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James R DeLisle
The Appraisal Journal; Oct 2001; 69, 4; ABI/INFORM Global
pg. 365

Real Estate Capital Markets: Transitional Economic Turmoil Amidst Demographic Change

by James R. DeLisle, PhD

Commentary

Six months ago, we labeled the U.S. economy as transitional, making a structural shift from the old to the new economy. A lot has changed since that time, especially the economic outlook. While we are still in transition, the battle lines between the two stages have become less clear. In reality, we are moving into more of a hybrid economy that draws on the solid business fundamentals of the old, and modifies them by integrating the new. In this financial update, we explore the macroeconomic environment and outlook to develop a better understanding of the economic forces that will serve as the backdrop for the real estate market. In an effort to understand the changing demand side of the equation, we also look at some of the demographic trends that have surfaced from Census 2000. Finally, we explore the current real estate market, both capital and spatial, with an eye toward the near-term outlook.

While a weak economy is certainly capturing the spotlight, not all is negative. We should remember that tax rebate checks are moving into consumers' hands, interest rates remain low with little upside risk, and some, albeit limited, sectors are perking along. However, consumer confidence is lagging, inflation is nagging, and the stock market is staggering. When we looked forward to this eventual downturn several years ago, we took solace in the fact that corporate coffers would be relatively flush as a result of the prolonged bull market that carried through the 90s. The notable exception to this caveat was the technology sector that burst upon the scene.

The unsustainable growth of many companies and their technology sectors has fallen into line with market fundamentals rather than hype. Thus, we expect the convergence of the old and new economies to continue, while traditional players integrate technological innovations and surviving dot-coms embrace solid business fundamentals. Over the near term, a tentative cloud will hang over real estate decisions, creating a backdrop that favors intermediate short term goals over long term strategic plans.

The Economic Environment

Economic Growth

During most of 2001, the economy has continued to struggle, eking out the moderate growth of consumer spending and government expenditures. The rather abrupt downturn in growth raised the specter of a self-fulfilling prophecy that has the potential to dampen the spirits of consumers and businesses. On the corporate front, economic growth is much more restrained than the overall figures as companies cut investments, shore up bottom lines, and respond to overall weakness. This downturn in business spending spread across most frontiers, with the most pronounced downturn in the technology sector. In addition to declining investment, companies have also scaled back inventories in an effort to adjust to relatively stagnant demand. This contraction has had far-reaching ripple effects, hitting the already weakened manufacturing sector the hardest. There is also little to cheer about on the international front as exports also declined due to a spreading global weakness.

Looking forward, gross domestic product (GDP) growth might once again accelerate, as low interest rates, tax cuts, tax rebates, and declining energy prices are factored into the market. The timing of a turnaround is uncertain. Once optimism returns, companies should quickly drop their defensive postures. This will entail rebuilding inventories and increasing capital expenditures in an effort to capture a fair share of rising revenues. The cumulative effect will be bolstered by productivity gains associated with new technological breakthroughs and

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investments. Such a scenario would quickly spill over into the retail sector. It should be noted that for the remainder of 2001, the prospects for economic growth are rather dim. Consensus forecasts show that GDP growth is in the sub-2% range for 2001, ultimately rising to the low 3% range for 2002.

Employment

In light of historical averages, unemployment in the U.S. remained low through the summer of 2001. However, the unemployment rate is somewhat higher, reflecting corporate layoffs. Three employment categories were especially affected by the downturn: young workers, temporary workers, and technology workers. Job losses were particularly devastating to young workers since they entered the job market toward the end of one of the longest bull runs in history. Many of these new workers were drawn to the technology sector and saw their worlds collapse in the face of an industry meltdown. Even new employees with jobs outside of the technology sector were affected by the business contraction, as companies followed the "last hired, first fired" model. In addition to personal setbacks, these job losses will have a negative impact on retail sales prospects since this demographic group, flushed with earnings, was in its peak purchasing period.

Over the past several years, companies have increased the use of temporary workers. This trend can be attributed to several demand-side factors, including the desire to add greater flexibility to payrolls, the need for companies to respond to changing market conditions, and the periodic need for specialized skill sets that could not be justified to employ on a full-time basis. The acceptance of skilled part-time employees was also fueled by supply, as more and more employees sought balance in their life by cutting back on work activities. In addition, some of the more mature workers who had opted out of the workforce or were laid off earlier than anticipated, returned to the workforce. While the combination of these supply and demand factors created a more efficient employment market, they also set the stage for quicker downside adjustments. Temporary workers have taken the brunt of these "adjustments" with little institutional support and job security.

Outsourcing has set the stage for quick and dramatic adjustments in net employment roles. This trend has been particularly prevalent in technology. When coupled with declining revenues and disappointing technology gains, companies have been quick to pull the trigger on information technology contract renewals. In some cases, projects have been scaled back or abandoned to gain control of runaway costs and marginal benefits. Projects have also been re-bid in order to bring expenses in line with revenues. This trend has been initiated by customers who were not satisfied with results, as well as by the collapse of many dot-coms. This secondary contraction has exacerbated the plight of technology workers who have been let go in record numbers by companies that were severely cut back or failed outright. Fortunately, the country remains under-supplied in terms of technology workers, which suggests that once employees adjust to the new mindset of moderation in the modern workplace, they should be able to re-enter the labor force.

Interest Rates and Inflation

During 2001, the Fed has cut interest rates seven times for a total of 3%. With the last cut in August, the Fed set the record for the longest sustained easing policy and created a fine line between controlling inflation and dragging economic expansion. The end result has been relatively favorable, although the loss of freedoms (i.e., room to maneuver) associated with each decline suggests that the Fed has played its hand.

One additional interest rate cut is likely. Despite the consistent and anticipated pattern of declines, the Fed's actions have not been able to reinvigorate the economy or market. This was evidenced by the market's ho-hum response to the August decrease. The market actually weakened as investors began to wonder what unknown concerns might have triggered additional easing. In the future, investors and consumers will pay less attention to positive rhetoric, turning to other indicators and prognosticators for their cues. Absent of any major shocks, interest rates are expected to remain relatively flat to slightly down.

Due to energy price surges and core inflation, the year got off to a rather poor start. Through August 2001, the combination of declining energy prices and the consistent policy of Fed intervention took pressure off the consumer price index (CPI) as annualized rates of growth declined to the low 3% range. Within the CPI, cost of services continued to hold at relatively high annualized growth rates, while rises in

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the costs of goods moderated. This cooling off was largely attributed to the declining energy prices, which were abruptly adjusted downward to reflect supply/demand conditions. Computer prices continued to plunge, while manufacturers ratcheted up hardware specs faster than consumers embraced obsolescence. Apparel prices also languished because of the lack of consumer enthusiasm. Food, beverage, and medical prices also rose in the first half of 2001.

Housing Market

The housing market has been one of the bright spots in the U.S. economy during 2001. Indeed, the sector has been surprisingly strong in spite of falling consumer confidence, economic turmoil, and rising concern over employment prospects. The robust housing market is evidenced by several indicators:

- Housing permits remained strong, rebounding from the fourth quarter of 2000 and on par with the first half of the year.
- Housing starts were slightly ahead of the fourth quarter, although down from the beginning of the year.
- Sales of new and existing homes went up, both over the fourth quarter and the whole year.
- Housing prices continued to increase, for both new and existing homes.
- Housing affordability levels are improving.

The fact that interest rates have been below historical averages for some time suggests that consumers, at least housing consumers, are discounting an anticipated reversal in economic fortunes. Activity levels in consumer demand and rising housing prices have been tempered over the past several months. Despite the mid-year slowdown, the Housing Market Index (HMI), which measures builders' prospects for the sector and is generated by the National Association of Home Builders (NAHB), rebounded up to mid-2000 in August. This pick-up in the HMI was attributable in large part to a modest decline in interest rates and solid demand. Helping explain the sector's strength in general economic malaise, there is evidence that potential buyers see the real estate market as a safe haven relative to the stock market. The ratio of homes for sale to homes that sold suggests that activity levels may continue over the near term.

On the remodeling front, housing activity remained solid, although economic conditions put a damper on the sector. The remodeling sector will be easier to track in light of the introduction of the Remodeling Market Index (RMI) by NAHB. Although still below the first half of the year, both mortgage applications and refinancing activity picked up toward the end of summer. Fixed mortgage rates declined moderately, with rates holding 125 to 150 basis points below the previous year. The spread of 30-year mortgages over 30-year treasuries was relatively flat, although the pattern over the past 15 months has been one of steady decline due to strong market fundamentals. The spread of 1-year adjustable loan rates over 1-year treasuries remained above 200 basis points—a record spread over the past decade. With respect to the multi-family market, starts have continued at a healthy clip this year. The multi-family market remains healthy, with few localized pockets of weakness.

Business Indicators

Overall, in terms of the economic outlook, consumerism has declined and business has risen. Furthermore, there are no clear economic leaders among the sectors. Rather, there is a revolving door of candidates, with no sector strong enough to become independent. The good news for prognosticators is that the technology sector will clearly not be reincarnated, at least over the near term. In order to get a handle on the overall business outlook, one must develop a holistic approach to explore a number of business indicators.

Over the past several years, many companies were caught up in the technology boom, optimistic that structural change was both inevitable and impending. After a brief period of denial, most of us got sucked up into the virtual vacuum. Due to its unique, specialized nature, the virtual world turned out to be an elusive concept, both in terms of business strategy and execution. As a result, a number of windfalls and wipeouts occurred. The casualties among the broader business sector are not very visible. In many cases the symptoms have not yet surfaced, masked by strong balance sheets and a growth mindset. Thus, many companies are facing a conundrum. They are mired in slowly forming quicksand somewhere between the old economy and the new economy. In this quagmire, they must figure out how to balance their true investment needs in the face of moderate to declining market fundamentals. As might be expected, these deliberations will be fraught with peril, especially in light of an investor market

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with little tolerance or appreciation for defensive investments that have no immediate, positive impact on returns.

During this period of generalized business contraction, it is important to focus on insightful indicators that give the necessary momentum to catapult the economy out of the doldrums. For example, the inventory-to-sales ratio suggests the surplus must be absorbed before the market can respond to increasing demand. This ratio also gives insight into the pessimistic expectations of business. During the first half of the year, a dramatic reversal in inventory build-up moved into the negative range for the first time in recent history. This decline was led by the automotive industry as companies anticipated a softer consumer market.

The broader manufacturing sector saw tightened supplies, which helped drag down GDP growth in the first half of the year, but positioned businesses for expansion when conditions picked up. After rising during the latter 90s, utilization levels continued to plummet, falling to the lowest levels since the early 80s. Not only does this suggest a drain on profits, but it also creates a drag on the potential demand for new plant and office capacity when the economy ultimately turns. Companies tightened their belts in the first half of the year while productivity continued to rise, benefiting from accelerated labor force contraction and technology-enhanced gains. The ability to position individual companies to exploit the potential for added productivity gains via current investment in technology would determine the real winners.

There is little positive news in the manufacturing sector. Factory orders, production, purchasing, and earnings have all fallen off the charts. While the eternal optimist could argue that the only way from here is up, it is by no means clear that the sector has bottomed out. The Leading Economic Indicators appear to have bottomed out, suggesting that the fourth quarter could see some improvement in the general business climate.

The Stock Market

The stock market picture remains clouded by the combination of continued economic uncertainty, sticky cost structures, and declining revenues. While there have been some success stories recently (e.g., basic materials, consumer cyclicals), they are few and far between. Within these categories, experiences also have been mixed, with leaders changing positions from quarter-to-quarter. More importantly, few sectors have been able to establish any sustainable momentum, creating a churning cycle. Earnings are particularly troublesome, with widespread declines across industry groups. In addition to negative outcomes, a more vexing pattern has been the common practice of "estimate reductions." The worldwide slowdown in earnings will create a greater drag on the domestic scene. In this environment, investors will be even more finicky. Unfortunately, the recent attention pointed to sell-side analyst bias won't help the situation. The end result is that the market will continue to function, the Fed's impact will be muted, and investors will be in for a ride. The good news is that there are few signs that investors will get off the roller coaster en masse. If the economy does start to pick up early in 2002, the situation should stabilize. However, few will be able to convince investors to relax.

Consumer Confidence

During the summer, consumer attitudes were consistent with the overall market and economic turmoil. There was erosion in consumer confidence, both in the Present Situation Index and Expectations Index. Although unemployment remains below long-term averages, consumers on the margin remain concerned over the general economic climate. This is reflected by the number of discouraged workers, especially the increase of males that entered the work force in late spring. In addition, there has been further erosion in consumer attitudes toward business conditions, both current and near-term. Another factor is the recent decline in the wealth-to-income ratio. This deterioration was attributable to a stock market induced negative wealth effect and the declining savings on the expenditure side of the equation. This lagged effect might suggest that consumers are poised to rally, assuming evidence of an economic rebound in the second half. Thus, the tax rebates might create a blip in consumer sales and attitudes. Unfortunately, few are arguing that a broad-based economic turnaround that consumers are looking/hoping for is imminent. Consumer confidence will be flat to slightly negative, therefore they cannot be counted on to lead the economic recovery.

Retail Sales

Consumer expenditures continue to grow moderately through much of 2001. Although sales rose

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above some expectations, consumers remain skittish. This situation is expected to continue, with more downside than upside risk. The year-to-date figures are somewhat disconcerting in light of the promotional campaigns launched by retailers to attract shoppers. While some are looking to tax rebates to create a surge in buying, it will be temporary. Consumers will fear job security, the decline in savings due to the ripple effects of the stock market, and the continued turmoil in the technology sector; on the other hand, they are expected to focus on value, which benefits discounters and hurts traditional department stores and non-anchor mall tenants. The outlook for durable good sales remains guarded, with consumers reluctant to take on more debt or to draw down their savings. Anticipation of this decline has already spilled over to the automotive sector, resulting in slowdowns and another round of layoffs.

On the Internet front, sales activity continued the downward spiral that began after its fourth quarter 2000 peak. The collapse of the home-delivery grocery industry (e.g., Webvan, Peapod) caught many proponents off-guard. Some believed that Internet shopping would be a short-term phenomenon rather than a sustainable business activity. However, more in-depth analysis reveals that the collapse was due to the combination of a flawed business model, logistical issues, and excessive expectations. As with many other retail sectors, the home-delivery industry has not disappeared. Instead, it serves as a useful case study for main-street retailers that help highlight the advantages and disadvantages of such a distribution model. Traditional supermarket chains (e.g., Kroger, Publix) are introducing technology-enhanced channels, including Internet-based home delivery systems. This learning curve is expected to be played out across the retail frontier, suggesting that retail sales and margins may be enhanced over the intermediate term.

Demographic Spotlight

Why Demographics are Important

In addition to increases in population and household growth, households benefited from a strong business environment that drove down unemployment rates and increased income levels. The strong stock market created significant wealth, thus improving the balance sheets of many households. The convergence of strong earnings, wealth effects and sheer mass explains the strength of the recent consumer movement and the role that it has played in fueling the overall economy. While consumers continue to spend during 2001, it is clear that the economy cannot rely on them. This does not imply that consumers and households will not play a critical role in the economic outlook. Indeed, to sustain any major resurgence they must be in the game. Scrutiny of changing demographics is necessary to help understand consumers' composition, situations, preferences, and likely behavioral responses to various economic conditions.

Population Profile

The official figures for the U.S. population tallied 281.4 million, which is 32.7 million more (up 13%) than in 1990. This dramatic and sustained population growth during the 90s has had significant impacts on the population profile. For example, the age distribution of the population has changed, with a bimodal pattern of increases in the young and old. As a consequence, there has been a contraction in the middle, 25- to 45-year old, population. These changes can be traced to lag effects of low birth rates in the late 1920s and early 1930s, high birth rates in the post-war era through to the early 1960s, and a more moderate population in recent times. Immigration has played an increasingly important role, boosting overall population growth profile. This trend is expected to accelerate.

The recent population growth is a mixed blessing for the economy, sectors, and individual companies. The aging population is skewing the labor pool toward older workers who tend to be less mobile, more educated and professional, have fewer accidents, and have fewer young children at home. On the other hand, these older workers tend to demand higher salaries, seek greater job security, expect better benefits, are more dependent on pension plans, and have more health issues, which triggers higher medical costs. The aging of the workforce will create additional uncertainty for forecasters. This is due to the fact that they have unknown labor force participation rates, job preferences, and career aspirations.

The outlook for population growth is for moderate levels of natural population increases, with immigrants expected to account for almost half of it. Educational needs of the expected population will change, placing greater pressure on public education and job training. In many of the faster growing markets, the special needs of students for whom

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English is a second language is placing additional stress on already stretched budgets as schools attempt to accommodate the sheer number of new students. Unless these needs are addressed, the economy will be faced with a decline in the educated population and workforce, along with a critical shortage of professional workers.

Household Composition

According to government definitions, a household is broadly defined as one or more person(s) living in a housing unit. Households are subdivided into two categories: family households—at least two members are related by blood, marriage, or adoption; and non-family households—a person that lives alone or shares a housing unit with non-relatives. Increasing diversity, a common household trend, accelerated during the 90s. Household diversity is related to lifestyle and lifecycle changes of the resident population, as well as differing ethnicity and household patterns of immigrants. Other factors that have led to changing household composition include marriage, divorce, fertility, mortality rates, changing values, economic conditions, laws, and social mores.

The mixture of family and non-family households has continued to shift. For example, in 2001, the percentage of non-family households has risen due to the increase of men living alone. The family category lost market share due to decreases in married couples—with and without children—which exceeds moderate increases in the other family category. Household size continued to shrink during the 90s, with the number of households with children at home falling to less than one-third, down 45% in 1970. The number of one-parent families increased, the number of single-mother households has risen threefold since 1970, and the number of single-father households has increased even faster. Despite these differential rates of growth, single-mother households still outnumber single-father households by a 5:1 ratio. The single-parent growth stems from higher, although stabilizing, divorce rates and an increasing number of single females having children.

Households are experiencing temporal compression with fewer children being born close together. This pattern differs by economic status, with more affluent people waiting to have childeren later in their childbearing years, while lower income people are bearing children in their early child bearing years. The median age of first marriages is rising for both males and females. The interactive effects of aging and household changes have also led to additional household composition changes. For example, the typical baby boomer couple has more living parents and siblings than children. Furthermore, many married couples have multiple sets of children from their previous marriages, creating a hybrid form of extended family.

For the country as a whole, tenure choice revealed a continued bias toward ownership, accounting for two-thirds of occupied housing units. However, for the 30% living in Central Cities, tenure choice was much more balanced. For those living in the suburbs, ownership ratios were much higher, accounting for 75% of all households. The average household size was greater than renter-occupied units at 2.69 and 2.4, respectively. Similar tenure figures prevailed for 80% of the population living in metropolitan areas, with only moderate declines in the Central City figures. Renters exhibited less stability, with 20% moving during the year and another 58% in the previous five years, compared to 4% and 32%, respectively.

Despite success in improving mass transit, Census 2000 revealed that this is still an automobile dominated nation. 76% of the working population over 16 years of age are driving alone, and 11% are carpooling. Public transportation accounted for only 5% of commuters, with another 3% reported that they walk to work. The number of those who work at home rose to 4 million. The time spent commuting increased, due to rising congestion and expansion of trade areas. 30% of workers' commutes were less than 20 minutes, 66% were under 30 minutes, and 18% were over 45 minutes. The propensity to use public transit rose moderately.

Workforce Composition

A number of other changes in population profile and household composition are noteworthy. For example, employees with college degrees have increased dramatically. To some extent, this increase has offset the surge in demand for more educated employees although it has not kept apace. Unfortunately, an increasing number of potential employees are considered to be academic underachievers. Therefore, new forms of educational enhancement and training must be developed. Never-married mothers place additional stress on educational and family support systems. These trends elevate the importance of childcare—a situation that is getting worse for many households.

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The workforce profile is changing as a result of differential participation rates. The growth in the unmarried ranks of households has led to a decline in labor force participation and a rise in structural unemployment. For the overall population, female participation rates are expected to stabilize or decline. The exception to this pattern is among higher-income females. The aging population, and reliance on immigration to fuel population growth, increase uncertainty regarding labor force participation rates and the intensity of work being sought. For the workforce as a whole, working hours have declined due to a combination of later childbearing ages and early retirement. Many families recognize the importance of balancing work and personal/family lives. This results in rising stress levels, especially among single parents, particularly working mothers. The growth in older workers has triggered the demand for more flexible, less intense work options (e.g., work at home, part-time work, consulting, and self-employment). Unfortunately, there is no solid historical data to suggest how these preferences will ultimately impact the workforce.

The workforce trends from the 90s, both in terms of growth and composition, suggest a continued scarcity of labor, especially for skilled jobs. While the recent economic slowdown has affected this trend, the anticipation that it will continue is leading to a number of corporate responses. First, companies are placing more emphasis on recruiting, expanding beyond immediate markets to broader regions. Second, some companies are looking beyond industry boundaries, seeking skills that can be channeled into new careers. Third, companies are relaxing hiring requirements, with the assumption of in-house and contract training. Fourth, companies are placing more emphasis on retaining employees by adding flexibility, benefits, compensation, and enhancement of the work environment. Finally, some companies have responded to these demands with extended maternity leaves, job sharing, flextime, and four-day work weeks. More enlightened companies are also revisiting location, design, and infrastructure investments to ensure that they satisfy the needs and desires of potential employees.

Real Estate Implications of Demographic Trends

The demographic trends that were revealed in Census 2000 have a number of implications in the real estate industry. The number of residents reflected in the population figures increased for the first time in modern history. Despite this overall growth, the real news was in the dispersion of that growth. Although the states on the bottom end of the growth curve were able to hold their own on an absolute basis, they lost market share as the overall pie got larger. As in previous cases, the population increased the most in the West and the South. Indeed, three states, California, Texas, and Florida, dominated the race accounting for over 40% of net growth. These three Sunbelt markets benefited from a combination of net in-migration and high immigration rates.

Growth in a limited number of markets, especially among immigrants, has created a number of opportunities and challenges for local markets. High population growth has triggered the demand for new housing with many in-migrants choosing rental over ownership, at least in the early post-move stages. The influx of new residents and skilled employees in search of jobs in a number of cities has created positive centripetal forces. Skilled employees and new companies seek to tap into the new labor pool. In many of the Sunbelt cities, high population and employment growth, coupled with robust economic times, have bolstered tax coffers. Cities and governmental bodies have engaged in a number of infrastructure and service improvements that, in a more stable environment, would be hard to justify.

Above par growth has not been without its downsides. Sunbelt markets are struggling to accommodate the tremendous influx of new residents. While some cities have successfully absorbed new residents, the sheer volume of in-migrants has strained most. Many larger high-growth cities are struggling with environmental issues including air quality, water shortages, and sewer congestion. Population levels have risen dramatically, resulting in massive congestion, longer commute times, and increased safety risks. The need for infrastructure improvements is greater than the revenues. This is especially true in markets where existing capacity and quality infrastructure were already marginal. Schools in many cities and outlying markets simply have not been able to keep up with the surge in demand. In these areas, temporary trailers and classroom facilities are being added to new school sites before, or shortly after, they open. The high rate of immigration and non-English speaking households has created an additional strain on school budgets. Funding used to enhance the educational experience and

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to raise standardized test scores are being used to keep educational attainment levels constant. Cost of living rates have increased dramatically. At the same time, quality of life has eroded, setting the stage for slower growth in urban environments.

The U.S. exhibits a markedly increased diversity, both in terms of population base and household composition. This trend will continue, especially to the extent that immigration continues to play a major role in population growth. The increase in diversity of the workforce and consumers suggest that we are treading on new ground in a number of frontiers that make forecasting more perilous. Increasing diversity argues that much more attention should be paid to the behavioral dimension of real estate. Various demand segments differ in terms of composition, employment status, preferences, and tastes. The decline of married couple households has an impact on residential choice, both in terms of location (i.e., more likely to live in the suburbs), and tenure choice (i.e., have a much higher propensity to own rather than rent). Insight is necessary in the inefficient, imperfect real estate market in which decisions are relatively capital intensive and enduring. Despite the advances of information flows, real estate transactions are still largely conducted on a proprietary basis—personal preferences and perceived values are the ultimate determinants. Understanding demographic trends and the implications they have on the overall market will be paramount to long-term success.

Real Estate Capital Markets

Overview

During 2001, the real estate capital markets have begun to tighten. This tightening reflects the combination of continued concern over the broader economy and rising concern over the health of the commercial real estate market. It is beginning to spread beyond speculative projects, putting some developers and borrowers on the defensive. There are no signs of widespread capital shortages reminiscent of the recent past. Capital markets will continue to support real estate transactions that make economic sense; however, the velocity of transactions will slow down. Troubled loans and failing projects are the exception. As the year unfolds, investors and lenders are expected to pay increasing attention to economic conditions, market balance, sector fundamentals, and credit risk. This will result in upward pressure on cap rates, and as investors and lenders become more finicky regarding real estate, attrition rates will rise.

Construction Activity

In early 2001, construction completions remained fairly robust, benefiting from lagged starts that surged 12 to 18 months ago in a more robust economic environment. By mid-year, however, the pace of completions actually declined, putting an end to a six-month run. In addition, construction activity became more divergent, both in terms of property types and markets. The housing market has been the only stable performer, although home improvement spending experienced a slight decline. Office, industrial, and other commercial completions have been mixed to down, with industrial completions briefly rebounding. Property type disparity is expected to continue without a major industry-wide catalyst to catapult activity levels across the board. Both single and multi-family housing rose through mid-year. The slowing economy and rising consumer concerns should dampen the housing market, although the industry outlook calls for moderate gains. This positive outlook is due in part to continued price gains in the existing home sector coupled with robust activity levels. Median home prices typically gained at a positive spread over inflation. Rising lumber prices could push new home prices out of the range of some marginal buyers, dampening activity levels and slowing down the market. Fortunately, the specter of lower interest rates could offset this impact.

Private Equity Market

During the first half of 2001, private equity returns for commercial real estate continued on a gradual downward trend. On an annualized basis, the NCREIF Index provided a total return slightly over 11%, which is on par with our expectations, but down from previous levels. The Leveraged Index faired better, held steadily and took advantage of low interest rates and favorable financing to turn in a premium of 275 basis points. We expect both rates to decline moderately as market conditions soften. Due to the likelihood of declining-to-flat interest rates, the spread between leveraged and unleveraged investments should continue to widen. Private real estate investment should remain attractive in light of the downward spiral in the technology sector and continued volatility in the equities market.

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On a risk-adjusted basis, the real estate market is not subject to a dramatic downswing, while supply and demand should remain in relative balance. Pension funds and other institutional investors are expected to remain active buyers in the real estate market, only somewhat dampened by declines in other asset classes that have indirectly raised real estate allocations. These will not likely affect institutional investors who have remained significantly under-invested in the asset class; however, it might inhibit the more aggressive or successful players. It could also create additional returns for opportunistic real estate since traditional investors continue to eschew risk and search for what they perceive as safer, core-like investments.

Investors should not assume that they will experience similar results. The general state of market balance is not as pervasive as it has been in the past. That is, some property sectors and markets are in trouble. This is especially true for the dynamic markets that enjoyed a tech-boom in employment growth, rental growth, and an attendant surge in new construction. Many of the no-brainer investments of the mid-90s have burned off their market correction subsidy and now must ultimately stand on their own from a competitive perspective. Real estate asset and property management skills, coupled with an adequate supply of capital, are critical for maintaining values and stabilizing returns. While some of the needed investments will be offensive and add to the value proposition, other investments will be defensive and potentially dilute holding period returns. It is likely that many of the opportunistic investors who have yet to unload their market timing plays will be caught in a market fundamental squeeze. Overall, investors can expect to experience dramatic downward spikes in returns.

Proactive management of real estate assets and the tightening on the public side, especially for opportunistic deals, has opened the window for more private action. Caution and risk-aversion will begin to creep back into the mindset of traditional investors. Opportunities will be isolated and will forestall opportunistic players who look for systematic capital shortages and a large economy to justify marshalling resources toward some out-of-favor asset class. Single-minded price pressure and the push for quality have made such overall assets less attractive (i.e., lower yielding). Despite this, the institutional real estate market is expected to remain active. Private investors should continue to enjoy attractive risk-adjusted returns and should be able to capture excessive returns on emerging, albeit somewhat isolated, opportunities.

Public Equity Market

After struggling in 1998 and 1999, the public Real Estate Investment Trusts (REITs) market has had a very strong run. While the maturing of the sector, general economic malaise and a softening real estate market dampened returns from 2000, REITs have had relatively strong returns through the summer. In July, the NAREIT Index experienced negative returns due to a price correction that moderated the pervious month's high price returns. On an annualized basis, public REIT returns came in on par with private leveraged returns and above the unleveraged returns. Performance levels have been more attractive to institutional investors compared to the other asset classes that are more volatile and face additional downside risk. While the REIT sector is subject to similar pressures and a general softening in the real estate market, there are few danger signs that would suggest a major retrenchment over the intermediate term. Assuming the economy strengthens in 2001, REITs should benefit from ripple affects that spill over to the real estate industry.

REITs appear to have stabilized at slightly under $150 billion in total market cap. However, consolidations have shrunk the number of companies from a peak of 226 to 188 by mid-2001. Further consolidation is expected, although not on a massive scale. The debt ratio for REITs has trended moderately upward to 47%, ranging from slightly over 60% for mall companies and 39% for industrial/office. Debt ratios remain below the peak from 1998 and in 1999. Both interest and fixed expense coverage ratios (i.e., earnings over expenses) remained stable, following the same pattern of the past several years, although below those ratios of the 1996 and 1997 period.

Reviews of REIT publications emanating from companies suggest that the industry is in a more mature phase. REITs are paying more attention to strategic planning, seeking to articulate and implement programs that can enhance performance. Nonetheless, REITs are struggling to find balance between same store growth and new business. They continue to place emphasis on efficiency, seeking the use of technology, strategic relationships, and controlling

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costs. Similarly, REITs are placing more emphasis on customer satisfaction, focusing on developing sustainable relationships with larger players whose spatial needs match their current portfolios or anticipated expansion. REITs are seeking new revenue sources. Management is creating viable growth streams that complement existing operations and are strategic in nature. Convincing analysts and investors that these new initiatives are sustainable and can create even more synergies that should be factored into stock prices. Over the intermediate term, new security offerings and acquisition appetites should be moderate as the industry sorts through the market plateau and focuses on stabilizing existing operations.

Commercial Mortgage Market

During 2001, several clouds have begun to dampen the commercial mortgage market outlook. There are rising concerns over the real estate cycle, triggered by the combination of economic stagnation and rising vacancy rates in some property sectors and markets. The commercial mortgage market itself has experienced a slight uptake in mortgage delinquencies. Delinquency rate increases have been more pronounced in the retail and hotel sectors, and overall rates have crept up as well. Current levels remain very low with respect to long-term averages. Historical comparison has helped avoid any significant curtailment of funds, although the market's angst has still risen.

In terms of private debt, lenders are expected to continue to be selective, paying more attention to the individual market fundamentals associated with prospective deals. This added scrutiny suggests greater price differentiation. Transaction volume is expected to slow down, while borrowers do more competitive shopping and lenders become more selective. It will remain extremely difficult to finance speculative projects, thereby dampening new construction. Lenders are expected to pay more attention to the ripple effects of higher vacancy rates and to avoid situations in which new projects overcome their leasing hurdles, and diminish their own submarket.

The CMBS market has experienced rising delinquency rates during 2001. As a result, spreads have widened, but have not created a major influx of additional capital. Volume did pick up dramatically during July 2001, when a flood securities came to market and drove up triple-A spreads. Leverage exposure to financial structuring (i.e., percent of loans with loan-to-value ratios over 90%) within CMBS issues has also dramatically risen. This has raised additional concerns among investors, and has forced a moderate skewing of CMBS issues toward higher subordination levels. However, concern over the volatile stock market and the appeal of attractive spreads might increase CMBS activity.

Foreign Investment

During 2001, foreign investment activity levels have held up, although flows have slowed in some of the traditional European sources. One pattern emerging is the concentration of foreign investment activity on a limited number of major markets. According to the Association for Foreign Investors (AFIRE), foreign investors will continue to concentrate their U.S. acquisitions on New York City, San Francisco, Boston, and Washington D.C. markets. Moderate net positive capital flows are expected to continue in other markets. The softening of the U.S. real estate market will create downward pressure on new activities, with investment levels exhibiting a slight plateau until economic, business, and real estate conditions improve.

Offices will continue to attract foreign investors, although concern over technology will skew capital toward core investments. Multi-family and industrial properties will also remain high on investors' lists, while smaller average investment sizes will inhibit major moves on the sectors. Retail remains a concern for foreign investors; however, smaller retail that can be accessed in more digestible chunks in fast-growing markets will continue to attract investors. Hotel investments will remain mixed to negative. Foreign investors will eschew innovative, non-traditional investments (e.g., lifestyle centers, R&D facilities, live-work-play developments) to their domestic counterparts, seeking security in more traditional real estate offerings.

Real Estate Outlook

Overview. Over the past 18 months, real estate observers have become less complacent in their outlooks as weakening fundamentals have crept across most markets and property sectors. Indeed, many investors and real estate champions were caught off guard by the confluence of events; the speed of the economic downturn, the collapse of the technology

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sector, and the contraction of demand. Over the intermediate term, the ripple effects of these broad economic factors and shifting demand functions will continue to soften the market, resulting in a gradual increase in vacancy rates and a decrease in rentals. Since these forces vary by sector, it is useful to review the major property types.

Office Market. During 2000, dot-coms were the heroes of the office sector, fueling demand and stimulating activity. Unfortunately for developers (although good for the overall industry), dot-coms saw real estate as an opportunity to make a cultural statement. Thus, corporate logos sprung up in unexpected places, with billboards for newly minted companies that would take the world by storm. Their demand for office space was skewed as unusual spaces. These spaces ranged from abandoned office bunkers to underutilized industrial properties located in sub-markets off the beaten path. There are no usual suspects for unusual spaces. It is important to focus on fungible real estate (i.e., easily substitutable real estate) for most investors.

The overall office market has weakened during 2001, with increased vacancy rates. The first half of the year the U.S. actually experienced a negative net absorption of office space. As a result, vacancy rates crept above the 10% threshold, and affected suburbs more than central business districts. Despite controlled construction activity on the supply side, the demand side contracted quickly as companies postponed expansions and gave back space. This trend is expected to continue as companies are putting more space back on the market than they are leasing. Based on long-term supply and demand models, office rents should soften in an even more pronounced manner. Corporate real estate officers are more attuned to market conditions because of new information sources and the Internet. Tenants will be better informed than in the past, suggesting a downward pressure on rental rates for lease renewals. Concessions and broker incentive programs are also expected to increase, along with other expenditures designed to improve prospects for new tenants.

Private office returns have reflected weakening market fundamentals, with annualized returns continuing to drop. Due to widespread business contraction, the downward pressure was greater than anticipated. Office returns still remain above long-term averages, with solid income yields and slowing price appreciation. The decline of regional returns was uneven, with the mature Northeast and Pacific regions holding up and most others dropping off. CBD properties outperformed suburban properties, with suburban properties actually reporting a moderate decline in the value component of returns. In the public market, the year began with two consecutive declines in office returns before recovering and, ultimately by mid-year, turning in positive numbers. At the second half of the year the office sector slipped once again with returns declining for the month, but still up for the year-to-date. Weakening conditions should continue to dampen performance in the office sector, although a number of externalities and changes in capital flows could reverse that outlook.

Retail Market. Retail sales in 2001 have been surprisingly strong in light of overall economic conditions. However, the consumer-driven good times are not expected to continue as consumers begin to retrench and reign in their buying patterns. This will be another promotional year going into the holidays, suggesting that value will once again rule the day. Mall-based department stores already have declining sales. On the other hand, non-anchor mall tenants have recorded advances in their overall retail sales. Retailers have recognized this softening demand and have moderated their growth plans. This has been amplified by the stock market's malaise and the renewed emphasis on bottom lines and unit profitability. Retailers continue to explore new opportunities and overlook niches in search of competitive advantages. Lifestyle centers, live-work-play developments, and in-fill opportunities remain on the radar screen for new, although still selective, development. Integrated e-commerce strategies will gain attention over the next 12 to 15 months as traditional retailers mimic good ideas from their dot-com competitors that failed on the basis of business models rather than customer demand. For example, in the grocery arena, Publix, Kroger and other chains are exploring technology-enhanced grocery sales similar to PeaPod and WebVan.

Many investors during 2001 under-allocated retail, skewing investments toward smaller retail properties, or ignoring the sector completely. This behavioral pattern can be attributed to a general lack of confidence or understanding of the sector. Retail

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is an extremely competitive business in which companies are continuously re-engineering themselves to respond to changing consumer demand, competitive pressures, and economic times. Thus, investment strategies and policies must be more dynamic than other sectors and create additional decision points. The Internet and the e-business revolution raised very fundamental questions regarding the viability of traditional brick and mortar stores. Investment performance, especially on the private side of the market—larger regional and super-regional malls—has lagged behind other property sectors. There is significant confusion over the structure and market balance of the entire sector. With respect to structure, a recently released study by the International Council of Shopping Centers (ICSC) calls into doubt the fundamental question of how many malls there are in the U.S. According to commercial vendors, the number ranges from 2,869 to 3,600. But, if a consensus is ultimately reached, it will not reduce current saturation levels.

The private market reported moderate 7.4% returns for the first half of the year. In asset allocation decisions, the overall retail sector was disappointing, with only the hotel sector leading. Results within the retail sector were more mixed. Neighborhood and power centers reported above-sector earnings and regional centers lagged. On the public market front, the property type comparison was markedly different. Although July was an off month for REITs, the year-to-date retail actually led the other sectors (with the exception of health care). Regional malls outperformed smaller retail by over 400 basis points through July. Several explanations are plausible.

At the upper end of the market, private sector retail holdings have been generally weaker, suggesting an adverse selection process in which better malls have wound up in public hands. The public sector has been able to leverage its scale economies to enhance earnings in larger properties that are typically geographically dispersed. Private sector management has been somewhat ineffective in terms of bottom line performance. Private investors have been unwilling to fund large retail investments on par with their public counterparts, suggesting a shortage of capital that has driven cap rates up.

The private sector has been unable to assuage the fears of investors due to the absence of objective analyst coverage and a reliance on anecdotal evidence. It is interesting to note that income returns and dividend yields for larger malls are actually lower than those for smaller properties on both the private and public fronts. Thus, retail investments will likely lag total returns for other property types until risk/return levels come into balance or investors are drawn to the sector for its stable returns and inflation-hedging potential. Such arguments will remain a hard sell, suggesting private institutional investors will continue to underweight the sector compared to market basket allocations.

Industrial/Warehouse Market. The industrial sector continues to enjoy strong investor demand. To some extent this investor interest ignores current market conditions that are softening in many markets. Several concerns are hanging over the sector:

- The widespread contraction in manufacturing has resulted in excess capacity in plant and equipment, with utilization levels significantly below long-term averages.
- There has been mixed success in reconfiguring supply chains to take advantage of technological innovations, with many e-solutions falling. This shakeout has been particularly pronounced in the business-to-business (B2B) category, and has affected the buying consortia and other e-procurement businesses that promised to revolutionize the industry.
- The relatively soft export market and weakening global economy placed a drag on shipping and warehousing.

These and other negative forces have had the combined effect of driving up vacancy rates for the industry as a whole. This impact has been much more pronounced in markets and segments targeted for the B2B activity or tied directly to the still-weakening technology sector. General weakness in the economy and specific weakness in manufacturing has been making it increasingly difficult to fill space with new tenants. Thus, owners and managers have been forced to focus their attention on tenant retention more than relying on referrals or cold-calling potential tenants. Customer orientation has been driven by economics (i.e., it is cheaper to rollover leases than to market raw space) and a higher probability of success. Since many existing tenants will be in a contraction mode and/or will be forced to relocate, the pressure to at-

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tract replacement tenants will focus more attention on the brokerage community.

The bottom line of the various forces operating on the industrial sector over the near term will dampen performance. However, over the intermediate term, the sector should continue to fair relatively well due to the curtailment of new supply and the strength of investor demand. This is good for the private sector where industrial properties outperformed all property types through the first half of the year. Similarly, R&D facilities that are currently priced to yield high-income returns should hold their own. Companies will seek to create a competitive edge to catapult themselves out of the downward spiral when the economy turns. In addition, there will be growing demand for more specialized distribution facilities (in both location and physical attributes) to respond to logistical and technological innovations. Capital, which generally prefers generic space, will create a temporary profit spread until these developments become the norm or their staying power is understood. Industrial properties should remain competitive, without any major sector shifts undermining recent performance levels. However, the macroeconomic picture, changing market fundamentals, and investor demand should be closely monitored.

Apartment Market. The apartment market has been one of the bright spots in the U.S. economy during 2001. Continued population and household growth, coupled with a resurgence of younger households in their peak rental stages, helped the sector. Similarly, the trend toward more diverse household composition created the need for greater product stratification and the opportunity for more effective market segmentation, tying residents into projects for a longer period. Strong net in-migration also helped in many markets—immigrants occupy a larger percentage of households and have a higher propensity to rent.

The slowing economy is a mixed blessing for the apartment sector. Rising consumer angst and concern over future prospects skewed demand toward rental occupancy versus ownership. However, job losses and deteriorating economic conditions made it more difficult to push through rental increases. Technological innovations have improved the apartment sector, enabling managers and owners to operate more efficiently. Increased emphasis on tenants also improved relationships and reduced turnover. The extent that apartment tenants and condominium owners are attracted to the inner city is currently in question, especially in cities where urban issues are not being aggressively resolved to make in-town living more acceptable.

Apartments remained one of the favored sectors during the first half of 2001. The growing interest by foreign investors is a relatively recent phenomenon. Investor interest in apartments has been particularly strong among domestic pension funds. This demand leans on pre-sales with funds taking on leasing risk and uncertainty. It should be noted that although this capital source has bolstered construction levels, it has not resulted in excessive flows to the sector.

Privately owned apartments have experienced consistently higher returns than other sectors (with the exception of industrial properties). Within the sector itself, high-rise apartments have led the pack—a figure extracted from a rather limited sample size. B and C apartments followed, as pension funds moved down the pyramid to a section of demand that is deeper and more stable, with a propensity to continue to choose rental over ownership. On the public side of the market, apartment returns have been relatively strong, especially in light of the other leading property types for 2000 (e.g., industrial and lodging). This trend should continue over the near-to-intermediate return, suggesting relatively strong performance for the sector.

Conclusion

The U.S. real estate market is at an interesting stage of its cycle. While there is a distinct and justified dampening of the recent euphoric past, there is little evidence that a major implosion is about to occur. At the same time, the economic, real estate, and demand sides of the equation remain in a state of constant flux. Overall, the trend is toward moderate softening, with increases in vacancy rates and downward pressure on prices. Despite this situation, investor interest is expected to remain strong, although not across the board. In particular, stable, core investments will remain the favorite of investors—especially private investors seeking a safe haven from the stock market or otherwise looking for solid, stable performance. At the same time, new opportunities

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to satisfy narrow niches or exploit market transitions will emerge. Unlike the past market turn, there are few sources of abundant, ready capital that are mobilized to act on emerging opportunities. This is especially true in the technology-dependent markets where the general cloud hanging over that sector will amplify perceived risk. In order to exploit these opportunities, investors will have to marshal the specialized expertise necessary to create value—timing plays simply will not work. Overall, commercial real estate is expected to provide solid, stable performance, although continuing the downward trend of the recent past.

James R. DeLisle, PhD, is director of the Real Estate Research Center at Georgia State University, Atlanta. In addition to his experience within the academic community, he has worked on the industry side of the real estate business. Dr. DeLisle has been a guest speaker at numerous industry conferences and has published his work in various journals. He is also the president-elect of the American Real Estate Society. He received his BBA in real estate, MS in market research, and PhD in real estate and urban economics from the University of Wisconsin.

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