

Real Estate and the Capital Markets: The Queuing Up Stage

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Commentary

Earlier this year our nation was in a transitional economy where consumers, businesses, and investors were adjusting to the recession. Real estate market fundamentals continued to weaken, but there were prospects of a moderate economic recovery in the second half of the year. Considerable uncertainty, such as the threat of terrorism, clouded the economic outlook, especially with the economy's dependency on consumer spending. The clouds over the economy darkened over the summer due to unexpected sources such as the Enron corporate scandal.

The confidence of businesses and consumers must be rekindled. Isolated reports of positive economic signals will not be sufficient to turn the economy around. Investors should draw solace from the tougher penalties that President Bush signed into law for executives who commit fraud. The new Securities and Exchange Commission now requires chief executives and chief financial officers of the country's top companies to personally attest to the accuracy and completeness of their latest financial statements. Investors will likely remain cynical and react swiftly to new corporate scandals. The corporate optimism and positive spins that helped build investor confidence in previous cycles will significantly dampen as companies remain defensive regarding disclosures and heightened corporate accountability. Therefore, an economic recovery will hinge on facts rather than rhetoric. Economic and business indicators will have to shift in a clear and sustainable manner before businesses and consumers create the positive momentum needed to launch the economy into a new growth cycle.

On the real estate front, the news is a bit more positive, although also somewhat mixed. With respect to property fundamentals, we expect generalized softness coupled with some moderate weakening. On the

capital side, however, investors are queued up with moderating return expectations/requirements and a significant amount of capital searching for deals. This will indeed be an interesting period in which the theme may well be "How low can you go?" As such, the buyer/seller gap is closing, with more movement on the buyer side than on the seller side. Whether this holds up depends on the overall economy and equity markets, although real estate looks well positioned in terms of capital flows.

The Economic Environment Economic Growth

In the spring a number of economists argued that the economy would stay on track and reflect the "V" recession recovery forecast in late 2001. Indeed, preliminary figures for the first quarter suggested the economy was in a recovery phase. This brief surge was attributed to a number of factors such as a strong housing market and continued consumer spending coupled with increased private inventory investment, government spending, and exports. However, consumer resiliency did not ripple over to the business sector as companies continued to tighten belts and deferred investing in new plants and equipment.

Over the summer the economic scene slipped into a downward spiral led by a spate of corporate accounting scandals, a struggling stock market, and weakening economic indicators. The airline crisis, although not unexpected in the post-9/11 era, led to further erosion in investor, business and consumer confidence. Rather than looking for a solid recovery, concern shifted to the risk of a classic, double-dip recession and prospects for the U.S. economy remained guarded, though slightly positive. With midterm elections on the immediate horizon, it is likely that Washington will try to bolster the economy. Assuming there are no surprises, the

economy may be able to struggle back to its feet with careful nurturing and determination. However, spreading global economic weakness and the structural challenges faced by emerging markets will remain beyond the control of domestic policymakers. Thus, while there might be some improvement in the fourth quarter, the recovery will likely remain tenuous.

Employment

Employment during the first half of 2002 was a trouble spot for the economy, with downsizing characterizing the first quarter followed by flat-to-moderate gains in the second quarter. The unemployment rate stabilized prior to a midyear spurt due to a slowdown in layoffs, suggesting businesses had sufficiently tightened their belts. The telecommunications and technology industries continued to lead the declines, suggesting they have yet to plateau. Service gains were offset by construction declines as the business slowdown and excess capacity curtailed the pace of building activity. After several months of declines, the number of workers forced to settle for part-time employment rose again in midyear. This increase reflected the unwillingness of companies to risk taking on excess capacity in the face of uncertainty and further economic weakness. After several positive months there was a midyear decline in hiring temporary workers, suggesting there would not be near-term recovery for permanent jobs.

Inflation and Interest Rates

Inflation remained off the radar screen with little prospect for a near-term change. During June and July, inflation came in at an anemic level, only modestly above that of the prior year. Compared to last year the most pronounced price increases were in medical care, education, and communication, while the apparel and energy sectors reported declines. Prices in the energy sector increased by midyear, with rising gasoline and fuel oil prices in the lead. On the other hand, import prices were down across the board relative to year-over figures. Export prices were moderately down, due to a global surplus in capacity. Over the near term, inflationary pressures are expected to be moderate on both the domestic and global fronts.

The tenuous state of the economy, continued turmoil in the equity market, and the moderate risk of inflation has left the Federal Reserve Bank (Fed)

with some flexibility regarding interest rates during the summer. Rather than trying to offset general weakness in the economy and stock markets, however, the Fed made no rate changes at their August meeting though they signaled that they might lower rates in the foreseeable future. This bodes well for potential borrowers. Liquidity gains from the resulting refinancing activity might provide stimulus to consumers. But rising concerns over retirement security might undercut the past tendency to use those proceeds for consumption.

Business Indicators

Business indicators were mixed through the first half of 2002, opening the door to debates on whether the country is on the right track or courting further disaster. These debates are likely to become even more heated in the face of midterm elections this fall. Since voter interest in economic issues was heightened by recent events and voters fear the health of retirement plans, a number of elections will be swayed by a combination of rhetoric and finger pointing. Confusion surrounding what the indicators are actually signaling will create a downward draft on a near-term recovery.

Business indicators are likely to remain mixed over the near term. The burn off of inventory/sales ratios during 2001 continued this year, yielding the lowest ratios in more than a decade. The most significant declines were in the manufacturing and wholesaling sector, suggesting producers continued to adjust to declining demand and economic uncertainty. Productivity gains were positive during the first quarter, followed by a moderate slow down. Output rose at lower rates, reflecting the reduction in labor. Unit labor costs increased, creating more pressure on productivity gains.

Factory orders slid at midyear due to the previous recovery in the manufacturing sector. The aircraft, industrial machinery, and communications equipment sectors in particular experienced declines because of rising corporate scandals and bankruptcy turmoil. The inconsistency in economic indicators led the Conference Board to accelerate its year-end benchmarking to midyear, creating a moderate decline in composite indicators. This decline pointed out that the previous recession was even more pronounced than expected. For the balance of the year, business indicators are anticipated to be mixed, suffering from a combination of real and perceived weaknesses.

Stock Market

During the summer the stock market continued to struggle, responding to a number of shocks. The seemingly endless tide of corporate scandals caught regulators, policymakers, and investors off guard. In addition to the hysteria that wiped out a significant share of investors' portfolios, the wave of scandals placed a significant drag on investor confidence. This outrage triggered a number of regulatory and legislative initiatives to correct the situation and rein in renegade business practices.

The corporate scandals led to a number of major initiatives targeted at U.S. companies. They include

- Increased scrutiny of accounting standards and disclosure requirements set the stage for new professional and regulatory standards. These changes range from stricter limits on the consulting work audit firms do for their clients to the creation of independent bodies, charged with establishing and enforcing ethics rules. More changes in accounting policies and professional practices are likely, with public outcry dampening the effectiveness of the accounting industries' powerful lobbying machine.
- The Securities and Exchange Commission (SEC) now requires that CEOs certify financial results, imposing greater accountability on top management. CEOs of the top 695 companies operating on fiscal years had to personally certify the accuracy of their financial statements by August 16, 2002. Only 20 companies requested an extension or missed the filing date. A pending deadline looms over 300 companies and 15,000 smaller companies for filing certifications.
- Stricter legal practices will be enforced, and white collar criminals will be aggressively and publicly pursued. A number of corporate America and Wall Street executives, analysts, brokers, and investment banks are the targets of investigations. The National Association of Securities Dealers (NASD) and the SEC censure and fine companies for conflicts of interest and trading abuses.
- Increased pressure on compensation programs will create greater alignment between the interests of investors and executives. Stock options triggered public outcry over CEOs cashing them in while employees and other investors were left holding the bag. A number of options could

emerge, including restricted stock options subject to performance goals. Emphasis will be placed on base compensation, where stock options are used as incentives rather than the windfalls they were during the dot-com boom.

- Renewed interest in corporate governance has already created change, such as skewing board composition toward more external representation and imposing greater responsibility of oversight. Workloads are likely to increase while compensation packages will be restructured to provide greater alignment of interests with shareholders.

Whether the changes in corporate practices will boost investor confidence remains to be seen. Over the near term, heightened scrutiny of business practices, the demand for greater transparency, and a movement toward conservative forecasts raises the risks around a recovery. While there is little doubt that businesses can weather this storm, the nation's skepticism over corporate accounting practices will make it more difficult for businesses to lift the economy out of its latest downspin and avoid a double-dip recession. Early signs of increased disclosure and accountability have not pointed to an iceberg effect. Thus, it appears that questionable business and accounting practices have not been as widespread as initially feared. Therefore, it is likely that businesses and, ultimately, the stock market, will regain their upward drive.

But the stability of the stock market continues to be shaky. The White House is exploring a number of initiatives to stimulate investments: raising the ceiling on how many capital losses individual investors can use to offset taxes, allowing employees to contribute more to their 401(k) retirement plans, and eliminating double taxation on dividend income. While such changes could provide some upward momentum to the stock market, they would not remove downside risks associated with external threats (e.g., terrorism and the conflict in the Middle East) and a weak economy.

The renewed interest in portfolio risk should bode well for real estate as investors seek real estate investments, avoiding the inherent risk in the stock market. However, initiatives such as the elimination of taxation on dividends would negate the tax advantages of REITs and could create turmoil in the public real estate equity market. Since the stakes will be high and vested interest groups will be on guard,

the public will be in for a number of lively debates surrounding such reforms. Due to the possible impact of the market's collapse, these debates could capture the attention of the public-at-large and backfire, heightening awareness of the risks inherent in investing and interfering with the market recovery.

Consumer Confidence

Despite the woes that hit the equity markets and the overall economy in 2001, consumers demonstrated remarkable resilience. Consumer spending was one of the few bright spots in 2001's economy. During the first half of 2002, the confluence of negative news with two back-to-back declines ate away at consumer confidence, creating more downward spirals than upward gains. Erosion in consumer confidence levels was fairly widespread, with current conditions holding up better than expectations. The weakness in expectations was particularly troublesome and will raise the stakes in the economic debates waged during the midterm elections later in the fall. Politicians will have to walk a fine line since the pendulum in consumer confidence could swing further on mere rhetoric. A sustainable rally will depend on a series of clear signals and market evidence that can convince consumers that the end is in sight.

Over the near term, consumer confidence is expected to fluctuate. Individual households should draw solace from stable housing values. However, despite low and declining interest rates, the press is mentioning the term "bubble" when discussing the housing market. If the housing market softens and incomes don't close the gap on price increases, consumer confidence faces greater downside risk. Additionally, the fact that the stock market is unlikely to build sufficient momentum to power itself into another bull run suggests consumers will continue to anguish over their retirement prospects. It is unlikely that consumers will step up and support the economy.

Retail Sales

During the first half of the year, retail sales growth fluctuated with moderate increases interspersed among periods of declines. Despite this vacillation, on a year-to-year basis, consumer sales continued to rack up net gains. Increased sales figures were broadly based with general merchandise, electronics and appliances, food services, and drinking places leading the charge. After losing some momentum, ve-

hicle sales rebounded at midyear because of steep discounts and the reintroduction of 0% financing. While rising vehicle sales helped the overall economy, they were not sustainable and will deter future sales, creating a downward drag on growth. In addition, despite increasing sales volumes and cost cutting, the promotional efforts of retailers continue to cut back profit margins.

The combination of economic weakness and faltering consumer confidence suggests retailers will have to work hard to lure consumers to the registers. In some states retailers' efforts were bolstered by sales tax holidays that coincided with back-to-school sales. It is likely the retail sector in search of a market share will be forced into a promotional state because of disappointing back-to-school sales. The end result will be rampant use of discounts in consumer incentives, possibly a zero-sum game, with retailers intercepting sales from competitors and hurting holiday sales. Retail sales figures may receive moderate stimulation from the falling interest rates that are allowing homeowners to refinance existing housing. However, since interest rates have hovered downward for some time, many consumers have already turned to this cyclical path of wealth to justify purchases. Furthermore, widespread losses in the stock market may cause homeowners to rethink current consumption and use their refinancing proceeds to replenish depleted retirement accounts rather than indulging in current purchases. This shift toward fiscal responsibility may be amplified by the haunting reminders of the past year as the nation struggles to deal with 9/11 and the other shocks they weathered over the past 12 months.

On the Internet front, strong fourth quarter sales carried over to the first half of 2002, outpacing the rate of total retail sale gains. Despite their strong growth, Internet retail sales still remain under 2% of total retail sales. However, the sector has shown no signs of peaking, and future gains should be fairly consistent as the sector matures and finds its niche in retail. Many traditional retailers have retooled their Internet strategies in light of disappointing results and the overall decline in the dot-com arena. As a result, e-commerce sales have become an integral part of the marketing and distribution channels of many retailers. Pure online merchants who have survived the dot-com collapse have developed more viable business models, allowing them to focus on value-added opportunities rather than being forced to make a mar-

ket. With respect to business-to-business purchases, online sales activities have also settled into a groove, although not nearly to the extent forecasters predicted several years ago. The gradual maturing of online sales, coupled with greater acceptance by consumers and businesses alike, suggest a healthy outlook that should be able to survive tough economic times.

Housing Market

In early 2002 the housing market was one of the few economic sectors that continued to be strong despite the country's economic woes. New residential permit volume rose 2.6 percent through June. Reflecting regional variations in the housing market, only 12 of the top 25 markets reported gains in permits over the first half of 2001. In July, housing starts slowed down, with declines in the multifamily sector outpacing those in the single-family market. Permit activity remained fairly active, proving that the housing market was catching up. On an annualized basis, new home sales in June edged over one million units, setting another record for the industry. At the same time, inventory levels remained relatively stable, only slightly above those of the previous year. The housing market continued to reward existing owners with consistent gains in median prices. At year-end housing starts are projected to come in at roughly 1.65 million units.

Despite the continued strength in the housing market, there is growing concern that the sector is riding a bubble due to two phenomena. A "speculative bubble" appears when purchasers are drawn to homeownership in anticipation of rapid increases in value rather than to accommodate their particular housing needs. A "price bubble" occurs when appreciation rates are supported by cyclical factors rather than sustainable improvements in effective demand. For example, effective demand (i.e., the will and ability to pay) for housing could rise because of a decrease in the cost of capital (e.g., mortgage rates) rather than rising incomes. Thus, although current owners might operate within traditional affordability ratios, their exit strategies could be significantly compromised unless the next wave of buyers' income streams catch up. While both of these bubble forces have operated over the past several years, there are few warning signs that a major correction is imminent. An uncertain stock market and a shaky economy are likely to continue to skew purchasers toward home ownership. Thus, the near-

term outlook for the single-family sector remains fairly solid with moderate downside exposure.

Real Estate Capital Markets

Capital Market Overview

The integral relationship between real estate and capital markets continued to receive attention during 2002 as real estate markets responded to weakness in the overall economy. Real estate professionals have been paying more attention to the overall economic environment in order to predict when the cycle might change and how it will affect real estate demand. But the decline in interest rates made real estate ownership and investment a more palatable proposition, drawing more interest in the asset class, especially among those investors who might have previously eschewed such investments in favor of more traditional alternatives. For investors with existing real estate exposures, the collapse of the stock market has created a denominator effect (i.e., real estate that held value increased as a share of total portfolios), forcing many players to stay on the sidelines despite relative values and emerging opportunities to increase investment exposures. However, there is no shortage of capital for real estate as the industry has queued up and is sitting on significant allocations that are in search of acceptable risk-adjustment returns on both an absolute and relative basis.

The "flight to safety" that swept across investors has renewed their interest in real estate due to its real asset base, income generating potential, and improved transparency and liquidity. These forces are expected to continue to operate over the near term, focusing more attention on the asset class and forcing even greater alignment of the real estate and capital markets. This alignment will strengthen as real estate begins to move into the individual investor arena, capitalizing on the opening that institutional investors have created. While such efforts have failed in the past, the convergence of competitive returns and the quest for safe investments, coupled with increased efforts to develop and market products for 401(k)s could help real estate succeed. However, a number of challenges will have to be overcome to open up this new source of capital. In the meantime, traditional players are expected to remain active.

Construction Activity

Construction activity increased at the end of 2001 and during the first several months of 2002. This

acceleration in construction spending was the result of project deferrals rather than underlying market fundamentals. Thus, the subsequent slowdown in construction spending was not surprising and demonstrated self-restraint. Private nonresidential and new multifamily facilities were the leading sectors in this decline. Within the nonresidential component, retail, warehouse, and office sectors experienced the highest mid-year declines. The industrial sector, which encountered more downward pressure throughout the year, experienced a slight gain. The pattern of public expenditures was less pronounced, although construction levels were disappointing. Commercial construction activity is expected to remain tempered, with some pockets of activity due to local market conditions rather than any sustainable rebound.

Private Equity Market

During the first half of the year, real estate capital markets continued to plug along as investors paid close attention to real estate fundamentals. At the same time, they cast a weary eye on the struggling economy and the corporate scandals that continued to unfold. The interest in the corporate scene operated on several fronts. First, investors began to revisit their individual tenant rosters because highly regarded credit tenants could be tainted by unforeseeable scandals, erasing their credit worthiness and changing the risk profile of the buildings they occupied. Second, the weaknesses that seemed to ripple across certain sectors (e.g., telecommunications, technology, airlines) had the potential to trigger supply and demand imbalances in markets and/or investment portfolios.

Interest in commercial real estate investment remained strong through the summer. Thus, real estate appears to have emerged from the economic and corporate frays as a viable, attractive asset class for private equity players such as traditional real estate investors and those seeking safe investments and income generation. The quest for safe investments in the broader investment market and the rising interest in real estate had ripple effects on yield. For example, the National Council of Real Estate Investment Fiduciaries (NCREIF) equity index reported declining value components, continuing the downward trend that began in the aftermath of 9/11. With little or no change in income returns, total returns have eroded with four-quarter moving averages com-

ing in under 8 percent for the industry as a whole. Rather than triggering another flight of capital as seen in the last major real estate recession, investors seemed to accept these declines because real estate advisors predisposed investors to lower yields and a lack of viable alternatives. Commercial real estate generated positive returns above the long-term rates and the assumptions plugged into asset optimization models. The denominator effect (i.e., increasing real estate portfolio allocations as a result of declining stock values) may keep existing players on the sidelines for the balance of 2002. However, some investors will remain active by selling into the lower yield, low-risk market, using the proceeds to enhance yield, rebalance real estate portfolios, and position themselves for the next recovery phase.

The private real estate market remained constant during the first half of 2002. Over the near term, it is likely that some classes of investors will continue to acquire real estate with total yields dipping into the upper single digit range, especially the more stable, secure investors. While this downward adjustment in yield requirements had cyclical roots, it is more than a short-term move. With few exceptions, investors will not be able to push through rental increases, and to boost gains they will either have to tolerate lower yields or find some way of further reducing costs. Once the stock market finds its bottom and gets on track with the overall economy, it is likely that the spread between real estate yields and other asset classes will widen. To some extent transaction volume will pick up as existing owners lose patience with lagging real estate values. However, the stock market debacle will provide solace to many investors who will institutionalize their real estate allocations. Thus, over the next 6-12 months, commercial real estate transaction volume will likely reflect a relative supply and demand balance.

While historically low interest rates and a lack of comparable risk and return options for investors hold down weighted costs of capital, this situation will change during the intermediate term as the economy picks up. Although interest rates are likely to decline, moderately commercial real estate holdings will face downward price pressures when the trend reverses and rates begin to rise. It is likely that rising costs of capital will outpace the recovery in supply and demand fundamentals. As a result, investors will experience further erosion in holding

period returns, placing real estate allocations at a disadvantage relative to other asset classes. However, the lower risks associated with such returns will provide more compensating benefits relative to other asset classes. Thus, the private real estate equity market is expected to remain active as real estate attracts new sources of capital.

Public Equity Market

In the three years since recovering from a downturn in the late 1990s, Real Estate Investment Trusts (REITs) have outperformed other asset classes. With the exception of U.S. Treasuries and other value sectors, REITs were the only asset class reporting positive returns that averaged in the midteens for the two-year period extending through June 2002. Despite a downward trend, the spread of dividends over 10-Year Treasury Bonds remained attractive. In addition, REITs attracted investors as strong liquidity and average daily trading volume regained the momentum lost in the fourth quarter. The market cap of the industry grew significantly in early 2002. Gains were equally spread among equity and mortgage REITs, while hybrids slipped moderately. This growth was due to nominal increases in debt levels, coupled with net inflows of equity capital. Despite increasing debt holdings, average debt ratios did not increase and remained significantly below those of the go-go period in the late 1990s. Fiscal discipline was self-imposed and coincided with the tightening of lending standards by banks.

REITs picked up the pace for property acquisitions in the first half of 2002. Despite weakness in many office and industrial markets, the market cap of the office and industrial sectors expanded, reversing the declines experienced in the fourth quarter. Although there was relatively little change in gross leverage ratios, REITs were able to improve bottom-line performance by replenishing debt at lower rates. Interest in REITs is expected to remain strong among institutional and individual investors seeking safe income-generating investments. However, observers are beginning to openly wonder whether the real estate industry is experiencing a temporary bubble, or whether values and yields remain steady. As real estate market fundamentals continue to weaken, questions regarding the ability to generate income by increasing rents arise. Real estate market fundamentals are expected to change gradually, suggesting there are no major shocks on the horizon that

could cause a dramatic reversal of fortunes. In addition, REITs are fairly well positioned to withstand further declines in market conditions with diversified property portfolios, solid balance sheets, moderate debt, reduced development exposures, and seasoned management teams.

As with other public companies, REITs are facing a number of regulatory, legislative, and accounting rule changes. They include

- REITs are now subject to changing corporate governance standards such as requiring additional shareholder approvals for stock option plans and a clearer definition of "outside director" for corporate boards.
- Rules for capitalizing costs will be finalized by the American Institute of Certified Public Accountants (AICPA) based on more than 400 comment letters regarding proposed standards.
- The Securities and Exchange Commission (SEC) is phasing in greater disclosure requirements regarding the application of critical accounting policies.
- Joint venture disclosures are being addressed by NAREIT's best practices initiative to provide greater transparency and foster improved understanding of the implications of increasingly common, complex joint venture agreements.
- REITs are being included in the requirement that senior officers personally certify financial results, with compliance deadlines mirroring that of companies in other sectors.
- Companies are expanding employee options with efforts to include REITs in their 401(k) plans.

To the extent such efforts are successful, REITs could enjoy an expansion of the capital base to non-traditional sources. Despite concerns, the outlook remains positive, especially compared to other asset classes that will suffer from high volatility with no clear avenue by which to regain momentum.

Commercial Mortgage Market

During the first half of 2002, the commercial mortgage market continued to slow down. This moderation was attributed to the static economic climate and other externalities that affected the demand side of the equation. In addition, investors enforced floors and/or slowed production activity. Lenders tightened loan standards, especially in light of concerns over

terrorism insurance, weakening market fundamentals, toxic mold, and other risk factors. The decline in rates was not sufficient to trigger additional loan demand, which resulted in lower loan production. Despite lower loan production, the commercial mortgage market continued to reward borrowers and investors. The soft economy and corporate woes had a limited impact with delinquency rates remaining flat to slightly up, but significantly below long-term averages. The supply and demand of commercial loans should remain in relative balance, helping sustain current activity levels.

The Commercial Mortgage Backed Securities (CMBS) market entered the year with a record pace of new issuances. Although the level of new issuances could probably not be sustained, the outlook was for a solid year with slight declines in volume. But weaknesses in real estate fundamentals dampened the CMBS market, placing pressure on originators seeking to satisfy investor requirements. Also, rising uncertainty associated with increased delinquency rates, terrorist insurance, and toxic mold shifted the perceived risk of real estate-linked investments. During the second quarter a number of these concerns were addressed when delinquency rates tapered off and the issue of insurance was thrust into the national spotlight. However, the pace of downgrades increased, (e.g., Kmart) exceeding year-over figures. The outlook for CMBS is moderate with capital seeking product and relative performance remaining steady.

The CMBS market's maturity resulted in a number of industry changes, such as appropriately accounting for the lagged effects of aging asset pools. This process involves a life-cycle view of transactions in which ratings change as a result of market conditions, seasoning, and principal down payments. The industry should benefit from the insight analysts glean as current CMBS issuances weather various economic and real estate market cycles. The end result should be greater transparency and stability, with fluctuations more attributable to market conditions and capital flows rather than surprises. Portfolio managers can expect to deal with more strategic issues, shifting attention to assembling portfolios of CMBS rather than individual transactions. In addition, the risk/return profile of issuances will change over time, allowing more dynamic portfolio-level models to emerge and helping stabilize the sector.

Real Estate Market Fundamentals

Overview

In early 2002 it looked like real estate market conditions would improve, joining the overall economic recovery. However, once the economy began to stumble in the second quarter, it became clear that the real estate market was in for further softening, amplified by the corporate scandals that raised havoc with the spatial markets. The real estate market at large showed no signs that investor confidence would be wiped out by external shocks. Most analysts agreed that the real estate market would be able to avoid a deep recession, suffering only from a flight of capital.

During the first half of the year, capital sources seemed to adjust quite smoothly to the deliberate but gradual softening of the market. A reduction in yield requirements supported relatively normal transaction volumes, although buyers remained selective and eschewed avoidable risk exposures. Property hit by downsizing and bankruptcy was able to refinance at lower interest rates, thus reducing default ratios in spite of rising vacancy rates. However, significant prepayment penalties tied to yield maintenance agreements put a damper on this activity. On the other hand, with a lot of commercial real estate capital financed on a floating basis, the downward adjustment was automatic and took pressure off of the "market fundamental" side of the equation. The market was able to function in the face of disappointing results and declining expectations unlike the capital void faced in previous downturns. Clearly, the real estate asset class benefited from the other asset class's turmoil that eroded confidence. A growing number of investors perceive the real estate market as more transparent than the stock market despite its largely private, inefficient nature. Investors can expect to draw solace more from the known enemy of market cycles than from the hidden enemy lurking within the corporate suite. Over the next six months, the real estate market should continue to decline moderately, with rising vacancy rates, lagged recovery periods, and lower yields. However, the market is expected to remain fairly active with new sources of risk-averse capital providing a floor on values and cushioning yield requirements until recovery kicks in.

Office Market

During the first half of 2002, office performance struggled as REITs reported total returns of -2.3

percent through August with dividend yields of 7.4 percent above those of the overall equity market. Private market results were disappointing, although total returns were positive with income returns slightly above other property sectors. On the central business district (CBD) versus suburban front, downtowns held the advantage, with slightly lower income returns but higher value preservation. The losses in value were partly attributable to rising vacancy rates as corporate scandals exacerbated the effects of a weakened economy. Downtown markets withstood the declines better than their suburban counterparts, reverting to a long-term trend that was forgotten by many investors.

The outlook for CBD office space is somewhat tempered by the cloud that hangs over the financial sector that concentrated in CBDs. From a theoretical perspective, downtown space fares better than suburban space because of higher barriers to entry, larger scale production, and constrained supply chains. However, this caveat is tempered because the market was fairly quick to pull the plug on new suburban construction once the office market began to deteriorate. Whether this decrease was coincidental or the result of greater transparency and market efficiency remains to be seen.

An interesting aspect of the recent rise in office vacancy rates is the speed with which it occurred. It took almost 10 years of gradual improvement for vacancy rates to dip below 10 percent, but less than two years to catapult back to the mid-teens. This surge in vacancy was attributed to rapid declines in demand as the economy contracted and corporate scandals rippled across the sector. Excess supply was not the culprit, although there were a number of markets in which cranes were too active, suggesting that stock may be more suitable for a recovering market. Therefore, as the economy picks up and companies focus on growth, the market should recover more quickly. Declines in per capita real estate allocations will dampen this recovery, especially where economies of scale, productivity gains, and technological innovations were used to cut costs.

The office sector will be forced to deal with a number of challenges that could inhibit a recovery. First, problems surrounding terrorist insurance must be resolved. Second, emerging toxic mold issues must be resolved, reducing the risk exposure without undercutting investor confidence and/or raising operating expenses. Third, the amount of sublease space

must be reduced, creating a balance among traditional drivers of lease volume (i.e., new construction, renewals, relocations) and sublet space. The large overhead of sublease space has numerous side effects, such as:

- Decrease in rent due to the discounted subleases experienced in a soft market
- Distortion of spatial choice due to economics skewing site selection, which creates the potential for spatial imbalances after leases expire and markets recover
- Distortion of lease cycles accelerating turnover and reducing the probability of tenant retention
- Loss of control over multitenant facilities and the quality of sublease tenants
- Loss of class distinction—Class A buildings sublet by Class B or Class C tenants
- Creation of infrastructure functional obsolescence induced by unanticipated tenants potentially creating shortages in parking, elevator systems, HVAC, and security
- Distortion of lease renewal patterns from pro forma statements affecting the ability to manage rent rolls
- Disruption of supply/demand forecasting models for investors and developers, creating the potential for over/under building.

Despite these challenges, the overhead in the sublet market should be manageable, except in markets and submarkets with concentrated exposure to impacted business sectors (e.g., telecommunications and technology). Although sublease space will create a drag on an eventual recovery, staggered leases over the next four or five years should offset potential damage.

There is little danger of an imminent collapse in the office sector. Market conditions expect to suffer further erosion through year's end and then begin to recover. The speed and scope of the recovery will depend on the condition of the economy. Since financial services depend on a recovery, the office sector will trail other property types. Companies should continue to cut back spending. New development should not spring up en masse to derail a recovery. The availability of low rate debt should allow owners to hang onto properties with weak revenue streams. Positive office absorption, although somewhat anemic, was reported in the second quar-

ter for the first time in more than six quarters, and buyers are beginning to purchase space.

Moderate erosion in fundamentals associated with gradual increases in vacancy rates is expected for the office sector. Improvements are forecasted for 2003, assuming the economy avoids a major recession. Regional variations will affect the pace of the office market recovery. Identifying the likely recovery markets will be elusive. Portfolio managers expect to pay more attention to the composition of their portfolios, concentrating on economic diversification (e.g., grouping of markets into homogeneous groups). Furthermore, investors will pay more attention to property type and sub-type diversification, insulating real estate portfolios from cyclical downturns.

Retail Market

In the public arena, retail REITs generated solid returns of 17.5 percent through July, with a slight drag at the end of the period. Among retail categories, regional malls continued to lead the pack (although the yield premium over the broader shopping center category was lower) and reversed their fortunes in the second quarter relative to smaller retail properties reporting positive appreciation for the first time in 10 quarters. To some extent, this positive spin can be attributed to low expectations for the sector during recessionary times. On the private market side, retail returns were less spectacular, but were still competitive relative to other property types and above the overall averages. The resiliency of consumers has also helped carry the day, although the recent confluence of negative news took its toll on their confidence. Furthermore, there are some nagging questions about whether consumers have been accelerating sales to reduce stress, or are taking advantage of heavy promotional efforts from some sectors (e.g., automobile), thereby cannibalizing other retail spending.

Within the broader retail category, results have been mixed. Once again, "value" has been a theme that pervaded the sector for a number of years. In this environment, the "usual suspects" have remained on the winning side of the equation, including discounters, drug stores, and home improvement stores. Consumers' quest for efficiency in shopping activities has also improved the performance of convenience retailers. Similarly, shoppers have flocked to volume retailers offering broad-based, bulk merchandise that helps reduce shopping frequency. On an-

other front, a number of specialty retailers have been able to create successful niches and are in the midst of rolling out national expansion programs as they move into new markets and penetrate more into existing markets. The "loser" side of the equation features a number of retailers who lost their distinctive niches and/or failed to keep up with industry leaders. The most notable and significant of these merchants has been Kmart, although other companies have also struggled and are retooling, contracting, or reorganizing (e.g., Gap, Payless, Toys 'R Us). Within categories, there has also been some shakeout as industry leaders seek to increase their grip on the market. In addition, the foray into grocery by Wal-Mart and Target has also hurt the grocery sector, although the top merchants have been able to maintain market share while the next tier has struggled.

Though traditional department stores have continued to struggle because of having to compete with other merchant categories, malls have not been relegated to dinosaur status as some predicted. Indeed, malls have enjoyed a resurgence of sorts, as teens turned to them for a combination of social and retail needs. Teen purchases have been a welcome source of revenue for merchants. This trend bodes well for in-store retailers, especially because "generation Y" buyers (i.e., children of baby boomers) are beginning to seek permanent jobs and move into their initial earning stages. Similarly, when the economy gets back on track and the stock market recovers—although when and how is anyone's guess—baby boomers should begin to buy again. As in the last wave, baby boomers are expected to be searching for higher-end products that can bolster spirits and divert attention from the inevitable effects of the aging process.

Industrial/Warehouse Market

During 2002, the industrial/warehouse segment lost some of its resiliency, due in large part to the nagging effects of a recession that weakened the manufacturing sector and derailed its recovery. In addition, R&D space was hit on two fronts. First, the continued turmoil in technology was amplified by the collapse of the telecommunications sectors and others drawn to R&D. Second, continued declines in office markets created substitution effects at the lower end of the class spectrum, with vacant office space cannibalizing some of the potential demand for R&D and flex space.

With respect to investment performance, industrial REITs were the second strongest property sector through July, reporting strong total returns but lower dividends. While total returns slipped at mid-year as the economy stumbled, the declines were still less volatile than those in other property sectors. On the private market front, investors favored industrial properties. Despite this interest, industrial values continued to slide moderately, marking the fourth straight quarter of value losses for the property sector.

Through midyear, industrial vacancy rates continued to rise, pushing the double-digit threshold the sector has largely been able to avoid. Although still respectable compared to other property types, vacancy rates were more than 200 basis points above recent averages. On a positive note, new construction tapered off, taking supply side pressure off the spatial imbalance. As such, the industrial sector is fairly well positioned to take advantage of an economic recovery. As in other property classes, the recovery in the industrial sector will be uneven. The speed and scope of the recovery cycle will depend on which sectors lead the charge and how fast some of the markets that suffered through a glut of new space in 2001 can absorb excess stock. In the meantime, industrial rents will be flat, especially for older facilities in secondary and tertiary markets.

Going forward, industrial properties are expected to outperform some of the other property sectors on a risk-adjusted basis as the economy picks up and the overhang of space is absorbed. However, total returns may lag due in part to the nature of the supply/demand function that differentiates the sector from other property types in the form of boom/bust cycles. Despite this rather sanguine outlook, it should be noted that the industrial/warehouse sector continues to become more differentiated as technological and logistical advances revolutionize the broader supply chain. To manage industrial portfolios in this environment, investors must monitor such trends to understand, anticipate, and react to the potential for shifting demand and the potential creation of functional and economic obsolescence. At the same time, such advances will continue to have ripple effects on the economic profile of industrial assets, creating upward pressure on costs to remain competitive and satisfy new drivers of value. In this environment, investors will be somewhat defensive in their industrial portfolios. This lesson

was driven home by the dot-com fallout that could have created a major drag on industrial portfolios. This is especially true of the home delivery debacle in which the fungible, commodity-type nature of the bulk space that was vacated under bankruptcy protection allowed owners to remarket the space to other tenants.

Apartment Market

For a number of years, the apartment has been one of the favorite property types of institutional investors, allowing them to tap into the jet stream of the overall housing market. Unfortunately, multifamily investors, with rising vacancy rates dragging rental increases and lowering net operating income, have not benefited to the same extent as homeowners. On the public market front, apartment REITs have been unspectacular, lagging in both the retail and the composite index measures but on par with office and industrial. With respect to the private market, recent returns have also been disappointing, with four quarters of moderate value declines offsetting average income returns. While garden apartments have been more stable on the value front, returns still lag, especially compared to the high-flying single-family market.

An analysis of the recent performance of the apartment sector suggests that although apartment performance competes well against other property sectors over the long term, it also has a strong cyclical component. In particular, the fortunes of the housing market are subject to distinct supply and demand forces. On the demand side, investment performance is tied to the overall economy and long-term demographic trends. On the supply side, performance is dependent on capital flows, the availability of entitlements (i.e., building permits), and available land supplies. Since the supply side has not changed recently and is fairly well aligned with the supply of single-family housing, one might wonder about the divergence between the booming single-family market and the struggling multifamily markets in terms of performance. To some extent, this difference can be attributed to the relative "costs of capital." In the case of the single-family market, record-low mortgage rates have increased purchasing power of households, creating an upward spiral in values of existing homes and making homeownership an attractive wealth-builder. On the other hand, while commercial mortgage rates have

also declined, stickiness in return requirements of investors has somewhat elevated the weighted cost of capital for multifamily properties. Thus, the performance of rental housing has been more aligned with the absolute level of housing payments rather than the purchasing power that has fueled the single-family market. Going forward, the different drivers of value are expected to converge, bringing the fate of the ownership and rental housing markets back into alignment. Furthermore, the emergence of the generation Y demand segment should help, especially when the economy turns and the higher unemployment rate this segment currently endures falls into line with other demographic segments.

The outlook for the apartment sector has not changed materially over the past six months, although the failed economic rebound had postponed the anticipated recovery. In addition to the economy, the apartment sector will have to deal with a number of issues. Some of these issues have been around for a while (e.g., lead-based paint, energy, indoor air quality, technological innovation) and some have recently arisen (e.g., mold and mildew, pressure-treated wood, terrorism). Despite the challenges, none of these issues should disrupt the normal market cycle. Indeed, the decline in new construction coupled with a bottoming out of interest rates should set the stage for moderate improvement in market fundamentals over the next six months. Thus, the outlook for private and public apartment investment is stable to moderate, with some improvement anticipated as the economy recovers and occupancy rates rise. In this environment, investors are expected to concentrate on market fundamentals, seeking quality assets that satisfy their preference for defensive investments.

Conclusion

As noted in this edition, the economy, capital, and real estate markets all face a number of distinct challenges. While there is expectation of additional softening and moderate downside risk, market fundamentals appear to be stabilizing. In addition, the pace of transaction volume and pricing suggests that the capital markets will continue to serve the asset class, with a gradual pick-up as the overall economy recovers. Indeed, the relative strength of the real estate market during the recently tumultuous equity market and the rising interest in safety of investment bode well for capital flows from new sources

of debt and equity. Once the stock market recovers, institutional investors who have capped out their real estate allocations should be back in the mix. In the meantime, individual investors should join the ranks of institutional investors to skew additional capital to public avenues of investment, benefiting REITs and CMBSs. The private market is also expected to function fluidly, with tempered return expectations and requirements helping maintain market balance. With respect to higher yield investors, the flight to safety and the general apprehensiveness that permeates the capital markets will spill over to real estate. As such, the window of opportunity to capture higher returns will open, creating a new avenue to higher returns. However, tapping into such potential without assuming excess risk will depend on the ability to form effective teams that possess solid real estate skills and can exploit the expanding knowledge base associated with a maturing asset class.

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