

**Changing Conditions: Understanding Commercial Real Estate's Shifting Dynamics is the Key to Success This Year**  
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The U.S. Economy, while remaining relatively strong, is facing greater challenges than it has seen in more than two decades. Volatile energy prices, a slowing housing market, consumer spending shifts, geopolitical risks, natural disaster recover costs, inflation, and increasing interest rates are just a few of the factors now affecting the U.S. economy.

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And as the economy goes, so goes commercial real estate. Market performance increasingly is becoming dependent on the overall economy's strengths and weaknesses. Economic growth of 3.0 percent to 3.5 percent is predicted into 2006 along with a population increase of approximately 2.5 million and some two million new jobs. For the last several years, consumer spending has fueled the economy, but this tide is shifting. With higher energy costs and increasing interest rates, consumer spending is starting to drag and businesses are beginning to provide fuel for economic growth. The remainder of this decade will be marked by job growth as a key ingredient in allowing commercial real estate fundamentals to strengthen, which translates into improved property earnings.

This updraft for commercial real estate markets is coming at a critical juncture. The markets have been paid a great favor in the form of low interest rates, which came at a time when commercial real estate could take full advantage of them. Commercial real estate finally was poised as a credible, mainstream investment while alternative investments offered relatively lower risk-adjusted returns. As a result, investors decided to allocate much more capital to this asset class.

This confluence of factors sets the stage for commercial real estate returns to come under the greatest level of compression in recent history, and it is unlikely that this will repeat itself in the foreseeable future. Across the board, required capitalization and discount rates have declined by some 200 basis points, or more than 20 percent, since first-quarter 2001. Understanding the profound shift that the capital markets have experienced and the future direction of cap rates and discount rates is the new key to success for transaction brokers, advisers and investors. This skill falls under risk identification, risk management and risk diversification.

With the economy and the financial markets as a backdrop to this year's commercial real estate forecast, it's important to analyze market fundamentals relative to capital market dynamics to develop a return performance outlook for each of the major property types and forecast the property sectors that should provide the best relative performance in coming months.

#### 2006 Investment Insights

- Sustained net operating income is critical to offset potential upward pressure on capitalization rates caused by long-term interest rate increases.
- Landlord pricing power will vary significantly by market and property type
- Will new supply remain in check until space market fundamentals improve further? New construction levels are reasonably disciplined, but there has been a rapid build up of new supply in the planning stages as investors allocate more capital to higher risk strategies.
- Strong positive leverage, similar to what has been realized during the past few years, will be difficult to achieve on institutional-grade real estate deals where cap rates have been driven down to levels near interest rates. Positive leverage will be even more challenged as interest rates rise.

- Investment capital flow into commercial real estate will continue and the number of transactions this year should sustain last year's level. Returns will come down to more sustainable levels on both cap rate and total return bases.

### Cap Rates and Returns

Total realized returns for commercial real estate have outpaced the stock and bond markets on a risk-adjusted basis. This is reflected in Table 1, which compares stocks, bonds and commercial real estate from an absolute return perspective. Commercial real estate's realized return has shown the most relative strength during the past year, outpacing other investment alternatives and providing a high relative real rate of return (total return less inflation).

Table 1's total realized commercial real estate returns should be compared to market expectations that look at required total returns and cap rates. Required total returns and cap rates that get deals done today are significantly lower than historical levels and the level of realized returns. Table 2 provides an overview of required cap rates and total returns for commercial real estate on an unleveraged basis.

This outsized realized return performance has been a result of the capital markets' dynamics where required return expectations have been reduced significantly, including commercial real estate return requirements on both absolute and risk-adjusted bases, which is referred to as rate compression. The reduction in required returns allows values and prices to increase significantly even if the property's income is not increasing, which then results in very high realized or reported returns. However, this level of realized or reported performance is not sustainable as required returns will stabilize and value increases created by cap rate compression also will end.

Table 2 demonstrates commercial real estate's relative attractiveness in an environment where required cap rates and total returns on an unleveraged basis are historically low. Third quarter 2005 going-in cap rates range on average from 6.4% to 7.8% for office, industrial, retail and multifamily and 8.7% for hotel properties, while total unleveraged required returns or yields range from 8.3% to 9.4% for core assets and 11.3% for hotels. Suffice it to say, commercial real estate's performance in both public and private markets has been nothing short of spectacular relative to the stock and bond markets.

This compression, or lowering, of required returns is what has given the lift to values and prices for commercial real estate. If the net operating income stays the same, but cap rates and total yield requirements are lower by 200 basis points, then values and prices will increase 25 percent over that period. (Averaged over three years for an annual net appreciation on 8% and add a cap rate of 8%, the total unleveraged returns are roughly 16 percent. Add positive leverage to this simple math and leveraged total returns or yields rise to around 25 percent).

This leads us to the question: How long can the good times last? The short answer is that they cannot continue for much longer, particularly as the Federal Reserve Board increases short-term interest rates and long-term rates finally respond to existing imbalances. [Commercial real estate] is, and [has been] for the past couple of years, [in an over-performance phase of its investment cycle.] Real Estate Research Corp. analyzes commercial real estate's investment performance cycle by comparing the historical difference between realized or reported returns and investors' required or expected returns. It then assesses where a property is located within its investment cycle in relation to a market equilibrium point in which reported returns equal investor required returns. Reported or realized returns started to outpace required returns in early 2003. This continues to hold true, but for how long? This dichotomy puts investor expectations at risk.

Right now investors, brokers and advisers continue to be happy and they should be – commercial real estate has been one of the best places to be during the past several years. This happiness has been well earned by the industry through transparency, liquidity and prudent investment practices. While all good things must come to an end, there is no bubble in the commercial real estate industry and there will be no abrupt pop.

### Property Market Outlook

Offices and especially hotels are expected to have the strongest prospects for revenue growth while increasing their relative occupancy levels this year. This will translate into improved pricing power and earnings for these properties. Clearly we have seen well-leased and premier

properties fetch record-breaking prices; however, this year should bring a broader market recover in sales and prices for both offices and hotels. Their risk profiles reflect higher cap rates and total return requirements, and they are well deserved. As such, this is a great time to refocus on hotel and office investment opportunities.

With consumer spending being the stalwart of the economy during the last few years, retail investments have delivered the strongest returns among the major property types. Retail investments have regained the credibility they possessed in the late 1980s, especially high-end regional mall properties.

This year, however, consumers will face more challenges than they have seen in decades. Higher interest rates signal the end of using houses to finance expenditures, higher energy costs are starting to eat away at discretionary spending and it will be time for consumers to pay down their credit cards. Nevertheless, approximately two-thirds of the U.S. economy is driven by consumers. Employment will be strong in 2006 and we are financially a robust society. Cap rates for the retail sectors range from 6.7% to 7.0% with total yield requirements of 8.4% to 8.8%. The bottom line: Retail fundamentals are reasonably strong, but do not expect the level of realized returns seen in the past several years for this property type this year.

#### Multi-family Outlook

Apartment returns have been extremely favorable due to their perceived risk profile and the changes that have taken place in the residential markets, particularly condominium conversions.

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Required returns for apartments are some of the lowest among all of the core property types with cap rates of 6.4% and total return expectations of 8.3% for an unleveraged basis. They are priced for perfection. The demand fundamentals look promising for this sector as job growth is very favorable to this property type and rising interest rates will push some hopeful home buyers back into the rental market. But as is always the case for multifamily, the supply side of the equation poses risk to overall balance of the fundamentals. On a risk-adjusted basis, apartments will continue be highly sought-after investments and will provide low but solid returns.

#### Investment Climate

Looking ahead, this is a tipping point for commercial real estate where the favorable capital markets providing a boost in values and prices through low interest rates will give way to the challenges of the economy, and subdued consumer spending will be offset by more business spending. As this shift occurs, market factors or demand relative to supply, will be the focus in pursuing solid real estate strategies.

Property earnings will take the front seat in driving value versus cap rates, which have driven up values and prices. But, this shift will not be as universal in supporting values and prices as was the cap rate compression era. Hotel and offices will start to deliver stronger returns relative to the other property types. However, both cap rates and total returns are forecast to be lower for all core property types. There is not likely to be an abrupt shift in investor attitudes toward commercial real estate – this is not a bubble – but this will be a year in which the market searches for more sustainable levels of returns.

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