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The Appraisal Journal; Oct 1999; 67, 4; ABI/INFORM Global
pg. 440

FINANCIAL VIEWS

Real Estate and Capital Markets: Concepts Essential to Developing Forward-Looking Real Estate Decisions

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Increased alignment between real estate and capital markets resulted in the recovery of the real estate market in the 90s. This column will explain how this convergence came about and will provide details on the emergence of the public real estate market and its inherent dependency on the overall capital and investment markets.

Some industry professionals claim that the greater attention paid to real estate (attention that is measured by increases in analyst coverage, data availability, and market transparency) signified the maturing of the asset class. They argued that commercial real estate was entering a new era of market efficiency, whereby public market scrutiny and improved information would dampen future cycles and thus reduce the risk of overbuilding.

The real estate industry has indeed drawn much attention to itself and improved data flows, but it is also more complicated now. Economic conditions and other factors continue to drive market balance for space, but the market has also become more dependent on capital flows and perceptions of relative investment value than ever before. This condition was most apparent in the second half of 1998 when we witnessed a disconnect between the spatial markets and the public real estate markets. Despite solid real estate fundamentals, the commercial mortgage-backed securities (CMBS) market slid into a tailspin and real estate investment trusts (REITs) underwent a prolonged correction unprecedented since their post-1993 resurgence. The disconnect and the poor performance of the public market became even more pronounced in the strong economy, the continued bull stock market, and the solid private real estate market in which investors racked up solid returns.

Some "traditional" real estate players view the recent turmoil in the public market as evidence that real estate will slip back into its private market abyss. They believe the asset class will be relegated to a niche sector that will repeat the boom and bust cycles of the past.

The truth lies somewhere between the positions of the "efficient market" proponents and that of the "traditionalists." Commercial real estate markets will become more aligned with the overall economy and with capital flows, especially on the public real estate front. In this environment, it is critical that real estate professionals approach the asset class from a more holistic perspective—that is, tracking macroeconomic conditions, monitoring capital flows, considering the implication of emerging industry trends, and anticipating a supply and demand balance for the various sectors and markets in which they operate. This column elaborates on four key drivers to help industry professionals develop more proactive, forward-looking approaches to real estate decision making.

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THE ECONOMIC ENVIRONMENT

Economic Growth

Going into 1999, the U.S. economy was poised for continued growth, with investors, businesses, and consumers benefiting from a strong year end. In early 1999 the bullish economy was prolonged—with solid growth in gross domestic product (GDP) until the second quarter. The major drivers of growth in the second quarter (personal consumption expenditures, nonresidential fixed investments, and exports) were partially offset by an increase in imports and a decrease in inventory investment. The increasing trade deficit remained a trouble spot, although the stronger global economy should ultimately translate to improved export performance.

Going into the second half of the year, economic conditions remained strong, and the GDP was expected to reach the 4%+ range. This increase will be led by solid economic fundamentals, moderate Fed rate increases, strong consumer confidence, and a one-time surge in spending induced by Y2K. In 2000, the upward trend of GDP should decline moderately to a more sustainable level, relying, in part, on the support of a global economy that continues to gain in strength. However, improvements that took place on an international level over the summer will introduce additional risk to the domestic economy, placing downward pressure on the dollar and drawing capital away from the U.S. market. Despite these risks, the near-term outlook is positive, with little indication of a recession.

Inflation/Interest Rates

During the first half of 1999, inflationary pressures continued to build on several fronts, creating upward pressure on the price index. The major inflationary forces included high domestic sales, a weaker global economy that drew resources to the U.S. market and weakened the dollar, higher oil prices, and continued wage pressure associated with the tight labor market. Indeed, at mid-year the four-week moving average for unemployment claims was the lowest level recorded in the past 26 years.

Despite these pressures, inflation is expected to remain in check over the near term, especially with the Fed poised to pull the trigger to maintain control. Interest rates should increase in the near term and then remain relatively stable, as the Fed seeks to strike a delicate balance between inflation and economic growth. Rising rates should moderate demand, as in the case of mortgages where the mid-year increase stopped the surge of refinancing. In addition, rising mortgage rates, which abruptly broke the 8% threshold in August, raises the specter of an end to the housing boom. The bond market will also be under near-term pressure, with moderate coupon losses expected for long-term bonds.

Stock Market

A key question with which investors have struggled over the past several years is whether the stock market will finally undergo a correction or whether it will sustain its upward trend. The question will only get more difficult as the market continues to defy traditional logic.

While price/earnings ratios are clearly high by historical standards, most rational observers have all but given up trying to predict how much of a correction to expect and when to expect it. To many, the surging stock market has become a self-fulfilling prophecy. In this environment, positive expectations amplify positive news and downplay the impact of sector downturns as investors jump from bubble to bubble.

With the overall economy expected to continue to perk along and emerging trends constantly introducing new gusts of change, there will be no shortage of bubbles to help sustain growth. Thus, while the threat of a major stock market correction continues, over the near term investors should be spared the inevitable reality check. Trading ranges will probably widen though and the risk profile of the overall market will increase. This inherent risk has ramifications for the overall economy because the accumulated "wealth effect" from surging asset values is now a major driver of the current economy. Thus, a reversal over the next few years could have widespread implications.

Consumer Confidence

Consumers have clearly benefited from the strong economy and the wealth effect of the surging stock market. The first decline in the Conference Board's Consumer Confidence Index in July broke the string of the longest consecutive monthly increase in its 32-year history. Yet, most analysts saw the downturn as a temporary blip rather than a major reversal. Indeed, the current situation compo-

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nent continued to rise, while the expectations component was dampened by concern over job prospects, tighter credit, and interest rate increases. Continued strength in the overall economy, the tight labor market, coupled with expected restraint by the Fed should ameliorate consumers' concerns and help sustain consumer confidence.

Retail Sales

During the first half of 1999, retail sales gains were robust. Although the pace of growth fell off in July due, in part, to limited supply and clearances, the outlook for retail sales remains positive.

In addition to improved in-store gains, Internet sales continued to surge, although actual sales statistics and forecasts remained elusive. Going forward, strong consumer confidence, low inflation, and low, slightly rising interest rates should translate to strong sales. In the fourth quarter, Y2K should further bolster retail sales as consumers spend their way across the gap of uncertainty as the calendar turns over. Retail sales may turn out to be a letdown in early 2000 as consumers reflect on the impact of rising interest rates on build-up debt and as the expansion of the wealth effect slows down. Overall, sales should flourish in the healthy economy.

EMERGING INDUSTRY TRENDS

One of the by-products of the maturation of the real estate asset class is an increase in its dependence on macro trends that affect the overall business and economic environment. Thus, informed professionals should track major business and industry trends, with special attention to how they may ultimately affect real estate market fundamentals and market processes. Four ongoing trends are noteworthy: consolidation, globalization, securitization, and technological innovation.

- **Consolidation.** Although industry consolidation is not new, it is penetrating deeper into industries and cutting across sectors and global boundaries. This movement has created a number of real estate challenges as firms are faced with solving redundant space needs without compromising growth and productivity gains.

  Within the real estate industry itself, there has been a new wave of consolidations as firms have sought to capture greater economies of scale in order to respond to cost pressures and the demand for broader, more comprehensive services. Indeed, consolidation activity has permeated the entire real estate industry, including advisors, brokers, service providers, appraisers, and consultants. While the effects of consolidation are still being played out, the trend will result in a greater concentration of power and an increased homogenization of services and responses to external conditions.
- **Globalization.** The continued globalization of businesses, economies, and finance is impacting real estate in numerous ways. The demand for service providers who can offer more global support for real estate needs has increased dramatically. Also, the U.S. economy has become much more dependent on the global economy. The outlook of both the national real estate and regional markets tied to global commerce have experienced ripple effects. The globalization of finance also has tremendous implications on real estate capital flows, affecting the cost of capital and the demand for investments.

  At a minimum, real estate professionals must develop a greater sensitivity to the global forces that will increasingly impact customers, clients, and domestic markets, especially those with strong global business bases. Those real estate firms that actually move into the global arena will have to strike a balance between local insight and knowledge to compete with leading local and global players, as well as understand the processes and systems necessary to function as a truly global company.
- **Securitization.** The collapse of the commercial real estate market in the United States during the latter 80s and early 90s created a tremendous capital shortage as traditional private sources of capital dried up. The resultant liquidity crisis helped nurture the fledgling CMBS market, and contributed to the resurgence of the public real estate equity market.

  In the early recovery stage in the mid-90s, many argued that the explosive growth of the public components of the market would propel them beyond the private sector, forever changing the way the domestic market operated. While public real estate debt and equity are here to stay, they will co-exist with private, direct investment rather than dominate this traditional form of ownership.

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Indeed, given the different drivers of value for the two forms of ownership, the balance of power and pricing advantages will periodically shift among the two sources of capital, creating arbitrage opportunities that should be recognized by market participants. Thus, to operate successfully in this hybrid public/private market, real estate professionals and investors will have to maintain an eye toward both sides of the market.

- **Technological innovation.** The continued decline in the cost of computers, dramatic advances in technology, and the explosive growth of the Internet have combined to create a technological revolution that has swept across the business and consumer markets. This revolution, which is still in its infancy, has far-reaching implications for the real estate industry.

  Technological advances have already dramatically affected the level of demand for space and locational preferences. However, because of these advances, real estate markets are able to deliver services in a dynamic way. Although the ultimate impact of technology is uncertain, the changes it induces will cut across property sectors and markets.

  As technological innovations continue to be made at an accelerating rate, real estate professionals will have to develop appropriate business response systems. To the extent possible, the systems must be developed as an essential part of business strategy rather than as a reactionary response. Identifying the technological advances that will have enduring effects on real estate utilization or market processes, and adopting appropriate response strategies for one's business and customers will be key.

CAPITAL MARKETS

As mentioned earlier, the real estate market has become more aligned with the capital market, with investors increasingly comparing real estate opportunities with other asset classes. This practice is most pronounced in the public sector, where CMBS yields are quoted as spreads to treasuries and REIT returns are compared to the broader stock market. However, capital flows on the private side of the market are also somewhat dependent on the relative values of other asset classes, especially among yield-oriented investors.

Over the past several years, the domestic real estate market has benefited from solid capital flows, although the sources of capital have shifted. For example, during the first half of 1999, the strongest capital flows to real estate have come from the private side of the market, while public debt and equity capital flows have significantly ebbed. This resurgence of the private market was a welcome relief for many traditional players who had defended the viability of private investing.

The public and private markets will likely continue to vie for lead positions in the real estate arena, creating more arbitrage opportunities as activity shifts from one sector to the next. This shift stems from the different drivers behind the two sectors, with the public market more dependent on external events and short-term fluctuations in relative investment value and the private market more tied to long-term real estate fundamentals. During the balance of 1999 and through 2000, capital flows into real estate should continue, with much of the capital streaming into the private market.

Private Equity Market

The private real estate market has been active through 1999. Investors are enjoying the opportunities afforded by a slower public market and supported by solid market fundamentals.

On the institutional front, domestic investor activity falls into two classes: opportunistic investing and core investing. With respect to opportunistic investing, strong product demand will continue to force high-yield investors to move further out on the risk spectrum. These pressures may take a number of forms, including investment in more "value-creation" strategies and investment in nontraditional properties. Opportunistic investors will also increase their offshore investment activities, hoping to benefit from market timing opportunities no longer available onshore.

Core investors with more modest return targets have remained active. However, even with the retrenchment of the REIT sector, they have been forced to look hard to source double-digit total returns—the outcome of a reduced supply in solid investments. Existing product, however, continued to provide strong returns. The NCREIF Property Index (National Council of Real Estate Investment Fiduciaries) racked up 12.6% annualized returns through mid-year, off the recent pace

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but still solid by historical standards. The bulk of offshore capital has been skewed toward the core category as investors move to quality in search of long-term investment potential.

During 1999, German investors have been particularly active, prompted by the lapse of tax incentive for domestic investments, relatively attractive returns in the United States, the potential for higher domestic taxes, and concern over the euro. Going forward, the yield requirements of traditional investors are expected to recede. Their attention will shift to building solid portfolios that can provide the attractive risk-adjusted returns from real estate allocations.

Public Equity Market

Despite strong real estate market fundamentals, the public equity market continued to struggle through much of 1999. National Association of Real Estate Investment Trusts (NAREIT) returns lagged both the private market and the broader stock market. However, REITs were up during the first half of the year, reaching 4.8%, which is a welcome reversal from the -17.5% reported for 1998.

Despite overall improvement, many REITs have chosen not to focus on capital issuance and acquisitions. These REITs have turned, instead, to managing existing assets to improve bottom-line performance. In this environment, the growth in REIT market capital will slow, with limited new initial public offerings and increased asset sales to help raise the capital to acquire new properties that will complement and reposition existing portfolios. Consolidation activity should also increase, as REITs work to become more cost effective by capturing additional economies of scale. Through the expansion of REIT portfolios, we can expect more joint ventures to source new product and capture additional service revenues. REITs will also continue to push for legislative relief to lower distribution requirements and make third-party service activity more attractive. Finally, as they make the successful transformation from growth to income vehicles, market capital should increase, although the rate of growth will be more tempered than in the past.

Private and Public Mortgage Markets

The mortgage market was active during the first half of 1999, setting the stage for solid gains for the year and the potential for record production activity. Assuming production levels maintain this pattern, the year could wind up with record production activity. This increase in mortgage activity can be attributed to several factors, including solid performance, relatively attractive rates, and record low delinquency rates. In addition, the turmoil in the CMBS market opened the door for traditional private lenders, with insurance companies leading the pack. Other traditional mortgage capital sources are also expected to increase activity, drawn by relative value and attractive risk-adjusted returns.

Going forward, the outlook is for strong lending activity consistent with conservative underwriting. While capital will still be available for development, activity levels will continue to be moderate. Thus, the potential for massive overbuilding will be dampened, although there will be some excesses as well.

On the public mortgage front, the market has been more erratic than on the private side. Although CMBS spreads have been stable during the summer, they are still above the 15-month trough that led to the collapse that occurred in the third quarter of 1998.

In the public equity market, the correction can be attributed to a fundamental repricing as REITs moved from growth to income vehicles. In the CMBS market, the turmoil was due, in great part, to the sector's strong alignment with capital markets and fallout from the Asian and Eastern European crises. The impact of these global economic events was amplified by problems that shifted the perceived risk profile upward in relation to other fixed income investments. Despite the lost momentum and a decline in the volume of issuance in early 1999, the CMBS market was still ahead of where it had been in prior years.

Activity should pick up in the third quarter as lenders seek to move product before inflationary concerns, the Fed's intervention, and Y2K fears dampen the year-end market. However, investor interest may not measure up to production expectations, raising the possibility of upward pressure on yields spreads, especially for the lower-rated tranches.

On a positive note, underwriting standards have become more rigorous. Conduit originators have begun to focus more attention on ensuring that loans can be easily securitized. In a reversal from an earlier industry trend toward "branded" issues, some originators have begun to combine efforts with competitors to offset the decline in loan production by individual firms.

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REAL ESTATE OUTLOOK

The domestic real estate market continues to fine-tune its recovery from the overbuilding of the early 90s, with market balance generally improving. This overall improvement can be attributed to solid growth in demand and moderate additions to supply. The increased demand, which is likely to continue through 2000, is rooted in the favorable economic outlook and its ripple effects for space users. On the supply side, near-term additions to stock should remain in check. Capital flows will reflect continued discipline as shown by the recent demand for higher pre-leasing, which is needed to obtain financing for new construction. A modest increase in mortgage rates, coupled with scrutiny from Wall Street analysts and real estate researchers, should further help to keep construction activity in check. In this environment, private equity returns should decline slightly, although they should remain in the low double-digits for most institutional real estate. On the public side, returns should continue to improve once REITs are repositioned from growth to income vehicles and capital turns its attention to spatial market fundamentals.

Office Market

During the collapse of the domestic real estate market in the early 90s, the office sector led the four major property types on the decline. Closing out the decade, this situation has been reversed with the office sector as one of the strongest property types. This dramatic improvement is attributable to strong, sustained demand growth associated with the general economy and the corporate "wealth" effect, coupled with moderate additions to supply. The tempered supply figures are particularly refreshing, especially in light of the early wave of construction. If this trend had continued, the sector could have plummeted back into recession. Evidence of the renewed strength in the office market can be gleaned from improved performance (both in the private and the public sectors) and from improved market balance. For example, despite a slowdown in the private office sector in the first half of 1999, the NCREIF office index racked up solid 18.6% annualized returns. In the public sector, the turnaround in office returns was even more dramatic; it rebounded from -17% in 1998 to 10.5% through July 1999.

With respect to market balance, office vacancy rates have declined to some 10%, a figure that many thought would be impossible to reach before the next millennium. Even more surprising to those who wrote of the central business districts (CBDs), vacancy rates downtown were lower than in the suburbs. This CBD advantage is largely due to differences in construction activity, with the bulk of new construction going into the less restrictive suburbs that have lower barriers to entry.

Going forward, the prospects for the office market look positive because of strong tenant demand and moderate levels of new supply. However, two factors should be monitored. The first factor is the potential impact of technology, which is creating significant shifts in space utilization and locational preferences. The second is more subtle; it emanates from internal changes on how companies approach corporate real estate and places increased emphasis on flexibility in workplace design and lease commitments. In addition, companies are shifting this focus from the bricks and mortar of corporate real estate management to a broader vision that enfolds total infrastructure management. Coined "Corporate Infrastructure Resource (CIR^{SM}) Management" by The IDRC Foundation, this change could have profound impacts on space utilization as space users rethink how they approach resource management and how they can best impact shareholder value.

Retail Market

Of the major property types, the most troubling to many investors is the retail sector. This difficulty is attributable to a number of factors, from disappointing historical performance to concern over the implications of electronic commerce (e-commerce) on traditional bricks-and-mortar retail real estate. Despite these concerns, retail returns have been more stable than most of the other sectors. For example, during 1998 public retail REITs declined around -5%, with regional malls down only 2.6%. Through July, public retail returns were still moderately negative while retail sales and market fundamentals were positive. On the private front, retail returns in the NCREIF Index hovered slightly below 12% per annum through the second quarter based on solid income and moderate appreciation.

These strong private market returns were even more indicative of strong fundamentals when the adverse selection process of malls that are left in the NCREIF Index is

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considered. Since the bulk of the top-tier malls have moved into the public sector and out of the private market, the remaining malls tend to have lower productivity levels and thus somewhat lower returns than before the private/public conversion.

On the construction front, retail activity has been fairly active, concentrating on infill development of neighborhood centers, redevelopment and expansion of regional malls, and new centers targeted toward fast-growing areas spurred by the housing boom in many suburbs. The growth in entertainment and continued expansion of the supercenter concept has also contributed to new construction activity. Despite concern over new supply in some markets, the retail sector should continue to provide attractive returns, mirroring continued economic expansion and retail sales. However, investors will remain concerned over the hype surrounding e-commerce and the cloud that it has painted over the entire traditional in-store shopping industry.

Industrial/Warehouse Market

The industrial/warehouse market has remained in equilibrium through much of the year, benefiting from the strong U.S. economy. On the public market front, industrial returns have rebounded, although not as dramatically as in the office sector. During 1998, industrial REITs reported -11.7% returns, rising to over 8% for the year-to-date figures through June 1999. On the private market side, industrial returns for the 12 months ending June 1999 were over 14.6%, lagging only the office sector. While some might take this balanced state for granted, the sector is subject to a number of forces that could create demand/supply mismatches. For example, changing logistical models associated with technological advances and the elimination of the middle man in many industries could dramatically affect the level, design, and location of desired facilities. Similarly, a change in channels of distribution triggered by the success of e-commerce could have dramatic impacts on industrial and warehouse demand.

On the corporate front, many companies are beginning to look at manufacturing as a commodity, favoring turnkey processes with third-party producers over inhouse production. With respect to demand, the strong domestic market for goods could reverse if the economy stumbles, while the export market could improve dramatically as the world economy expands.

Finally, the concentration of industrial activity in the hands of well-capitalized public and private entities over their historically smaller, local predecessors could change the supply function, increasing the tendency to overbuild. Despite these risks, the near-term outlook for industrial and warehouse properties remains positive, with pockets of unusual strength and weakness.

Apartment Market

The apartment market has been a generally favorable performer, although the sector was not spared the REIT decline in 1998. Returns came in at -8.1% before rallying to over 13% during the first six months of 1999. On the private side, returns remained strong with 13.45 annualized returns through June. The strong sustained growth in new supply has been a cause for concern for the apartment sector, although the strong recent performance has been sustained through the prolonged bull economy and low interest rates that have bolstered sales in the single-family housing market. Going forward, apartments should remain solid. They should benefit from rising mortgage rates that dampen tenure shifts to ownership and a strong economy.

Some Sunbelt markets, favorable demographics, and strong in-migration rates bode well for apartment investors. Going forward, demographic trends should improve the demand outlook for apartments. The baby boom "echo" effect will create a surge in the "over 18" age group, which has the highest propensity to rent.

Assuming continued discipline on the lending front, the outlook for apartments should generally be positive and have limited downside risk. The exception will be in markets and submarkets in which infrastructure limitations and technological advances shift the locational preferences of renters away from existing stock that suffers from poor logistics.

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