2006 Real Estate

Investor Outlook

A SPECIAL RESEARCH REPORT

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Undaunted by Lower Yields

Investors sustain voracious appetite for real estate despite modest returns, exclusive research shows.

Single-digit yields aren't deterring investors from pouring billions of dollars into commercial real estate. A survey of more than 1,100 private and institutional investors conducted jointly by *National Real Estate Investor* and Marcus & Millichap Real Estate Investment Brokerage Co. reveals that nearly seven out of 10 respondents plan to increase their investment in real estate over the next 12 months.

Armed with that positive outlook and encouraged by low long-term interest rates — the 10-year Treasury yield was 4.49% in mid-October — investors continue to acquire commercial real estate at a feverish pace.

Commercial real estate sales volume for the four major property types (office, apartment, retail, industrial) is on pace to increase 35% in 2005 to $250 billion based on sales of $5 billion and above, according to Marcus & Millichap Research and Real Capital Analytics.

"We are in our ninth year of a rising real estate market. We have seen some compression of cap rates, obviously price escalation, and then a downward movement in interest rates. So, it continues to be a white-hot investment mar-

Survey Methodology

The annual Real Estate Investor Outlook was conducted by *National Real Estate Investor* and Marcus & Millichap Real Estate Investment Brokerage Co., which sponsored this special supplement. Data was collected in the third quarter of 2005. Questionnaires were mailed to a list of NREI's investment subscribers and Marcus & Millichap's private and institutional clients. A total of 1,167 surveys were tabulated, up from 647 in 2004, an 80% increase year over year.

The purpose of the survey was to gauge investor interest in real estate vs. other investment alternatives, obtain feedback on hot-button issues in the industry, and gain insight into real estate investment plans for the next 12 months.

NREI provides comprehensive coverage of commercial real estate with an emphasis on investment activity. Readers include owners/developers/managers, brokers, finance and investment professionals, as well as corporate real estate executives. This report also appears in the following publications: *Retail Traffic*, *Trusts & Estates*, and *Registered Rep*.

The nation's largest firm specializing in real estate investment, Marcus & Millichap closed more than $14 billion of investment transactions for private and institutional investors in 2004. The company has more than 950 brokers nationwide, the largest sales team in the industry.

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ket," says Harvey Green, president and CEO of Encino, Calif.-based Marcus & Millichap.

That white-hot demand is leading to lower cap rates — or the return investors get in the first year they own a property based on the purchase price. In August 2005, the average overall cap rate was 6.7% compared with 7.5% in August 2004. Meanwhile, sale prices of commercial real estate transactions completed in August 2005 jumped 14% over the previous year, reports Marcus & Millichap.

In order to gain a better understanding of investors' opinions about the state of the industry, *NREI* and Marcus & Millichap conducted an exclusive survey between August 4 and September 15. Private investors account for the largest group of respondents (45%) and nearly half of respondents report total holdings valued at $10 million or more [Figures 1 and 2]. Nearly two-thirds of respondents (63%) have invested in commercial real estate for 11 years or longer.

Among the study's findings:

• While investors have a large appetite for real estate, they are less confident of economic growth in the coming year. Forty-one percent of respondents expect the economy to be stronger 12 months from now, down from 63% last year. Nearly four in 10 respondents (38%) expect the economy to be the same a year from now, and 20% believe it will be weaker.

• Among 69% of respondents who plan to boost their investment in commercial real estate over the next year, the average estimated increase is 20%. Of those respondents who plan to decrease their holdings, the average predicted decrease is 27%. Twenty-three percent of all respondents plan no change in their investment level.

• More than 40% of respondents plan to invest in property types beyond their current real estate holdings. The largest percentage of these respondents will invest in mixed-use properties (13%).

• More than half of respondents (52%) plan to acquire properties specifically for redevelopment, renovation or expansion. Two-thirds of developer respondents (67%) plan to acquire properties for this purpose.

• Most respondents expect apartment properties to experience an increase in effective rents over the next year. Nearly six out of 10 respondents (58%) believe that effective rents in the apartment sector will rise over the next 12 months. (Effective rents take into account concessions such as free rent.)

FIGURE 1. RESPONDENTS ARE LARGELY PRIVATE INVESTORS WHO HAVE BEEN IN THE INDUSTRY AN AVERAGE OF 19 YEARS.

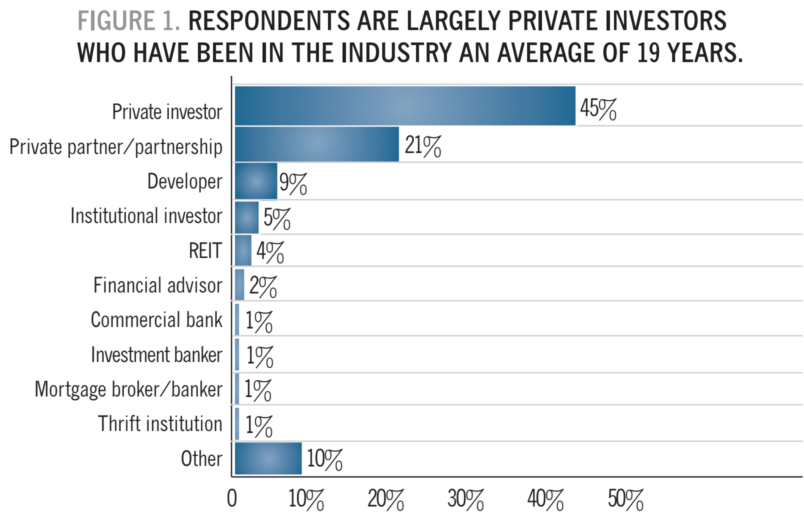
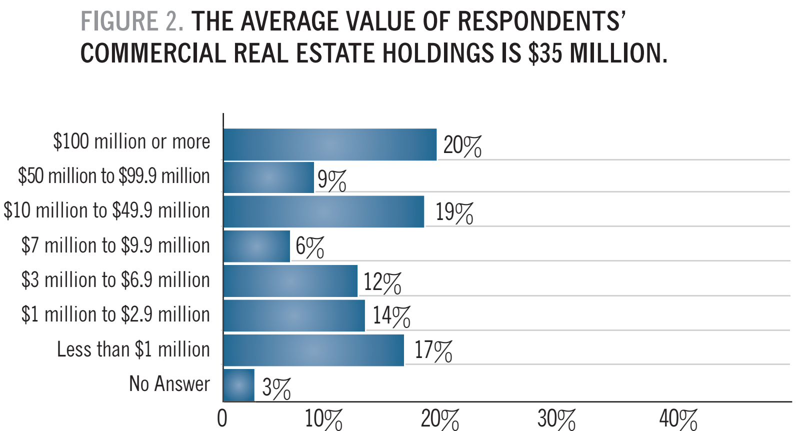


FIGURE 2. THE AVERAGE VALUE OF RESPONDENTS' COMMERCIAL REAL ESTATE HOLDINGS IS $35 MILLION.



Lower expectations

Tremendous demand for commercial real estate properties is responsible for significant yield compression over the past three years. Cap rates have dropped more than 200 basis points since 2002. What remains to be seen is whether that yield compression is a short-term cyclical phenomenon or a long-term structural shift in the U.S. real estate market.

Most respondents believe that the unusually low cap rates are the result of cyclical changes in the market rather than a structural shift [Figure 3]. The paradigm shift would mean that real

estate returns have been lowered permanently.

Green of Marcus & Millichap is convinced that compressed cap rates are not temporary. Factors that support a structural shift include greater stability in the real estate market, as well as the increasing flow of international capital into the U.S. market, he notes. Cap rates in Western Europe remain 200 to 250 basis points lower than cap rates in the U.S.

"Over the long haul, people are realizing that real estate is a stable investment with tangible hard assets with cash flow, and that those factors create a stable, long-term investment that does not require higher risk premiums that were there in the 1980s and 1990s," says Matt Cohoat, executive vice president and CFO at Indianapolis-based Duke Realty Corp. Consequently, real estate opportunities will not generate yields as high as in the past, he emphasizes.

"When interest rates rise and/or the stock market returns, there will be some competitiveness that will move cap rates from current lows," Green says, "but I don't think cap rates will move all the way back to long-term averages because of a more permanent shift."

FIGURE 3. A MAJORITY OF RESPONDENTS SAY REAL ESTATE RETURNS ARE TIED TO MARKET CYCLES AND WILL RISE AGAIN.

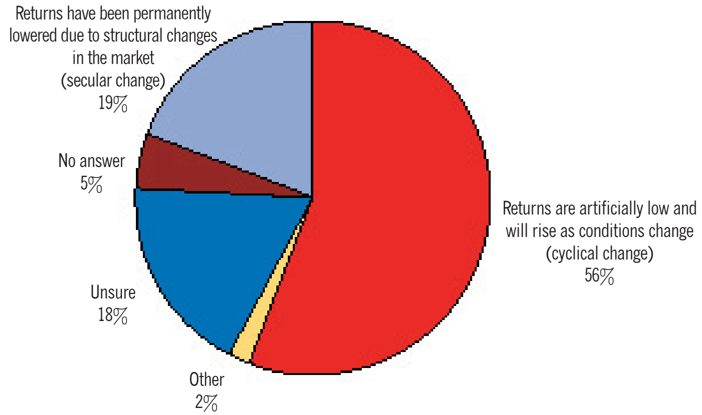
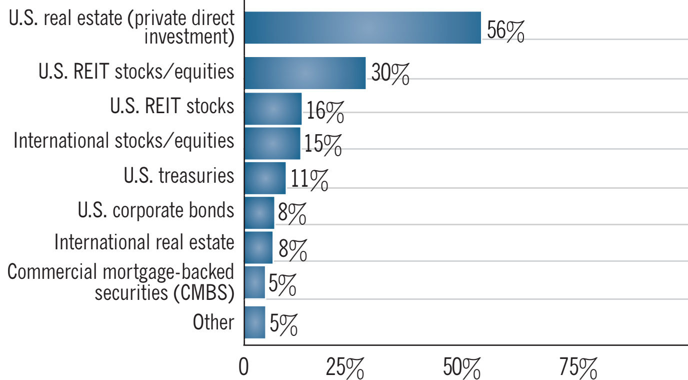


FIGURE 4. FACED WITH INVESTMENT OPTIONS, RESPONDENTS ARE MOST LIKELY TO INVEST DIRECTLY IN U.S. REAL ESTATE IN 2006.



Why real estate is still attractive

Although the percentage of respondents who plan to increase their investment in commercial real estate over the next 12 months is actually down slightly this year over last year, 69% vs. 74%, industry experts say the level of interest remains surprisingly strong.

"To some extent, that slight decline should be expected given the price increases we have had, and the increase in the number of transactions and pricing we have seen in the last three years," says Hessam Nadji, managing director of research services at Marcus & Millichap.

The 69% figure "comes across as a pretty big vote of confidence in the long-term sustainability of U.S. real estate," he says. "If investors thought the market was due for a major price correction, more would have expressed reluctance to increase their real estate investment."

Relative to other investment alternatives, real estate remains in high demand. Fifty-six percent of respondents plan to increase private direct investment in U.S. real estate in the next 12 months, while 30% plan to increase their holdings in U.S. stocks/equities, and 16% plan to invest in U.S. REIT stocks [Figure 4].

Developers seize the moment

Duke Realty is boosting its real estate investment activity because occupancies are rising throughout its portfolio, and the REIT is confident that the economy is on the upswing. Cohoat says that this year Duke expects to spend about $500 million on both acquisitions and development — double the amount invested last year.

"Clearly we have seen a pick-up in activity, both in opportunities and in our appetite for properties in 2005 compared to 2004," Cohoat says. Duke recently purchased a package of suburban office properties in Chicago's O'Hare submarket for $260 million.

Meanwhile, Developers Diversified Realty is expanding into the mixed-use arena due to rising land costs. The Beachwood, Ohio-based REIT is building Midtown Miami, which will feature 600,000 sq. ft. of retail space and about

300 condo units. “The condo market has been very hot, so the value of the residential component is very strong, which helps your overall returns,” says Scott Wolstein, chairman and CEO of Developers Diversified.

Pricing bubble?

The absence of attractive investment options has buoyed both commercial and residential real estate pricing in recent years, leading to a widespread perception that real estate values are in the stratosphere. Forty-five percent of respondents believe the housing market is experiencing a pricing bubble, 18% indicate there is no bubble, while 25% believe the bubble to be limited to certain markets. Eleven percent are uncertain.

Any dip in housing prices likely will be in the form of a soft landing rather than a hard fall with few exceptions of over-heated markets, Green predicts. “I don’t think we are going to see a collapse of the housing market. I think that household formation, job formation and the demographics of Generation Y and X will help to create a soft landing in the housing market,” he says.

Among respondents who believe that a pricing bubble exists, more than half (51%) anticipate a modest correction with prices falling between 10% and 20%. Nearly one in five respondents (19%) expects a major pricing correction of 20% or more [Figure 5].

Respondents’ views on the issue of a pricing bubble in the commercial sector were split, with 45% believing there is no pricing bubble, 36% saying yes to a bubble and 18% uncertain. Among respondents who see a pricing bubble, by far the largest percentage (63%) believe the bubble to be most pronounced in the apartment sector [Figure 6].

High prices have clearly influenced buying decisions and strategies. LaSalle Investment Management, for example, has lowered expectations for unleveraged returns. Three years ago the range was 9% to 10% for unleveraged returns; today it’s 7% to 7.5%.

FIGURE 5. THE MAJORITY OF RESPONDENTS WHO SEE A BUBBLE IN THE HOUSING MARKET EXPECT A MODEST CORRECTION.

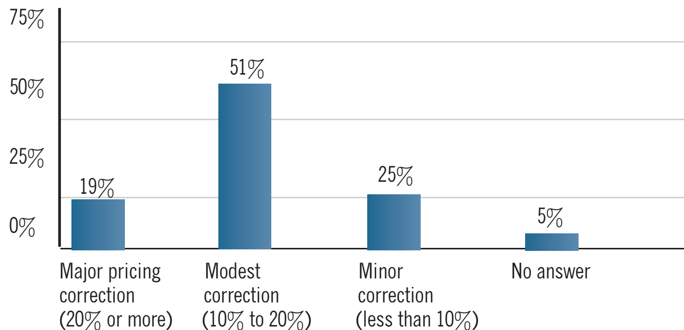
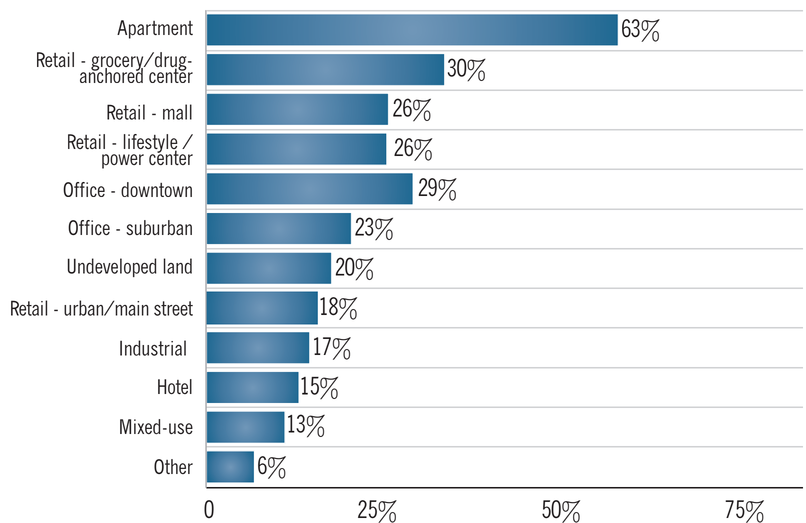


FIGURE 6. AMONG RESPONDENTS WHO SEE A PRICING BUBBLE IN COMMERCIAL REAL ESTATE, A LARGE MAJORITY SAY THE BUBBLE IS MOST PRONOUNCED IN THE APARTMENT SECTOR.



“The underlying theme for core, low-risk investors is that they are looking at returns based on cash flow or income stream, and not necessarily expecting appreciation in value,” says Peter Schaff, regional CEO for North America at Chicago-based LaSalle Investment Management.

“That makes me think we are not so much in a pricing bubble because people are taking a sober, clear-eyed view of real estate returns,” says Schaff. Overall, 67% of respondents expect a price increase in one or more property types and 27% expect a decrease in one or more property types.

The bears are more skeptical of apartment pricing, with 12% of respondents predicting a drop in apartment prices in the next year, the highest of all sectors. However, 42% still expect prices to be higher for apartments. Investors are the most confident on the values of mixed-use properties, with just 5% of respondents predicting a decrease in prices.

Cooldown for condo market?

The majority of respondents (59%) believe the frothiness of the condo market is not sustainable. Eighty-five percent of all respondents expect the

condo market to experience a downturn over the next three years [Figure 7].

"I would have thought there would have been a cooldown by now," says Jeff Franzen, senior vice president in the Washington, D.C., office of Lincoln Property Co., a major apartment owner and developer. Yet, some segments of the condo market appear to be carving out a viable niche among homeowners.

Franzen expects to see some softening within certain pockets of the condo market, such as the super-luxury segment, but those middle-market condos priced for young college grads may have more staying power. "It appears to me, after reading exhaustive studies and reports, that the condo phenomenon is here to stay as a starter home for the next generation," Franzen says.

FIGURE 7. THE MAJORITY OF RESPONDENTS PREDICT THE CONDO MARKET WILL EXPERIENCE A DOWNTURN WITHIN THREE YEARS.

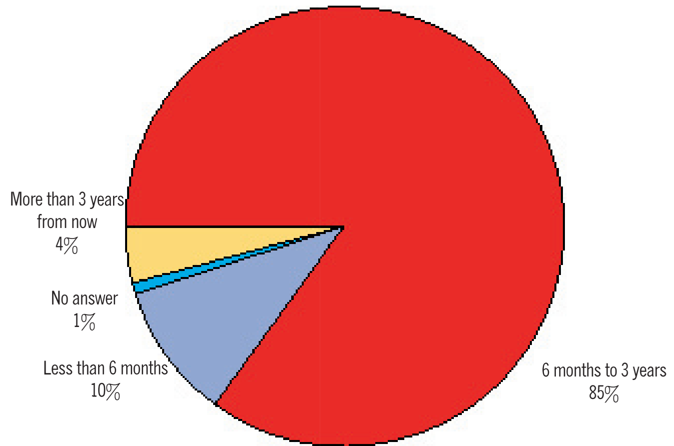
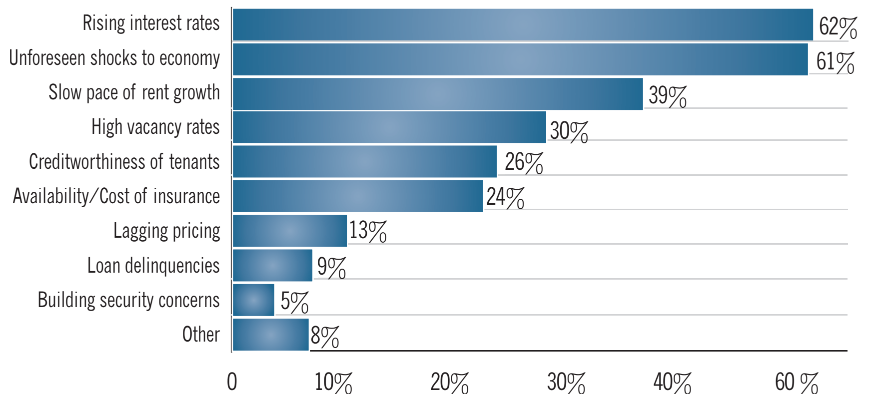


FIGURE 8. RISING INTEREST RATES ARE MOST OFTEN CITED AS RESPONDENTS' TOP CONCERN, FOLLOWED BY UNFORESEEN ECONOMIC SHOCKS.



All eyes are on interest rates

What keeps investors up at night? Sixty-two percent of respondents indicate that rising interest rates are their top concern, followed by unforeseen shocks to the economy (61%) and a slow pace of rent growth (39%) [Figure 8].

"Investors are worried that there could be a surprise lurking that spikes interest rates, but they are not seeing any evidence of it," Nadji says.

One concern is that inflation could materialize in late 2006 and 2007. Eighty-eight percent of respondents expect mortgage rates to increase in the next year, down from 93% in last year's survey.

"Going into 2005, investors were probably more concerned regarding a rise in interest rates because the economy was doing well and there was evidence that the recovery was real," Nadji says. But neither large-scale inflation nor a substantial rise in interest rates has materialized.

While it's unlikely that interest rates will rise 150 basis points in the next year, at some point it will be a natural progression for the 10-year Treasury yield to move northward of 5%.

"As long as that movement is happening in an orderly fashion, and is occurring along with improvements in occupancies and rents, it is not going to create a major disruption in the investment market," Nadji says.

Thirty-four percent of respondents say that the 10-year Treasury yield would need to reach 5.5% to 6.5% before rates would have an adverse effect on investment activity, and 35% say the 10-year yield would need to reach 6.5% to 7.5% before investment activity would be affected [Figure 9]. Meanwhile, 46% expect mortgage rates to rise 100 to 200 basis points over the next year [Figure 10].

"I think interest rates will have to move 150 basis points before there is a major pricing shift, and I'm not sure interest rates will make a major move in the next year," says Stuart Green, CIO and CFO of Denholtz Associates in Rahway, N.J. "I think prices will remain strong, while opportunities will remain abundant and competition will remain extremely high."

On the upswing

The vital signs of the real estate indus-

FIGURE 9. **A MAJORITY OF RESPONDENTS SAY THE 10-YEAR TREASURY YIELD WOULD NEED TO REACH AT LEAST 6.5% BEFORE ADVERSELY AFFECTING REAL ESTATE INVESTMENT.**

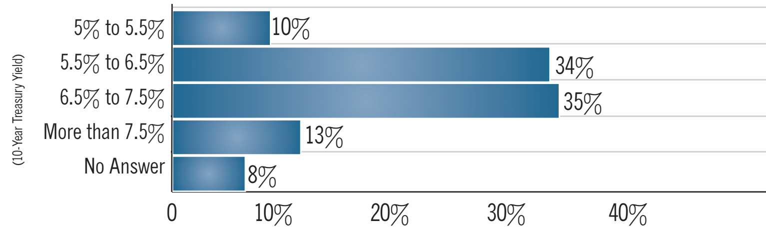
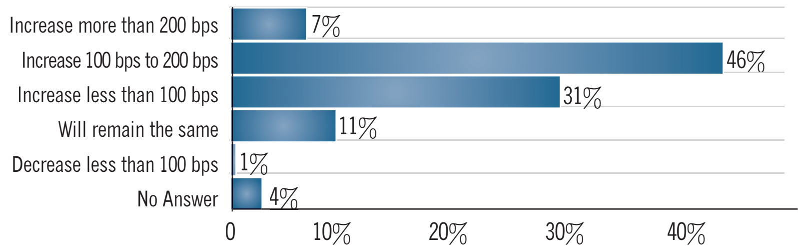


FIGURE 10. **THE MAJORITY OF RESPONDENTS EXPECT MORTGAGE RATES TO RISE 100 TO 200 BASIS POINTS OVER THE NEXT 12 MONTHS.**



try are improving, with absorption and occupancy rising across the board. While rents in most sectors have not risen significantly as of yet, 82% of respondents expect to see an increase in effective rents for one or more property types in the coming year.

"I was not surprised to see the overwhelming confidence investors have in the recovery of real estate markets," Nadji says. "If anything, investors may be just a tad over-bullish on the market recovery given a slower pace of economic growth in 2006."

Both office and industrial sectors have recorded modest rent growth in the last year. At mid-year, office asking rents were up 4.5% over the previous year, while rents for industrial warehouse-distribution space rose 3.5% over the same period, reports Reis.

The retail sector has been more robust, thanks to strong consumer demand over the past several years. Neighborhood and community center construction is forecast to total 27 million sq. ft. in 2005, up from 25 million sq. ft. last year, according to Marcus & Millichap. Nearly half of all respondents invested in retail properties expect retail effective rents to rise in the next year.

Any number of factors, including fuel prices, could diminish consumer demand over the next few years, and subsequently shake the strength of the retail sector.

The potential for such a downturn does influence investment decisions. That leads to greater scrutiny of tenant credit and places more importance on site selection, notes Glenn Rufrano, CEO of New York-based New Plan Excel Realty Trust.

New Plan also is being more cautious — paying down its debt and restructuring its payout ratio to a safer level. "You can plan around uncertainty in terms of offense, which includes acquisitions and capital allocation, and defense, which involves being a safer company, longer term with a better balance sheet," Rufrano says.

Despite their optimistic outlook for rising effective rents in the apartment sector, respondents most frequently cite the apartment market when identifying which property types they plan to exit within the next year (12%), followed by undeveloped land (6%) and suburban office (5%).

Although 58% of respondents were apartment property owners, apartments also could have scored high on the exit-strategy list for two reasons.

More owners may be seeking to exchange management-intensive apartment properties for more passive investments. Investors also may be looking to take advantage of rising values in the apartment market — many markets have benefitted by inflated prices due to demand from condo converters, Nadji notes.

As of August, mid- and high-rise apartments were selling for cap rates of 5.6% compared with cap rates of 6.1% a year ago, according to RCA.

Opting for exchanges

The use of 1031 exchanges is rising in popularity, particularly as more and more baby boomers look to shift their real estate holdings into less management-intensive properties, or start planning to transfer wealth to the next generation.

One-third of respondents have executed a 1031 exchange transaction in the past 12 months, and 44% expect their use of 1031 exchanges to increase somewhat or greatly over the next five years [Figure 11].

"That vehicle is still a major driver in the investment market," Nadji says. The booming 1031 market is responsible for fueling significant sales activity. Exchanges make it easier for investors to expand, diversify and shift portfolio strategies by buying and selling real estate in different product types and different geographic markets without tax consequences.

The tenant-in-common structure also has become an increasingly popu-

lar component of the 1031 business. Twelve percent of respondents have participated in a TIC structure in the past 24 months [Figure 12], and 53% of those investors expect to place more equity in TICs over the next five years. "The results do confirm our belief that the tenant-in-common industry is here to stay for at least two to three years and it is becoming more widely recognized and used," Nadji says.

TIC investors most frequently cite deferral of capital gains taxes as a benefit (58%), followed by ability to own institutional-grade property (38%), and the fact that TICs tend to invest in less management-intensive properties (35%).

The most frequently cited concerns about TICs are that major decisions require a consensus among investors (47%), lack of liquidity (39%), and possible regulatory oversight (32%).

FIGURE 11. **MORE THAN FOUR OUT OF 10 RESPONDENTS PLAN TO INCREASE USE OF THE 1031 EXCHANGE OPTION WITHIN FIVE YEARS.**

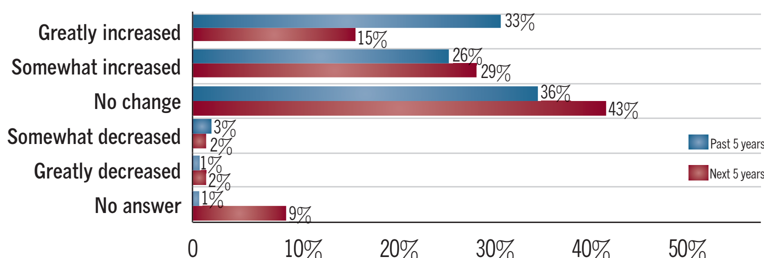


FIGURE 12. **MORE THAN ONE IN 10 RESPONDENTS HAS INVESTED IN A TENANT-IN-COMMON STRUCTURE OVER THE PAST TWO YEARS.**

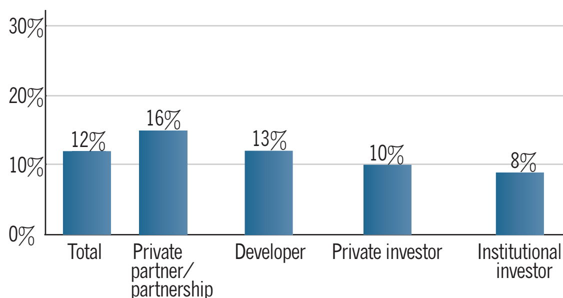
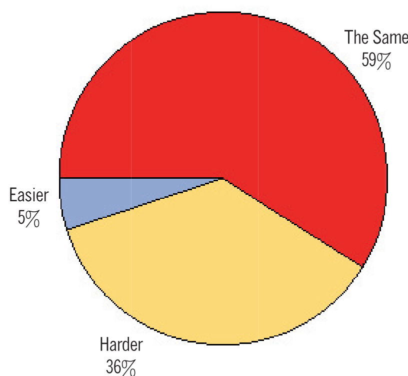


FIGURE 13. **MORE THAN ONE-THIRD OF RESPONDENTS ANTICIPATE DEBT FINANCING WILL BE HARDER TO SECURE A YEAR FROM NOW.**



Economic outlook

While investors remain bullish on real estate, the recent economic news hasn't been good. The Consumer Price Index rose 1.2% in September, the biggest jump since March 1980. Meanwhile, industrial production fell 1.3% in September and consumer confidence fell in early October to its lowest level since 1993. Undoubtedly, the effects of Hurricanes Katrina and Rita are rippling through the economy.

"If we were to take the survey now, there would clearly be more concern about the economic outlook in the short term — the next six months," says Nadji, who expects economic growth to range between 3.2% and 3.5% over the next six months, down from 3.5% to 4% the previous six months.

"I think that is a short-term phenomenon, and that the economy will pick up as the rebuilding takes hold in the regions that were affected by the hurricanes. However, with higher gas prices, higher interest rates and less money coming out of home refinancing, the economy should slow to its long-term growth rate of 3.3% in 2006," he adds.

Even before the hurricanes, respondents sensed that cheap debt would not always be so plentiful. More than one-third of respondents (36%) indicate that debt financing will be harder to secure 12 months from now [Figure 13], up from 28% last year and 14% two years ago.

Still, improving real estate fundamentals should benefit borrowers. "We might see a little flattening with sale properties staying on the market a little longer and prices moving 10 to 15 basis points here or there," Green predicts.

"But overall when you look back statistically, I think the investment market in 2006 is going to be within 90% to 95% of where it is at today," he says. ■

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