the sense that most investors are not justifying real estate based on dramatic market recovery scenarios or anticipated significant rent spikes built into discounted cash flow models as they did in the mid-1990s. Rather, they continue to underwrite real estate on a conservative basis, accepting lower internal rates of return. Thus,

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the private equity market has been quick to get over concerns regarding additional corporate fall-out associated with the scandals that dominated the press through much of 2002. Private equity market investors seemed to focus on long-term hold strategies that would straddle additional downward pressure. Similarly, the threats of war and additional terrorist attacks on domestic soil did not curtail investors' appetites for commercial real estate and may well have been responsible for the asset class's appeal relative to other more volatile investments.

The bulk of private equity capital continued to focus on core real estate during the latter half of 2002, with risk aversion remaining one of the dominant themes. This preference was evidenced by the National Council of Real Estate Investment Fiduciaries (NCREIF) equity index for the third quarter, which continued to report capital declines and falling total returns. Despite lower returns from commercial real estate as a whole, the low cost of debt allowed investors to benefit from positive leverage. The availability of debt benefited both existing owners and new purchasers by dampening value erosion that would normally be associated with increasing vacancy rates and lower renewal rental levels in the overall market.

At this stage in the cycle, the general expectation of continued low interest rates has deflected many buyers' attention from the potential for downward price pressure due to rising interest rates on exit strategies. This situation is partially explained by the limited use of leverage by many institutional buyers, as well as the longer-term planning horizon many buyers have brought to recent acquisitions. However, even these investors will likely face paper losses associated with write-downs tied to an increase in the weighted costs of capital for market-to-market accounts. Given longer-term, hold strategies, investors are banking on an improvement in real estate fundamentals that would translate to higher net operating income. Historically, rising income has offset the higher cost of debt if interest rates rise during an economic recovery. Regardless of whether the cost of debt rises, this insulation will be important to the market since real estate investors can be expected to begin to ratchet up real estate return requirements as returns from other asset classes become more attractive.

As in other asset classes, however, a growing number of real estate investors have begun to target riskier products in an attempt to capture higher returns. In general, rising risk tolerances could be expected to translate into greater development and speculative construction activity. This situation is not likely to occur over the near term due to the likelihood of further erosion in real estate fundamentals. In addition, although there is no shortage of mortgage capital overall, there is very limited capital for new development. In this environment, the search for higher returns has been focused largely on existing real estate that can benefit from market recovery, be repositioned to appeal to higher rent tenants, or be enhanced via capital improvements. In each of these cases, the ability to tap into such potential will depend on a combination of superior market knowledge and solid real estate expertise. These attributes will tend to be concentrated in the hands of larger players with the breadth of skills and the discipline and confidence necessary to execute such strategies. Unfortunately, these attributes were not key to success in the last real estate recovery and are not fully understood or appreciated by passive real estate investors. Thus, it can be expected that attempts to capture higher returns through proactive management will have mixed results, setting the stage for greater differentiation in returns than available in the current market. This situation should become more apparent over the next 12–15 months as the market begins to pick up and well thought out strategies pay off. However, there also will be some losers—those investors who take a passive approach and rely too heavily on safe, commodity-type investments that will be hurt when development activity returns. Once again, despite these caveats institutional returns should remain competitive with other asset classes over the near-term, especially on a risk-adjusted basis.

Public Equity Market

During the first half of the 2002, Real Estate Investment Trusts (REITs) were in a relatively strong position, benefiting from strong capital inflows as investors sought out alternative investments. In addition, REIT performance figures were compelling, especially in light of negative returns shown by most other asset classes. Beginning in the third quarter and carrying into the fourth, REIT returns declined, dragging annualized returns into negative territory—albeit slightly—for the first time in three years. On a positive note, REIT returns bounced back in late-

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November 2002, returning to positive territory. While the relative outlook for risk-adjusted returns from the two sectors is still in favor of REITs, it is clear that the sector will experience some fluctuations tied to real estate fundamentals. At the same time, REITs will not benefit as strongly as they have from further reallocations from other asset classes unless relative return prospects improve. However, the industry is not facing a major correction, but will have to rely on competitive returns to attract capital and support further growth.

The outlook for REIT prices is relatively flat, with the performance of many companies tied to that of existing properties. In terms of initial public offerings (IPOs), the outlook is rather limited because the most obvious prospects have already converted to public ownership. Similarly, secondary offerings of existing companies are expected to be moderate since there are few prospects for new acquisitions at accretive prices for which proceeds would historically be used. While there will be some efforts at consolidation, the poor track record of previous mergers, coupled with compressed yields, will not support widespread activity on this front. Indeed, as in the case of the contentious acquisition of Taubman Centers Inc. (TCO) by Simon Property Group, Inc. (SPG), targeted companies can be expected to resist takeover efforts, opting to hold on until market conditions improve and share prices rebound. This fight, which will be interesting to follow on its own merits as a precursor to REIT machinations, is also interesting in terms of the heightened disclosure statements that are being attached to individual analysts' comments on the relative merits of the deal. For example, in covering the story, reporters are explicitly stating any potential conflicts of interest, either current or prior, that might taint analysts' opinions.

Despite the relatively flat outlook for REITs compared to their recent successes, the sector should continue to provide attractive returns with stable dividends. For many larger companies that have been managed strategically, the prospects of facing lease renewals in a down market should be offset by diversification in real estate holdings and proactive management of rent rolls. Depending on their property focus, REITs that have more concentrated market exposure should be able to maintain earnings by selectively disposing of assets for which there is strong private sector demand. In both cases, management will be inner-focused, seeking to nurture existing tenants and achieve greater operating efficiencies to weather the expected weakening in market fundamentals and remain competitive. On a positive note, the passage of the Terrorist Risk Insurance Act was seen as a positive sign for REITs, especially for some of the major players whose portfolios were dotted with the types of trophy properties that had become almost impossible to insure against further terrorist attacks. This should reduce some of the perceived risk associated with real estate and lower the return hurdle for investors who had eschewed the sector to avoid catastrophic losses.

Commercial Mortgage Market

During the latter half of 2002, the gradual erosion in real estate market fundamentals was fully anticipated in the commercial mortgage market and created little disruption. As such, there was an adequate supply of mortgage capital for commercial real estate, creating an extremely competitive market for refinancing and new acquisitions. In terms of property types, the bulk of commercial mortgage originations were allocated to multifamily properties, followed by office, retail, and industrial. However, it should be noted that property type allocations shifted during the year, with multifamily experiencing the biggest declines, followed by hotels and offices. On the other hand, retail, health care, and other commercial shares increased over those in 2001, reflecting changing market fundamentals and investor appetites. In terms of delinquency rates, weakening market conditions rippled through to the mortgage market, creating an increase in problem loans, although foreclosure rates remained low relative to historical averages.

Despite ready availability of capital, multifamily and commercial mortgage originations by private sources dropped off significantly in the 2002 third quarter. It is noteworthy that this decline was attributable to a decrease in credit-worthy applications rather than a shortage of capital. This situation should abate as real estate fundamentals improve, although the economic outlook and the likelihood of a lagged real estate recovery will continue to dampen production for marginal products. As in the case of the equity market, the passage of the terrorist legislation should remove some of the risk cloud hanging over the market, providing a catalyst to new lending especially for larger properties that were the most affected by insurability issues.

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During the first half of the year, the Commercial Mortgage-Backed Securities (CMBS) provided the largest share of commercial mortgages, comprising almost one-third of originations. In addition to increasing market share, CMBS volume was up over the prior year, reflecting strong capital flows to the sector. To some extent, investor interest was amplified by strong ratings for seasoned CMBS that offset increasing delinquency rates in newer loans. In addition, lower spreads on some of the subordinated CMBS tranches made them more competitive with private mortgage capital. Going into 2002 year-end, the rush of offerings in the shortened Thanksgiving-Christmas season was expected to place upward pressure on spreads although institutional investors caught with surpluses could absorb the volume. Looking forward, CMBS volume will be tempered by strong competition for new loans, with investors preferring more simplified structures and sources to provide maximum flexibility and allow them to respond to new opportunities in a timely manner. In 2003, volume could also be dampened by fickle capital flows, with CMBS investors shifting out of a risk adverse mode and returning to other asset classes.

Real Estate Outlook

In general, the real estate outlook in the second half of 2002 continued the downward trend, with rising vacancy rates and falling rents characterizing the situation in most property types and markets. The good news is that this erosion was largely expected, especially among private equity investors who carried on with business as usual, seeking new investment opportunities and patiently selling existing holdings. Over the past several years, the convergence of the capital and real estate markets has caused many real estate players to pay more attention to the overall economy and its impact on the real estate market. This attentiveness has paid off in the current market, as evidenced by the ability of the market to continue to function relatively efficiently despite inherent weaknesses. In past downturns, these weaknesses might have led to bid-ask spreads that would have turned off transaction activity. Granted, the fact that investors have been willing to come to the table with more cash has helped, since owners have been reluctant to write down properties to clearing prices. Similarly, floating-rate debt has helped some current owners deal with rising vacancies and falling rents, enabling them to hang on to properties and book positive returns. On the other hand, current owners are also more attuned to capital flows and realize that investors would be willing to accept lower returns in exchange for less perceived risk relative to other asset classes. The situation has also been helped by the greater attention paid to market queuing systems that raised the flag regarding eroding demand and led to a slowdown in new development initiatives.

Going into 2003, the real estate market is expected to continue to chug along, lagging behind the economic cycle but maintaining a sense of balance. New construction activity will receive increased interest as market price increases for existing products approach the cost of new development. However, it should be pointed out that investors are unlikely to accept the low yields found in existing products when considering new products. This will create a yield cushion between prices for existing and new products. At the same time, new construction will not benefit from above-market leases signed a few years ago on an existing product that is sold at above replacement costs to investors buying for the contract income rather than focusing on market rents. Thus, no surge in development activity is anticipated, with lenders and investors remaining skittish until the economic recovery shows more signs of being sustainable. In the current environment, underwriting for commercial investments typically assumes that erosion in market fundamentals will stop within about one year and then will turn moderately positive shortly afterwards. Thus, investors have not been buying real estate based on aggressive pro-forma projections, but on the basis of lower anticipated yields. This approach is clear in the private equity market, where total returns have trended downward. For example, the NCREIF Index has been reporting moderate capital losses for the fifth straight quarter, with returns coming in at the lowest annualized rate since the 1994. On the other hand, income returns were relatively stable, holding the pace set for the prior several years. As rent rolls turn over in the current market, there should be some added downward pressure on income returns, although value losses will largely offset such declines. It should be noted that core properties have provided even lower returns than those reported in the overall index, which benefited from expansion of the database to include a more representative sample

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of properties than the tax-exempt, institutional holdings that dominated the index in the past.

On the public front, returns have also been adjusted downward as weakening market conditions begin to erode income streams on existing product. Despite this pressure, there are few signs of an impending collapse in REIT returns, although increases will be more tied to recovery in the spatial markets than in the past. In this environment, it is unlikely there will be a push to liquidate real estate holdings even if the economic recovery is postponed or if the country gets drawn into an international conflict. Indeed, the fear of such external shocks has predisposed recent buyers to hold real estate for the long haul, helping smooth out what might otherwise be a rocky ride at the bottom of the cycle. Thus, the outlook for the domestic real estate market is one of a gradual recovery, with some moderate downside risk.

Office Market

Throughout much of 2002, the office sector continued to lose ground with contraction in demand creating negative absorption. Recovery of the office sector will likely depend on a generalized economic recovery that will ultimately causes companies to ratchet up for a new expansion stage. However, in the current environment, most companies remain in a steady state or are continuing to contract, leading to excess space that is adding to the existing overhang of sublet space. This phenomenon has created a negative bottom to the leasing cycle, with investors and observers looking to a decline in negative absorption as a positive signal that the office market may finally be turning the corner.

Although the supply of new office product is expected to continue to taper off into 2003, there are few signs that demand will rebound over the near-term, making it likely that office vacancy rates will rise moderately. This caveat is especially true in the suburbs where the bulk of recent construction activity occurred and where sublet space is the most pronounced. Fortunately, the curtailment of construction planning over the past 12–15 months for both the CBDs and suburbs should translate into slower starts. This contraction in proposed projects will help reduce the pipeline and offset some of the downward pressure associated with weak demand out of the equation.

With vacancy already high and going still higher, market rents are expectged to drop. When coupled with an impending surge of rent rolls as leases written during the boom cycle of the late-1990s mature, the stage has been set for further erosion in net income and downward pressure on values or yields. The end result will be a tenant's market in which owners will be forced to compete for leases on both economic and noneconomic bases. Thus, during the first half of 2003, the outlook for the office sector should be flat to negative, with some moderate improvement in second half of the year, although the existence of phantom space may cloud this outlook. The situation will vary dramatically by market and submarket, with well-located, well-designed products outperforming in terms of occupancy, rent, and investor demands. Investor demand will remain strong, both for stable properties and for those with a slightly higher risk profile. However, investors will be selective and will expect to be compensated for differential risk levels, resulting in a greater dispersion in office performance with clear winners and losers emerging from the turmoil. To respond to these risks, investors will look at office market fundamentals more carefully, paying more attention to physical assets and to tenant mix to help ascertain which office investments will offer sustainable performance regardless of cyclical fluctuations in market balance.

Retail Market

As previously noted, the U.S. economy has been riding the wave of consumer spending for a number of years. While this trend is unlikely to continue, it has helped carry retail investments through the economic malaise that has plagued other property types. At the same time, the recession and pressure on corporate earnings has forced many retailers to revisit expansion plans, and avoid overbuilding that easily could have led to significant oversupply. Within the retail sector, tenant performance has varied widely, with many tenants who missed the consumer wave being faced with difficult decisions regarding their survival. As in the past, the list of winners has been concentrated among those who have offered consumers a blend of convenience, price points, and value. In addition, many upper-end retailers have fared well, especially those located in strong centers or retail districts that have created a certain panache and the economy of scale necessary to draw consumers from a wide trade area.

In terms of investor appetites, the retail sector has experienced a resurgence of sorts, with larger

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retail formats enjoying some of the positive capital flows from private investors that their smaller counterparts have experienced over the past several years. At the same time, there is still an active market for power centers and neighborhood centers. Increased investor demand can be attributed in part to weakening conditions in the office and industrial sectors whose fortunes were tied more to the national economy and business performance than to consumer appetites. The end result has been a shortage of investment opportunities, placing downward pressure on yields as investors are forced to compete for a limited supply of product. This situation is expected to carry into 2003, with private investor demand highest for smaller products (e.g., neighborhood, community, and power centers) that can be added to existing portfolios without creating excess exposures. Interest in larger retail formats also is expected to rise, although the bulk of such activity will be concentrated in the public sector, with some interest from larger investors and commingled funds. Finally, investors are expected to look for redevelopment and in-fill opportunities in an effort to capture higher yields and create viable exit strategies.

Industrial/Warehouse Market

The industrial real estate market had a difficult time through much of 2002, with the weak economy eroding demand in the early phases of the recession. This came on the heals of record construction levels during the early dot-com days, when the sector took advantage of short lead times to ratchet up for the "New Economy." Since peaking in 2000, industrial construction levels have tapered off consistently, with some evidence of bottoming out to a natural or sustainable level toward the end of 2002. Despite declining construction activity, vacancy rates have consistently risen due to a combination of negative absorption and additions to supply. While the supply side is expected to fall into line with market realities, vacancy rates are still expected to rise over the near term.

Despite weakening market conditions and declining yields, investors' appetites for industrial product have remained fairly strong. Among classes of investors, pension funds have been the most aggressive acquirers of industrial product, with REITs running up against a floor in yields that would make new deals dilutive rather than accretive as investors have been trained to expect with new acquisitions. When the economy begins to pick up, existing vacant supply will take time to burn off due to the level of excess capacity. At the same time, changing supply chains will create some risk of shifting demand functions as the market seeks more efficient ways of getting product into consumers' hands. Similarly, the build-to-suit market is expected to be active as tenants seek to control space that optimally satisfies their spatial and logistical requirements. Owners of existing properties are expected to be patient, waiting for market recovery and/or investors to come to their pricing. Thus, the outlook for industrial properties is rather guarded, although the bias is toward moderately positive returns as opposed to poor returns associated with major repricing of the sector.

Apartment Market

For a number of years, the apartment market has been the darling of institutional investors seeking to diversify portfolios and capture attractive risk-adjusted returns. This situation continued through much of 2002, despite declining market fundamentals that put downward pressure on yields. During the first half of the year, apartment vacancy rates rose. To some extent, vacancy rate increases were attributable to declining absorption rates. Absorption declines could in turn be traced to two key phenomena. First, the slowing of the national economy suppressed the pace of independent household formations. Second, for many renters, the lure of homeownership was so compelling that it shifted tenure choice from renting to ownership. This latter trend was related in part to the existence of low interest rates that made homeownership affordable coupled with strong capital flows to the sector. At the same time, widespread publicity over the recent history of strong appreciation rates for single-family housing caught the eye of tenants. When combined with the losses that many renters experienced in the stock market, the appeal of investing in a house became apparent to many tenants. The result was record-breaking homeownership rates, with about two-thirds of U.S. households opting for ownership rather than tenancy. In addition to a fall-off in demand, rising vacancy rates during the year can be traced to strong construction levels, as developers ignored market signals and continued to create new products.

While the failure to curtail new apartment construction was somewhat unusual compared to other

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property types, the situation is understandable in light of robust demand for new products. That is, despite projections of weakening conditions, apartment investments continued to entice capital throughout 2002, with demand for product outpacing the supply of product on the market. This situation was especially true in the first-tier markets that are most in favor, although transaction volume in some second-tier markets was lower than might be expected. The end result of strong investor demand for apartments has been a compression in yields, with apartment cap rates coming in below those of all other major property sectors. This situation is likely to carry into 2003, with strong investor demand remaining the norm. In this environment, a number of current owners are expected to bring existing products to the market, using the investment climate as an opportunity to cull portfolios of underperforming or non-core assets. However, most institutional investors who have been working at assembling apartment portfolios are expected to continue to hold on to their assets, using low financing and an expected recovery to compensate for lower operating income and lower near-term returns.

Conclusion

Going into 2003, the economy, capital markets, and real estate fundamentals remain on the same basic trend line established in the second half of 2002. While there are a number of signs that the economy may be finally pulling out of the doldrums, it is still not out of the danger zone and faces some risk of slipping back into recession. In addition, concern over the possibility of entering a round of deflation has begun to emerge, creating a fine line that monetary and fiscal policy will have to straddle to establish sufficient momentum to turn the corner. Investors will continue to be skittish, although abysmal returns on fixed-income products and the promise of a recovery will begin to draw more back into the equity market. This situation will bode well for real estate, as investors seek to diversify their portfolios to manage downside risk. Similarly, policymakers are expected to pass a number of stimuli measures that will help jump-start the economy and, in turn, the real estate market. Capital flows will remain strong for real estate, helping sustain the current market environment. Although most capital will continue to be skewed toward existing products, interest in new construction will begin to emerge over the intermediate term. The good news is that new construction levels are expected to be moderate, with sources of capital placing a governor on the development community to keep the market in balance. On the spatial front, further erosion in the supply/demand balance is expected for most property types and markets, although no major implosion is on the horizon. By mid-year, the situation should begin to improve, assuming that the economy gets back on track. However, due to excess capacity, the real estate market cycle should lag behind that of the overall economy. The wild card in this picture continues to be the threat of new terrorist attacks in the U.S. and the possibility of a war with Iraq, either of which could dramatically change the outlook for the economy and commercial real estate.

James R. DeLisle, PhD, is the Runstad Professor of Real Estate and the Director of the Runstad Center for Real Estate Studies at the University of Washington. Prior to his current assignment, he was an Executive Vice-President and head of Strategic Planning for Lend Lease Real Estate Investments, a global company and the successor firm to Equitable Real Estate where he founded the Investment Research Department and directed it for nine years. He has published widely in academic and professional journals. Dr. DeLisle received his B.B.A. in real estate and M.S. in marketing research from the University of Wisconsin. He received his PhD in real estate and urban land economics from the University of Wisconsin under his mentor, the late Dr. James A. Graaskamp, one of the leading academic proponents of applied real estate research. **Contact: jdelisle@u.washington.edu.**

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