

# Institutional Real Estate Quarterly

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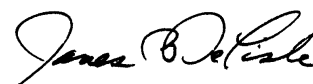
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## Commentary

*Going into the second quarter of 2005, the financial snapshot of the commercial real estate market is generally positive. This situation is likely to hold in the near term, although there are signs that the economic recovery might not be as smooth as some have predicted. In particular, inflation fears have led to a shift in the Federal Reserve's stance, and this might signal the beginning of more prolonged and pronounced increases in interest rates. Other factors of concern include the global front, where the weak dollar and record deficit are causing angst. Closer to home, the debates surrounding Social Security reform have shifted public attention back toward economic conditions that, coupled with rising energy costs, may place additional downward pressure on consumer confidence.*

*The U.S. economy itself appears to be on an upward track, although each wave of new government reports continues to provide mixed messages. The employment picture has been particularly troubling, with recent figures coming in at somewhat disappointing levels. In the current environment, uncertainty is likely to continue as the businesses, consumers and policymakers search for the right formula that will stimulate the recovery. Unfortunately, there is no way to ensure that these efforts will be successful, especially in light of global forces over which there is limited control. Despite these issues, the real estate market appears to have picked up some positive momentum. Confidence has returned to the real estate sector earlier and more robustly than many anticipated. To this point, the perseverance and patience that investors have demonstrated in the form of strong capital support has created an important cushion over the bottoming out of market fundamentals. While there is still some downside risk in the various property sectors and markets, it appears that this insulation may have helped avoid a market correction.*

*Going forward, net capital flows to the asset class are expected to remain strong. When coupled with gradual improvement in spatial market conditions, the outlook is fairly healthy. As such, the real estate industry should be operating at a brisk pace, with strong competition for scarce product continuing to drive the market. In an increasing number of markets, it is also likely that construction activity will begin to pick up. Hopefully, the combination of aggressive pricing and soft market conditions should help jog the memories and collective psyche of capital providers and keep construction in line with improvements in demand. At the same time, there should be strong investor appetites for higher return opportunities as investors move out on the risk spectrum.*



James R. DeLisle, Ph.D.

## Executive Summary

### The Economic Environment

- **Economic Growth.** U.S. leading economic indicators were positive during the first quarter, with the indicators up three out of the last four months. Assuming oil prices do not rise markedly above already-high levels, labor markets continue to improve, and consumers and the housing sector remain on track, the stage is set for further economic growth. However, going into the second quarter, economic indicators remain somewhat mixed, a situation that is likely to continue over the near term.
- **Employment.** The pace of job growth remains below par for an economic recovery even though it has remained positive as in 2004. In terms of earnings, the weak job market coupled with rising inflation has resulted in some erosion of real wages. Assuming the recovery continues, the job market should strengthen and ultimately translate to higher wages. However, such forces are unlikely to kick in over the near term.
- **Inflation and Interest Rates.** The reemergence of inflation is creating rising concern, with rising inflationary forces and mixing with slow economic growth. The fact that core consumer price inflation—excluding food and housing—has been moderate offers some solace. Additionally, the market seems to have already built in a cushion for upside risk seeing that there was no immediate market response to the Fed's hints of rate increases. On a positive note for the real estate market, long rates have remained relatively stable, causing the yield curve to flatten ever more than it was.
- **Business Indicators.** Although business investment continues to increase, there are some signs that this trend might soften. Rising prices in the cost of materials, energy, and benefits have created unease. The weak dollar remains a major concern, both on the domestic and global front. The fate of the dollar will be closely monitored with the outlook for moderate improvement if the economy can break out of its slow-growth pattern.
- **Stock Market.** Despite anxious investors seeking to tap into the next surge in stock prices, the market remains characterized by uncertainty. Given the economic uncertainty and the prospects for continued increases in interest rates, the market is likely to remain volatile, with investors focused on quarterly earnings and trying to pick the emerging winners. This situation is unlikely to change over the near term, with investors remaining nervous as to how the trade-offs between inflation and interest rates will play out and how they will affect corporate profits.
- **Consumer Confidence.** The news on the consumer front is moderate; while there is no sign of a collapse in consumer confidence, there is little to indicate a major resurgence is imminent. As long as the housing market holds up, inflation remains in check, and jobs continue to improve, confidence levels are likely to hold with some moderate improvement as conditions stabilize. Thus, in the absence of major external shocks, the outlook of consumer confidence levels is likely to remain mixed to positive.
- **Retail Sales.** In early 2005, the retail sector continued to exhibit relatively strong sales, attributable in part to consumers cashing in holiday gift cards and increased tax refunds. In terms of merchandise lines, apparel sales have been fairly strong, while sales weakened for big-ticket items. Going forward, the retail sector is likely to be dependent on consumers' fortunes, with prospects best for upper-end retailers.
- **Housing Market.** Evidence suggests that the housing market will continue to be frenetic, despite concern of illiquidity risks and raising interest rates. Lenders are expected to do what they can to extend the run, with such innovations as 40 year mortgages and 3-year interest-only payments designed to bolster purchasing power and place upward pressure on prices and transactions. Over the near term, the housing market should continue to perk along and defy traditional economic principles, although rhetoric surrounding a "bubble" and concern over the affect of investment-driven acquisitions will increase.

### Real Estate and Capital Markets

- **Overview.** The capital markets continued to provide strong flows to the real estate sector in early 2005. Robust investor demand and prospects for gradual improvements in fundamentals have helped hold cap rates down, with little near-term correction in site. In some markets, the promise of improved market fundamentals has induced investors to drive cap rates even lower, although most would agree the bottom is

in sight. Thus, over the near term, the real estate capital market should remain active and healthy with a shortage of product the only inhibitor of volume.

- **Construction Activity.** The upward trend in total new construction expenditures increased in the first quarter, with recent gains attributed in part to rising activity in the nonresidential sector. The outlook for commercial construction is for continued moderate expansion. This trend will likely continue as developers seek to capitalize on ready access to capital and investors seek higher returns on the margin to offset lower returns on existing, core assets.
- **Commercial Mortgages.** The commercial mortgage market remains healthy, with total volume of activity expected to remain on an upward tack. Going forward, private loan activity is expected to continue at a robust pace, with lenders funding new transaction and refinancing maturing loans. On the CMBS front, activity should remain strong, with a combination of new issuances and maturing securities fueling continued expansion of the asset class. At the same time, continued improvement in spatial market fundamentals, should help keep delinquency rates down and competition high.
- **Private Equity Market.** The private equity market continues to benefit from excess demand for investment-grade product. This supply-demand imbalance has placed upward pressure on prices, leading to cyclically high total returns but declining income returns. Improving market fundamentals may portend a return to more traditional pricing models. However, there are few signs that the commercial sector will be repriced over the near term, with strong demand continuing to hold cap rates down at near-record levels. Thus, for the balance of 2005, the private equity market should remain healthy, with strong capital flows and a shortage of deals.
- **Public Equity Market.** REITs began the year with an 8% decline, with no sectors being spared from the downturn. This situation reflected a combination of including profit taking and portfolio rebalancing after the long run. Given the early performance in 2005, the outlook for REITs is somewhat guarded. Improving market fundamentals may help the sector recover and generate solid income returns. However, although there are few signs that total returns will rebound to 2004 levels.

## Real Estate Outlook

- **Office Market.** Although new development is springing up in some markets, there is little to suggest a significant surge in office construction activity is on the horizon. This is good news for the sector, since employment growth and the demand for net new space is likely to be tempered over the near term. Assuming development remains in check and tracks improvements in net absorption, office conditions could improve to the point that net rents might begin to increase. However, with few exceptions a major rebound is unlikely. Despite these conditions, capital flows to the office sector from investors and lenders will continue to be heated.
- **Retail Market.** The retail sector has proven to be fairly resilient, with market fundamentals benefiting from strong consumer expenditures. New wave of lifestyle centers, mixed-use projects, and other nontraditional formats have been receiving the bulk of attention and are expected to gain momentum. Of particular interest will be efforts to stimulate urban retail to complement the movement toward urban revitalization. In terms of real estate fundamentals, the retail sector is likely to continue to outperform other property types as long as consumers remain willing to do their part.
- **Industrial / Warehouse Market.** This sector has been stuck on a plateau, with little movement in either direction. This situation is unlikely to dramatically change during 2005. However, there are some positive signs in manufacturing activity, employment, distribution hubs, and capacity utilization that suggest conditions could gradually improve. Thus, the industrial sector should continue to attract strong capital flows, holding up values as investors seek core product to balance their portfolios across property types and markets.
- **Apartment Market.** Market fundamentals of this sector eroded as former renters took advantage of low interest rates, opting for homeownership. To a great extent, this cannibalization of tenants has played out as homeownership rates hit the saturation point. Going forward, the fate of the apartment market will reside more on its own, with limited downward pressure from shifting tenure choice. Indeed, as the single family market plays out, there may be some positive spill-over effects for the rental sector. Investor demand should remain strong, holding cap rates.

## The Economic Environment

### Economic Growth

After a slow start in 2005, the leading index of economic growth regained some lost ground, returning to the upward trend that it had exhibited since mid-2004. Growth in gross domestic product has also been relatively steady, with 2004 fourth-quarter figures coming in at around 4%. During the 2005 first quarter, the U.S. leading economic indicators were positive, with the indicators up three out of the last four months. Higher oil prices have had a dampening effect on the economy, although not as pronounced as some expected.

Assuming oil prices do not rise markedly above already-high levels, the stage is set for further economic growth. This outlook is plausible if the labor market continues to improve and consumers and the housing sector remain on track. In the absence of a major shock, economic growth should show moderate improvement, with the positive and negative contributors fairly balanced. Thus, going into the second quarter, economic indicators remain somewhat mixed, a situation that is likely to continue over the near term.

### Employment

The employment front remains a source of concern, although there are some signs that employment growth may increase. In 2005, job growth has remained positive as in 2004. Unfortunately, the pace of growth remains below par for an economic recovery and continues to be monitored very carefully by investors and consumers. On a positive note, the help-wanted advertising index is up over the prior year in eight of the nine regions, suggesting that companies may be posturing for growth. This sentiment is echoed by the manpower index, which reveals an improvement in hiring intentions, especially in financial services, education, and public administration.

The unemployment situation also has improved moderately, although the rate of initial claims for unemployment benefits rose toward the end of the 2005

first quarter. It should be noted that the moderate improvement in the unemployment rate is more attributable to slow growth in the labor force rather than strong job growth. The outlook for unemployment is for some flattening out, with improvement hinging on a combination of slow growth in the labor force and continuation of the economic recovery.

In terms of earnings, the weak job market coupled with rising inflation has resulted in some erosion of real wages. While this has hurt consumers, it has helped corporate bottom lines during this economic transition period. Unfortunately, fringe benefits (e.g., health insurance, pensions) are rising, putting some upward pressure on payrolls. This trend is expected to continue, with little relief on the horizon. Indeed, the hype

surrounding Social Security reform may place more pressure on corporate pension programs, especially for some of the more competitive industries whose employee demographics place them on the firing line. Similarly, despite efforts to rein in health care costs,

there are few signs that they will be contained. Offsetting some of this wage pressure is the fact that productivity gains, after slipping a bit early in the year, are still rising at a healthy rate. This situation should carry forward as companies increase business investment.

Assuming the recovery continues, the job market should strengthen as companies are forced to add to payrolls to take some of the pressure off current employees. This will ultimately translate to higher wages and more inflationary pressures, although such forces are unlikely to kick in over the near term.

### Inflation and Interest Rates

The increasing attention on inflation can be attributed in large part to the Federal Reserve (the Fed). In March, the Fed's posture on interest

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rates became more aggressive, citing increasing concerns over inflationary forces. Until that point, the market had discounted the prospects for a series of steady 25 basis point increases and was set for a relatively smooth transition to higher short-term rates. There was no immediate market response to the Fed's hints that rate increases might be more dramatic and more prolonged, suggesting that the market had already built in a cushion for upside risk.

While prospects for the near-to-intermediate term are far from clear, investors and businesses are likely to step back and reassess their strategies in light of the potential for greater upside pressure on inflation and interest rates. The good news is that momentum in the overall economy and the strengthening of market fundamentals may be sufficient to weather a gradual return to higher rates that are more in line with long-term averages.

The flattening of the yield curve, with long-term rates holding despite rising short-term rates, is expected to continue, reflecting more confidence in the sustainability of the recovery. Thus, despite justifiable concerns over future rate hikes, it appears that the market has the ability to absorb moderately higher interest rates, especially if they are able to forestall an inflationary cycle.

The reemergence of inflation as a plausible cyclical factor is creating some concerns that the economy may be entering a period of "stagflation," with rising inflation and low growth. The fact that core consumer price inflation—excluding food and housing—has been moderate offers some solace. The inflation rate suggests that companies are holding the line on prices, concerned over market share and their ability to capture consumer expenditures in the face of slow income growth.

On the retail front, price increases are expected to be moderate for most categories, with business leaders expecting prices to stay in line with recent trends. To the extent that the employment picture improves and employees experience increases in wages, the strength in retail sales that has been concentrated in the top of the market should spill over to moderate-income households, especially if price increases are modest. However, in some sectors, more aggressive price increases can be expected as companies try to take advantage of near-term supply and demand imbalances.

## Business Indicators

**A**lthough business investment continues to increase, there are some signs that this trend might soften. For example, the Conference Board's survey of CEO confidence shows that confidence has slipped moderately for the past three quarters. While the rating is still skewed more toward the positive side than negative side, the spread has eroded somewhat. Rising prices paid purchasing managers have created concern, placing pressure on manufacturers that

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could dampen demand if prices rise. Similarly, some circles have been concerned about the run-up in costs of materials, steel, and energy that have emerged in many markets. On a positive note, employment costs have been relatively flat, with the exception of benefits, which continue to spiral upward.

Productivity increases tempered, but remained positive during the 2005 first quarter, as companies began to reap benefits from recent business investment increases. Manufacturing productivity gains were also stable, while activity continued to expand, especially in the durable goods sectors. Capacity utilization has continued to increase, despite downward revision for the previous quarter. Inventory gains remain strong, maintaining the upward trend that has held since 2003. At the same time, strong sales have driven stockrooms holding levels to about 1.3 months of supplies.

With respect to vehicles, the sector has been bolstered by gains in heavy truck sales associated with increased shipping and construction activity. In some markets, service-sector industries have strengthened over the recent past, especially in financial services, information technology, and accounting. Banking activity has been strong, with increasing demand for commercial mortgages and business loans. On the other hand, demand for household loans has been mixed, due in part to high current-debt loads and concern over rising

interest rates. The tourist and travel sectors have picked up, a trend that bodes well for the upcoming peak summer season.

The weak dollar remains a major concern and is something of a two-edged sword. From a theoretical perspective, the weak dollar should provide upward pressure on exports and a downward pressure on imports, leading to a reduction in the trade deficit. At this point, however, this tendency has not materialized, and the deficit continues to expand with few prospects for a major reversal. It is expected that the lagged effect of the decline in the dollar and the prospects for foreign economic growth will begin to translate to higher exports, depending on the relative health of other major economies.

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It should be noted that the U.S. economy has benefited from foreign investors who continue to purchase American securities. Indeed, net foreign buying of U.S. equities in January 2005 was at the highest level since mid-2001. However, there is concern that these figures are somewhat misleading in the

sense that they have been bolstered by purchases from foreign-based hedge funds that are driven by domestic investors.

The dollar's role in pegging many currencies has also provided some much needed insulation, although this support has eroded, as noted by the aggregate decline in the use of the dollar for reserves. The fate of the dollar will be closely monitored, both domestically and internationally, with the outlook for moderate improvement if the economy can break out of its slow-growth pattern.

### Stock Market

The prospect of increases in interest rates and inflation have added more volatility to the stock market, as investors continue to be nagged by worries over the stagnant economic environment. The good news is that the market seems to have discounted

moderate increases and has been on guard for signs of a more aggressive stance.

There is too much uncertainty to guess about prospects for the stock market other than to note that investors will be ready to respond if necessary. In some cases, portfolios will be tweaked to favor inflation-related price increases that can be sustained. Signs that inflationary forces are translating into wage inflation, which can erode profit margins and eat away at share prices will be of more concern to investors. Fortunately, excess capacity, productivity increases, and the ability to expand outsourcing to manage payroll risk, provide some insulation from such pressures. Going forward, investors are likely to remain nervous as to how the trade-offs between inflation and interest rates will play out and how they will affect corporate profits.

### Consumer Confidence

The indicators of consumer confidence remain mixed. Despite some fluctuations, consumers continue to feel positive about their current situation and somewhat concerned over the outlook.

The major source of consumer anxiety is the outlook for jobs, which has been ratcheted back for a more moderate outlook for near-term job growth. Financial gains of households have reached the highest level in four years; while the expected financial gains is at one of its lowest points. This situation is unlikely to change, with rising energy prices, a potential flattening in housing appreciation rates, rising interest rates and increasing concerns over inflation all creating downside risk.

***The debates surrounding Social Security reform have created a split psyche for consumers with respect to economics.***

While no collapse in consumer confidence is imminent, these clouds are likely to lower confidence levels, with consumers lagging rather than leading the economic recovery. In the absence of a major catastrophe or unexpected trigger, consumer confidence levels are likely to remain mixed to positive. The debates surrounding Social Security

reform have created a split psyche for consumers with respect to economics. Over the recent past, consumer confidence has focused on current and near-term factors, with confidence levels rising and falling on the wave of economic indicators and personal situations. While consumers have been relatively optimistic, debates over the prospects for Social Security and the need for reform may introduce a sobering note. This risk is amplified by the fact that the generation most affected—baby boomers—is also the one with the most aggregate wealth under its control.

Although the debates have focused on future needs, and efforts are being made to reassure the public, the debates are also forcing consumers to take a hard look at their current situations. How this scrutiny will play out is an unknown, but is likely to cause consumers to revisit their current consumption patterns, regardless of confidence levels. Indeed, it is possible that the historical relationship between consumer confidence and consumer spending might be in for a structural shift, as more emphasis is placed on intermediate-to-long term situations and less on current indicators. While this might take some near-term volatility out of the market, it may also accelerate the lifecycle-based decline in consumer expenditures that is typically associated with the aging process. The end result is the more mature generation of consumers will likely pay more attention to actuarial tables, life expectancy, and financial planning and less attention to impulse, short-term consumption.

At the same time, a shift in retirement financing might place downward pressure on disposable income of the younger generations that are likely to carry the bulk of the future burden. These long-term changes bear careful attention in light of the policy debates and the heated emotions they have triggered.

### Retail Sales

In early 2005, the retail sector continued to exhibit relatively strong sales, attributable in part to consumers cashing in holiday gift cards to take advantage of seasonal sales. The strong retail sales results for the first quarter were welcomed by many, although there is concern as to how long sales will hold up without improvement on employment, both in terms of number of new jobs and wage levels. Indeed, some of

the strength in the first quarter was attributed to the increase in tax refunds that exhibited a healthy increase over the prior year despite the absence of new cuts.

In terms of merchandise lines, apparel sales have been fairly strong, while sales weakened for big-ticket items. Similarly, automobile sales have been sluggish, reversing the surge of activity at year end 2004 when consumers took advantage of the latest incentive offers.

The retail sales situation is reflective of consumer confidence levels that are stronger for the current situation and weaker for future prospects. As was the case in 2004, the strength in retail sales has been buoyed by sales at the upper end of the market, which have more than compensated for slipping sales among moderate-level to lower-end retailers.

Looking forward, the outlook is for retail sales growth to keep pace with that of the broader economy. The outlook may continue to vary by income segment, with higher-end households continuing to outpace their more moderate counterparts whose discretionary income is eroded by higher energy costs and tepid wage increases.

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The recent increase in sales at some mid-priced and low-priced department stores, however, is a welcomed sign. These improved sales figures suggest that middle income consumers were willing to eschew concern over mixed signals for the broader economy. This reversal of a downward trend can be attributed in part to the dramatic growth in lower-cost imports from China due to expiration of the quota system. Going forward, the retail sector is likely to be dependent on improvement in consumers' fortunes.

### Housing Market

The housing market began 2005 with a strong showing, once again helping stimulate the overall economy and boost household net worth. The housing market is one of the key sectors that remains interest-rate sensitive and has some exposure to rising

rates; however, the housing market has shown few signs of reaction to the prospects of higher rates. One factor is that the increase in short-term rates has yet to ripple over to higher long-term rates. The mortgage market's insensitivity to short-term rate increases can be attributed in part to the wealth effects of the recent, prolonged bull housing market. Indeed, recent increases in homeownership rates, which are at record levels, show no signs of abating. This strong appetite for ownership housing should be insulated from moderate increases in mortgage rates, although more aggressive increases could temper demand.

Increasing mortgage rates could be problematic if they come at a critical point, such as when the housing market enters its active summer period. There also is a risk that the housing market could stumble if rates rise more than expected and owners hoping to move to capitalize on job opportunities find themselves tied to illiquid housing units. This is particularly true in the slower-growing secondary and tertiary markets where job growth is likely to lag the overall economy.

In many of these markets, housing appreciation rates have been primarily driven by low rates and easy financing rather than by increased demand and tightened supply. While this scenario should be localized, negative publicity could have a sobering effect on investment-driven homebuyers who make purchases to capture the seemingly limitless appreciation. This trend is punctuated by the dramatic increase in the sale of second homes and a tripling of the percent of households who reported that they purchased housing primarily as an investment.

The continued acceptance of adjustable-rate mortgages (ARMs) in spite of prospects for rising rates suggests that many households are stretching to get into new housing. At the same time, lenders are increasingly using prepayment penalties to provide some insulation from early repayment of option ARMs, which feature low introductory rates. Indeed, estimates of such penalties range from 40%- 70%, varying by lender and type of ARM and the level of points paid up front.

If the economy continues to expand, and this is followed by job and wage growth, the housing market might be able to make a smooth adjustment to more typical long-

term mortgage rates. However, more abrupt changes and a tightening of underwriting standards could create a more challenging environment. This situation has been particularly pronounced with respect to workforce or affordable housing, where many buyers have been unable to satisfy the appetite for homeownership. While the prospects of rising rates will not help this sector, continued efforts to stimulate the production of affordable housing might create some opportunities. The homebuilding industry will be watching mortgage rates, underwriting, and consumer demand very closely, with housing starts moderating somewhat.

Evidence suggests that the housing market will continue to be frenetic, especially in the peak summer months. Despite concerns in some markets over the liquidity of existing stock, there is relatively little risk of a major correction in the overall housing market. Over the near term, the housing market should continue to perk along and defy traditional economic principles. New buyers who have watched their peers gain from the home appreciation are likely to stretch to make purchases in the face of moderate increases in mortgage rates. In this environment, lenders are expected to step in and use creative financing and adjustable rate programs to help maintain a healthy market.

## Real Estate and Capital Markets

### Overview

Going into 2005, the capital markets continued to provide strong capital flows to the real estate sector. Indeed, there are few signs that the pent-up demand for investment product will abate, holding cap rates at historical lows. In light of this strong demand for equity and debt opportunities, the moderate improvement in real estate fundamentals that is expected to occur is likely to place more upward pressure on prices. To this point, there is little evidence that cap rates will trend upward. When coupled with flattening of the yield curve and tightening spreads on commercial mortgage backed securities (CMBS), the debt market should also remain strong.

In this environment, equity and debt players are expected to be more aggressive in sourcing product, moving out on the risk spectrum in pursuit of opportunities and higher yields. While this demand may

ultimately support new construction activity, the market has remained relatively constrained. However, the upturn in capacity utilization and the fact that many companies have tightened their real estate holdings suggest that a surge in economic activity could lead to a wave of new development. A risk factor supporting this tendency is the fact that analysts have begun building low, exit cap rates into their pro formas, which translates to attractive returns for assuming entrepreneurial risk. While current pricing models may hold for the near term, it is unlikely that cap rates will hold over the intermediate term, suggesting that analysts should use wider spreads between going-in and exit cap rates.

The good news is that rents should recover in many markets, dampening the effect of rising cap rates. The fact that the market seems to have discounted a continuation of the good times of low yields is somewhat disconcerting. If cap rates move more quickly than the market, few markets can be expected to be able to support rental increases of the magnitude that would justify projected sale proceeds, placing downward pressure on holding-period internal rates of return. Notwithstanding such concerns, the real estate capital market should remain active and healthy over the near term.

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### Construction Activity

During early 2005, the upward trend in total new construction expenditures increased, continuing the upward trend of prior years. While much of these gains can be attributed to the housing market, more recent gains can be attributed in part to rising activity in the nonresidential sector. The improvement in private nonresidential development has been fairly widespread, with commercial, office, lodging, and manufacturing all showing modest gains.

Despite these modest increases, nonresidential construction activity levels remained significantly below levels of five years ago. The exception to this pattern

has been commercial activity (a category that includes retail centers), which has remained relatively strong and has converged on earlier peak levels. This strength can be attributed in part to strong consumer sales and the emergence of new shopping center formats (e.g., lifestyle centers, mixed-use projects, infill development, and transit-oriented development) that have stimulated new retail-related construction activity. The outlook for commercial construction is for continued moderate expansion, as developers seek to capitalize on ready access to capital and investors seek higher returns on the margin to offset lower returns on existing, core assets.

### Commercial Mortgages

The commercial mortgage market remains healthy, with lenders continuing to compete for deals to satisfy allocations. In terms of total volume, activity is expected to remain on an upward tick as investors seek to capitalize on low-cost debt and lock in costs in the face of likely increases in rates. Pent-up demand for product, the modest improvement in real estate fundamentals characterized by declines in vacancy rates, and firming up of rent rolls should offset anticipated rate increases.

Looking at the industry from the mortgage banking side, the multifamily sector leads in terms of new originations, followed by office and retail, and trailed by other property classes. Indeed, in 2004, multifamily loans accounted for over one-third of commercial loan activity, while office financing accounted for one-quarter. Going forward, private loan activity is expected to continue at a robust pace, with lenders funding new transaction and refinancing maturing loans.

With respect to sources of capital, conduits (e.g., CMBS) led the pack with about 30% of total activity. While this market share was respectable in terms of year-over figures, conduits lost some of their edge over commercial banks and life insurance companies, which enjoyed a surge in activity. On the CMBS front, activity should remain strong, with a combination of new issuances and maturing securities fueling continued expansion of the asset class. For 2004, issuance of CMBS hit a record pace, pushing \$100 billion. This strong volume can be attributed to a number of factors including: refinancing activity as rates remained low;

stable and rising property values associated with low cap rates and improving fundamentals; low default rates; and expansion of the capital base for CMBS.

Due to strong investor interest and competition from private lenders, spreads continued to decline. In terms of property types, office and retail continue to be the dominant sources of collateral for CMBS, accounting for over two-thirds of issuances, followed by apartment, and then warehouse/industrial and hotels with other sectors making up the balance of collateral backing.

While the current state of the CMBS market remains strong, there is some concern that the pressure for deals may be exposing the industry to future risk of defaults and losses. Of particular concern is a movement toward more aggressive underwriting that is shifting more value attribution to improved market fundamentals and investment performance. At the same time, debt exposure is rising, especially for marginal borrowers lacking capital or seeking to reduce equity exposures. The good news is that such risks are not widespread, varying by originators. The real estate market continues to show some improvement in fundamentals, although not to the point that will insulate weaker properties and stressed borrowers.

***Due to strong investor interest and competition from private lenders, spreads continued to decline.***

### Private Equity Market

As with the equity side of the market, the commercial mortgage market has remained flush with capital, both on the private and public front capital markets should remain plentiful and supportive of an active real estate market with little risk of capital shortages. The private equity market continues to benefit from excess demand for investment-grade product. This supply-demand imbalance has placed upward pressure on prices, leading to cyclically high total returns. Indeed, for 2004 the NCREIF Index pushed the midteens. This strong performance was driven by aggressive appreciation rates as institutional appraisals

began to reflect recent cap rate declines that investors had struggled with for some time. Indeed, of the approximate 15% annual returns, more than half came from appreciation, while income yields came in at somewhat disappointing levels with respect to long-term allocations.

With respect to sectors, the strongest appreciation rates were recorded for retail, which helped reduce the gap between private sector pricing and public sector performance in which retail has led the pack. Apartments also regained some lost ground in terms of valuations, while hotels lagged. Looking back, the strong double-digit returns experienced by the NCREIF Index are a marked contrast to the sober outlook for the private industry where forecasters had been trying to figure out how to get investors comfortable with single-digit returns.

***The private equity market continues to benefit from excess demand for investment-grade product.***

While such an outlook remains, the strength of capital flows to real estate and strong domestic and foreign investor demand are likely to forestall such a reckoning. The hope is that improving market fundamentals will offset a return to more traditional pricing models, although

there are few signs that the recovery in market fundamentals will be that robust. For the balance of 2005, the private equity market should remain healthy, with strong capital flows and a shortage of deals.

### Public Equity Market

The public equity market provided investors with strong performance for 2004. For the year as a whole, the composite index provided returns slightly over 30%. Retail was once again the darling of the public industry, with returns coming in at a whopping 40%, with regional malls even higher. The other property sectors also enjoyed strong performance, all exceeding 20% on an annualized basis.

Due in part to the sheer strength of financial performance—and partly behind the strong numbers—capital raised by REITs approached the record levels of

the mid- to late-1990s, with over \$38 billion of total capital. Initial public offerings (IPO) activity was also up. Helping further enhance performance, REITs also turned to the debt market, with unsecured capital rising at near-record levels. Based on this stellar performance, some observers entered 2005 wondering when it would all come to an end. This question was short-lived, with REITs beginning the year with an 8% decline, with no sectors being spared from the downturn. The weakest sectors were apartments and industrial, which were down lightly over 10%, with retail close behind.

Through the end of the first quarter, there was little improvement in REIT performance, with declines in March reversing the modest gains in February to end the quarter on a down note. This situation reflected a combination of forces including profit taking and portfolio rebalancing after a solid bull run.

Given the early performance in 2005, the outlook for REITs is somewhat guarded. Improving market fundamentals may help the sector recover, although there are few signs that returns will rebound to 2004 levels. Despite disappointing returns, investors appear to have established firm asset allocations to real estate, providing some insulation from further declines. On the other hand, investors who are currently over weighted in REITs can be expected to pull back somewhat. In this environment, investors are likely to spend more time scrutinizing the REITs in their portfolios, placing pressure on management to hit estimates and capitalize on improving fundamentals. Thus, the outlook is somewhat rocky, although it is unlikely that the bottom will fall out unless the recovery in market fundamentals stumbles or lags the overall economic recovery more than expected.

## Real Estate Outlook

### Office Market

**A**t a national level, vacancy rates have improved, although the sector has not turned the corner. In a number of markets, positive net absorption has led to a gradual decline in vacancy rates. While improved market conditions have been welcomed, few expect a major resurgence until the economy picks up more momentum.

Given the tenuous nature of job formation, continued improvement in the office sector will depend on continued tempering of new construction. While this might appear to be a foregone conclusion, there are some signs that developers will attempt to rekindle stalled projects to take advantage of some of the opportunities in the sector. Although new development may be justified in some markets, there is little support for a renewal in office construction activity. Unfortunately, the lure of low cap rates and ready supplies of capital may tempt some to jump the gun.

To the extent that development remains in check or is tempered with improvements in net absorption, office conditions could improve to the point that net rents might begin to increase. While this would be a welcomed turn of events for many owners, it could create some upward pressure on near-term vacancy rates. That is, in a number of markets and submarkets, Class B and Class C tenants have moved into Class A space to take advantage of reduced rents. To the extent overall market fundamentals improve and rents rise, these tenants can be expected to vacate space, creating a form of shadow vacancy that could adversely affect net absorption and lead to an erosion in market fundamentals.

This risk could be offset by a robust rate of growth in office demand, although few are arguing that such resurgence is in sight. On the other hand, the fact that many firms have shed surplus real estate to address bottom-line concerns suggests that economic expansion could lead to additional positive net absorption that would help strengthen market conditions.

Although office fundamentals remain somewhat tenuous, capital flows to the sector from investors and lenders continue to be heated. This has led to an extension of the recent pricing models, with low cap rates based on stabilized income levels. Current pricing might be undercut by the fact that a significant number of current office leases, written in more favorable times, will be rolling over in the near term. In the face of tepid demand, such rent rolls may place downward pressure on values as pro forma rental levels can be expected to decline.

This situation could be amplified by an increase in cap rates as investors begin to demand risk-adjusted returns that are more in line with long-term averages and rising costs of debt. Thus, while office fundamentals can be expected to gradually improve, investment performance might lag until the economic recovery accelerates to compensate for such downward pressure. In the meantime, the outlook is for “much of the same,” with strong capital flows holding prices and marginal fundamentals inhibiting performance. The good news is that current owners should find a ready pool of potential buyers, helping to maintain prices.

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### Retail Market

**T**he retail sector has proven to be fairly resilient, with market fundamentals benefiting from strong consumer expenditures. At the same time, retailers have been in an expansion mode, seeking new opportunities to gain market share. The end result is an extremely competitive environment. This competition is not new to the retail arena. Many players have strong marketing and business acumen that will enable them to pull up the overall sector at an aggregate level, while outperforming at an individual level.

On the product side, the retail sector continues to innovate, with a new wave of lifestyle centers, mixed-use projects, and other nontraditional formats receiving the bulk of attention. This activity is expected to gain momentum, as efforts to use real estate development to affect desired public policy goals will be extended even further. Of particular interest will be efforts to stimulate urban retail to complement the movement toward urban revitalization. Similar attention will be placed on brownfield development as communities attempt to shore up their cores using retail as an important component of change and support for infill development.

In terms of real estate fundamentals, the retail sector is likely to continue to outperform other property types.

However, the continued industry consolidation (e.g., Sears and Kmart, Federated and Macy’s) is likely to create some challenges as retailers rationalize their portfolios. While many owners will view the closure of surplus properties as an opportunity to upgrade their tenant rolls, others will struggle to fill surplus space that has suffered from erosion in market fundamentals. Nonetheless, the prospects for retail remain fairly strong, although current owners will have to defend their market shares from the new competition in many of the new formats.

The battle over big-box retail has shown few sides of abating, with some key retailers making more aggressive responses to anti-big box sentiment. The intensity of the battle is punctuated by the fact that “Googling” the words “Wal-Mart” and “anti” returns some 875,000 references. Clearly, this is unlikely to change over the near term. While it is unclear what the end result will be, it is apparent that there will be more creative solutions proposed on both sides. The degree of accommodation by big-box retailers will be tempered by the fact that the very policies that are being most scrutinized go to the heart of the business model: low costs and high volume. Thus, the stage is set for a contentious period.

While the most immediate impact will be on the markets and retailers in specific battles, the spillover effects will undoubtedly affect many other markets and retailers. This situation is likely to lead to more polarization at a time when retailers, planners, and other parties need to address urban problems in a collaborative manner. Hopefully, business and consumer interests will converge to the point that the industry will be able to develop more sustainable, economically viable retail models within the parameters of public policy on managed growth.

***The battle over big-box retail has shown few sides of abating, with some key retailers making more aggressive responses to anti-big box sentiment.***

## Industrial/Warehouse Market

The industrial sector showed some signs of improvement during 2004, although the market was relatively static for much of the year. This situation has typified the past several years, and has been built into current pricing models. The end result is a sector that has been stuck on a plateau, with little movement in either direction. While this situation is unlikely to dramatically change during 2005, there are some positive signs. For example, manufacturing activity and employment has picked up, with the year-over figures some of the strongest numbers in five years. To some extent, this increase in activity can be attributed to the cheap dollar, which has stimulated exports, helping fuel production activity in markets where U.S. manufacturing has a competitive advantage. Similarly, there has been some improvement in distribution hubs, although companies have been reluctant to build significant inventories in anticipation of a burst of demand.

On a positive note, capacity utilization has increased from its trough, although it still remains below historical standards. Due to the relative ease of industrial construction in terms of entitlements, construction periods, and costs, there is some concern that

***On a positive note, capacity utilization has increased from its trough, although it still remains below historical standards.***

improvement in market fundamentals associated with an economic recovery could be undercut by a wave of new construction. While some of this activity will be warranted to replace functionally obsolescent facilities, it bears close watching. Despite continued concern, the industrial sector should continue to attract strong capital flows, holding

up values as investors seek to balance their portfolios across property types and markets.

## Apartment Market

Over the past several years, the apartment sector has struggled with high vacancy rates dampening performance. While some of this weakness can be attributed to additions to supply, the cannibalization of renters by low-cost ownership housing has been a major culprit. Market fundamentals eroded as former renters took advantage of low interest rates, raising homeownership rates to record levels.

During 2004, there was some improvement in market fundamentals, with national vacancy rates trending slightly downward, reversing the upward spiral that had affected many markets. Despite this situation, some rental markets remained relatively tight, especially those with supply constraints. Similarly, in expensive housing markets with low housing-affordability levels, the decline in interest rates was not sufficient to allow moderate income households to enter the market, especially traditional, single-family housing with a reasonable commute.

Going forward, there are some signs that as the economy picks up, household growth will increase rental demand and help absorb some of the excess supply that has hung over the sector. While the recent pace of economic growth does not suggest a quick fix for the sector, during the balance of 2005, there is likely to be some overall improvement. Indeed, in some markets concessions will continue to decline, with leasing activity picking up and moderate increases in net rents possible. Since some of the volatility has already been wrenched out of the apartment sector, strong investor demand is likely to help fuel an active transactions market. As such, cap rates should remain rather stable, although further declines are unlikely. Institutional capital will continue to favor larger properties, providing some support for urban markets and new development associated with programs to revitalize urban cores.

## Conclusion

During the remainder of 2005, the commercial real estate market should continue to enjoy robust activity in terms of transaction volume. However, the moderate economic outlook suggests that improvement in real estate fundamentals is likely to be relatively flat on the demand side of the equation. While some construction activity has picked up, much of it has been in niche areas (e.g., lifestyle centers, mixed-use). Strong capital flows continue to fuel investor demand and may leak over into the construction arena as pro formas get closer to penciling out if a market cure is built into the assumptions. Assuming everything remains on track, the asset class should be relatively stable, with continued upward pressure on prices.

This somewhat sanguine outlook is not to say the asset class is out of the woods. In particular, there is some risk due to rising interest rates and inflation which may directly and indirectly affect the market. The good news is that there are few signs of a major collapse. Indeed, even if the economy slips, the fact that real estate fundamentals have bottomed out and investors seem resigned for stable but unspectacular returns, provides some cushion. While cap rates are unlikely to decline much further, it is likely we will be reading more about “record prices” as investors jump on premier assets that come to market at the end of the cycle. Thus, the real estate market should continue to be active, with some upside potential led by improving fundamentals. However, current income yields are unlikely to pick up due to continued price pressure until the economic recovery accelerates and rental increases can be supported.