Emerging Trends in Real Estate®

2007

Urban Land Institute

PricewaterhouseCoopers

Emerging Trends *in* Real Estate® 2007

Contents

1 **Executive Summary and Preface**

2 **Chapter 1 Nothing Lasts Forever**
- 3 No More Easy Money
- 5 Wall Street's Expanding Influence
- 6 More Fundamentals, Less Frenzy
- 9 Definition Creep: Searching for Value
- 10 Development Costs Zoom
- 11 The Economy and Real Estate: Enough Momentum Amid Uncertainty
- 14 Best Bets 2007

16 **Chapter 2 Real Estate Capital Flows**
- 17 Time to Question?
- 19 Private Investors
- 22 Pension Funds
- 23 Foreign Investors
- 24 REITs
- 25 Banks and Insurers
- 26 CMBS
- 27 Mezzanine Debt

28 **Chapter 3 Markets to Watch**
- 29 Global Gateways
- 32 Development Havens
- 34 Major Market Review
- 40 Smaller Market Prospects

42 **Chapter 4 Property Types in Perspective**
- 45 Apartments
- 47 Hotels
- 49 Industrial
- 51 Office
- 53 Retail
- 55 Housing
- 56 Niches

58 **Interviewees**

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Executive Summary

- In 2007, real estate investment returns decline from recent peaks, comfortably producing average to above-average performance. Moderately rising property cash flows help offset modestly increasing cap rates. Investors will need to rely on asset management skills to boost leasing and rents in the absence of cap rate compression. A slowing economy and underlying event risk add cautionary notes.

- By any measure, capital will continue to pour into real estate markets, but at more restrained volumes in the wake of lowering return expectations. As long as stocks and bonds sputter, the property markets should retain their comparative allure. Leveraged private investors back off and are replaced by institutional cash buyers and foreign players. Hedge funds remain a wild card—this flight capital could overreach or leave quickly.

- Nosebleed pricing levels continue to favor sellers over buyers, who may not be able to achieve significant value gains during holding periods into the next cycle. Long-term owners seem best positioned to benefit from improving property revenues after enjoying fabulous appreciation returns. The transaction environment becomes less frenzied—pricing pressure eventually relaxes except in low-vacancy 24-hour markets.

- Lenders will tighten underwriting standards—lowered spreads and weakened covenants finally raise concerns. Improving market fundamentals will delay the surfacing of any problems in recent vintage loans, but issues could arise when refinancing looms. Default and delinquency rates have nowhere to go except up.

- Skyrocketing development-related costs (material, labor, entitlements) temper new commercial construction, helping keep supply in check. Most markets cannot sustain too many new office, warehouse, or retail projects. Failed condo conversions and developments may turn into rentals, negating the need for new apartments despite heightened tenant demand.

- Increasing property taxes, high energy costs, and pricey insurance premiums, especially in prime coastal regions, will challenge landlords and gnaw at property revenues. Improving demand tracks behind previous cycles in office and warehouse. Expect modulated revenue gains below some overly optimistic transaction pro formas.

- Housing markets head sideways or down after an unprecedented and unsustainable run-up. Prices advanced beyond affordability limits for many buyers in the face of higher mortgage rates. Builders need to back off in many regions where demand softens. Some speculators may get hammered. Except for recent buyers, most homeowners will fare well, cushioned by a decade of stellar gains, although higher property taxes bite in many places.

- Coastal metropolitan areas, particularly 24-hour cities on global pathways, remain the favored investment markets. New York, Washington, D.C., Los Angeles, San Francisco, and Seattle stand out. Sunbelt development havens show improved prospects, but trail the global gateways, which concentrate higher-paying jobs in burgeoning financial, high-tech, and health care industries as well as in international trade. Manufacturing-oriented markets, particularly in the Midwest, continue to struggle.

- All property sectors show reasonably good prospects led by moderate-income apartments, full-service hotels, and warehouses. Office markets should improve—vacancies will decline further and advance rents. Only retail expectations ebb—consumers may finally take a breather.

- Infill locations, especially near mass transit stops, remain attractive to investors and developers. People look for greater convenience and reduced car dependence. Suburban nodes will increasingly look more urban with mid- and high-rise apartments clustering around shopping centers and office cores and in new town centers.

Preface

Emerging Trends in Real Estate® is a trends and forecast publication now in its 28th edition, and is the most highly regarded and widely read forecast report in the real estate industry. *Emerging Trends in Real Estate® 2007*, undertaken jointly by the Urban Land Institute and PricewaterhouseCoopers, provides an outlook on U.S. investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues.

Emerging Trends in Real Estate® 2007 reflects the views of over 600 individuals who completed surveys or were interviewed as a part of the research process for this report. Interviewees and survey participants represent a wide range of industry experts—investors, developers, property companies, lenders, brokers, and consultants. ULI and PricewaterhouseCoopers researchers personally interviewed over 213 individuals (see the end of this report for a list of those interviewed) and survey responses were received from 404 individuals, broken down as follows:

34.8%	Private Commercial/Multifamily Property Companies or Developers
17.5%	Real Estate Service Firms
14.2%	Institutional/Equity Investors or Advisers
9.1%	Homebuilders or Residential Land Developers
6.3%	Lenders or Mortgage Bankers/Brokers
5.6%	Publicly Traded Commercial/Multifamily REITs or Operating Companies
12.4%	Other

To all who helped via surveys or interviews, PricewaterhouseCoopers and the Urban Land Institute extend sincere thanks for sharing valuable time and expertise. Without the involvement of these many individuals, this report would not have been possible.

"Operating *performance will be key.*"

Nothing Lasts Forever

Having crested during 2006 after a decade's worth of superior performance, the U.S. commercial and multifamily real estate investment market will slow down in 2007, comfortably producing average to slightly above-average investment returns. Most *Emerging Trends* interviewees expect to "sleep well at night," since improving supply/demand fundamentals in most property categories will help offset negative impacts of modestly rising capitalization rates and a laboring national economy.

Enamored capital, meanwhile, exercises slightly more restraint—"astronomical" flows into properties will decelerate merely to "moderately oversupplied." Focused on real estate's recent outstanding track record, many investors "will continue to act as if it [were] yesterday." Pension and global money sources pick up most of the slack as leveraged buyers back off in the face of higher interest rates. Until the stock market rebounds well into double-digit return territory or a series of blowups hits the property markets (neither of which is likely in 2007), investor demand—from equity and debt sources—should remain ample enough to cushion existing pricing levels.

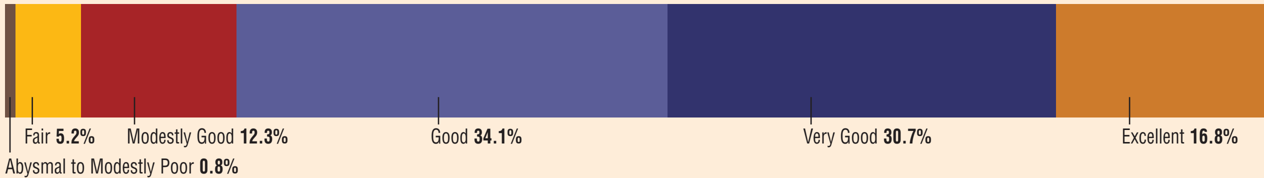
No More Easy Money

Portfolio returns now will depend on managers' ability to increase property revenues through leasing and asset enhancement, not effortless cap rate compression. "Operating performance will be key." Expect returns to revert to high single digits for core properties, close to their historical mean. Value-added and opportunity funds will see returns retreat to levels in the low to mid teens—relatively attractive, but well below recent dazzling performance. Real estate players want to believe that an unprecedented decade-plus of halcyon returns will endure indefinitely, but somehow sense "the boom is over."

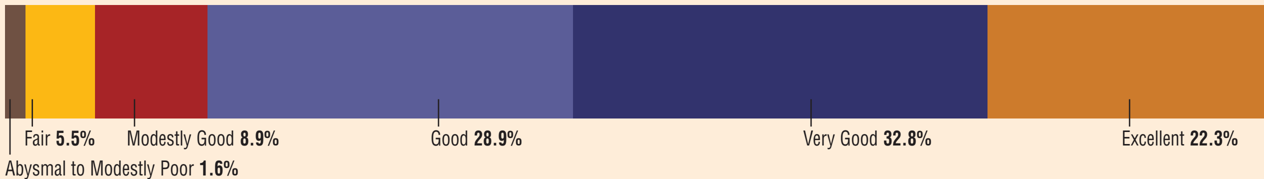
Everyone will lament the ending appreciation binge, but then again real estate has always been touted as an income-oriented investment. Welcome back to reality. Some recent vintage "priced to perfection" deals could struggle in the future under negative leverage and increasing expenses from high energy costs, rising taxes, and pricey insurance premiums, not adequately factored into "optimistic" pro formas.

Exhibit 1-1 **Real Estate Firm Profitability Forecast**

Prospects for Profitability in 2007 by Percentage of Respondents



Prospects for Profitability in 2006 by Percentage of Respondents

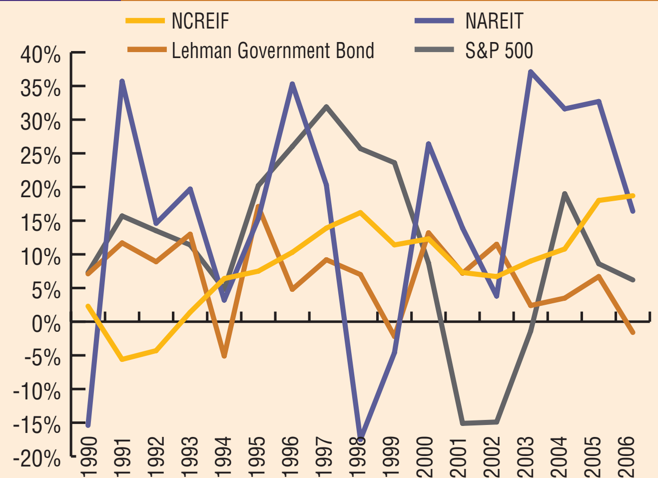


Source: Emerging Trends in Real Estate 2007 *survey.*

Relative Equilibrium. Skyrocketing development costs—for land, entitlements, materials, and labor—have deterred an unhealthy escalation in new construction. While helping keep new supply in relative check, rising replacement costs also give comfort to some investors who can argue that exorbitant prices for existing properties are justifiable. "We may be overleveraged or have overpaid, but we are not oversupplied," crows an investor. Adds a pension consultant: "We see no catastrophes or screeching-halt scenarios."

No Immunity. Still, institutional and hedge fund capital starved for yield—given tepid stock and bond markets—may fuel the project pipeline as the reality sinks in that "you cannot flip properties anymore" for outsized gains. "It always happens at this time in the cycle." Except in select sectors and markets with high barriers to entry, tenant demand will not support much additional new space. Builders should take note of cratered condominium developments and reeling homebuilders. Residential markets hit the wall in 2006 once mortgage rates began to bite buyer appetites for houses at stratospheric pricing in some areas. Despite improved transparency and research discipline, the commercial markets cannot claim immunity from overbuilding.

Exhibit 1-2 **Returns: Real Estate vs. Stocks/Bonds**



Sources: NCREIF, NAREIT, S&P.

**2006 data annualized from second quarter of 2005.*

Fear Factors. For 2007, real estate players' apprehensions shy away from commercial property market–related issues, which appear reasonably benign, and see out-of-their-control event risk as the main bugaboo. "Some exogenous shock is the likely culprit that will end this party." Concerns ebb and flow with Web site bulletins and cable TV alerts. Daily attention gravitates to the stream of reports on terror plots, Middle East

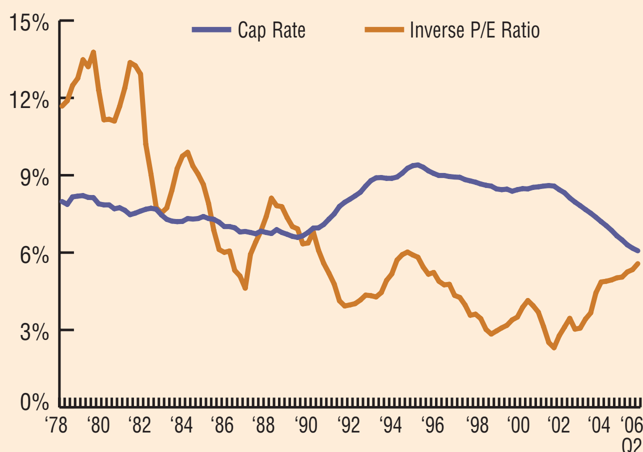
their relative value appeal.

flashpoints, Iraq war fatalities, nuclear threats, oil price shocks, and hurricane warnings. Anxiety meters ratchet up over just about anything that could spike interest rates in a seemingly more dangerous and unpredictable world. Says a leading mortgage banker: "Any major disruption would put many recent deals under water."

Although some *Emerging Trends* interviewees point out that property values stand at much higher levels than at 9/11 and have "further to drop" in an event crisis, others suggest that currently sidelined capital (upwards of $100 billion by some estimates), starved for anything resembling a bargain, will move opportunistically to backstop prices and prevent severe value declines from occurring. Real estate markets rebounded from the 2001 terrorist attacks and sidestepped the SARS scare and Katrina. For the moment, favorable supply demand dynamics position the asset class to weather any short-term dislocation. "For years now, people have been crying wolf and lost out over dire headlines when others kept investing."

Among other threats "closer to home," housing market deflation or a widespread condo market collapse could upend the psychology of sanguine investors and tar other property sectors by association. "When some real estate gets tainted, it affects all." Typically, higher interest rates take their toll gradually before forcing defaults in the residential market among overextended borrowers and speculators forced into fire sales. "The problems may not reveal themselves until well into 2007 and 2008."

Exhibit 1-3 **NCREIF Capitalization Rates vs. S&P 500 Inverse P/E Ratio**



Sources: NCREIF, Moody's Economy.com, PricewaterhouseCoopers, Standard & Poor's.

Ebbing Cycle. Jostled by threats and looking back at performance peaks, real estate markets will seek their footing in less frothy climes, expecting to retain their relative value appeal. The inevitability of cycles doesn't forecast dire outcomes, but certainly somewhat less desirable scenarios. "Real estate is cyclical. Cycles aren't dead. This is just a longer cycle than normal. You'll never see an imbalance coming. But take it to the bank, an imbalance is coming. It's just a matter of when and how severe."

The betting line suggests that real estate markets will not suffer from imbalance in 2007, just more modest performance. "There is still too much money in the marketplace and too favorable a view of the asset class."

Wall Street's Expanding Influence

Investors' perceptions of "real estate as a safe option" have focused public market interest in the asset class and prompted a raft of new managers, strategic options, and fund products to take advantage of the demand. Wall Street exerts its muscle and expands its power over how real estate is bought, sold, and financed, resulting in a capital flood to fill all the new investment niches and nourish the markets with welcome liquidity. Increasingly, property-related investments look and act more like stocks and bonds than real estate. Even if global financial behemoths are not guiding real estate investment trust (REIT) consolidation, they promote dispositions of smaller REIT portfolios into large private institutional funds, many of which other financial institutions manage. Institutional advisers—often subsidiaries of Wall Street conglomerates—offer a spectrum of core, value-add, and opportunistic property vehicles marketed not only to pension funds, endowments, and foundations, but also to offshore institutions, high-net-worth investors, and plain-old affluent individuals, many of whom are already brokerage clients.

REIT funds, meanwhile, become a more standard 401K offering in employee retirement plans, managed by various financial companies. Five years ago, investment advisers still impressed clients by talking "four [public/private, debt/equity] quadrants." In the new world order, "you play across the capital stack" where whole mortgages are "A pieces" and equity lies somewhere under mezzanine debt and "preferred equity." The entire real estate landscape and lingo transform Main Street to Wall Street.

Source: Emerging Trends in Real Estate 2007 *survey.*

Note: Prospects were rated on a total rate of return basis.

Trigger Fingers. Unleashed capital strips away old-school real estate buy-and-hold mentality in favor of trigger-finger trading. Lock in gains and get out as fast as lumpy property transactions allow. The new financier ownership mind-set takes no chance at falling in love with bricks and mortar and scorns the notion of hoarding psychic value from trophy assets. Gun-for-hire property managers and local operating partners handle day-to-day business for absentee investors, who control the equity from long distance and scrutinize quarterly revenues on laptop screens for telltale sell signals. The role of financial/institutional owners as "citizen" investors with a valued stake in the future of places and community naturally diminishes with these shorter-term perspectives. Aside from a focus on vacancy rate trends and tenant moves, far-flung ownership increasingly disconnects from local needs and priorities with uncertain consequences for cities and suburbs, especially in down markets where staying the course may help the long-term viability of certain communities and regions.

Mainstreamed. Global fixed-income investors, meanwhile, slice and dice their risk/return options, tapping into real estate debt markets through an "alphabet soup" of securitized mortgage tranches. Investment bankers have morphed commercial mortgage–backed securities (CMBS) structures into collateralized debt obligations (CDOs) using leverage to juice returns on diversified pools of debt instruments. Fixed-income managers relentlessly engineer real estate cash flows into instruments that mirror the complexity of corporate bond structures. Synthetic real estate securities and derivatives are coming attractions. Many investors in these instruments may have hardly a clue about what properties ultimately back their holdings. Agency bond ratings, analyst forecasts, and tenant credit reports substitute for old-fashioned kick-the-bricks knowledge. But it all means more dollars flowing into real estate from the capital markets.

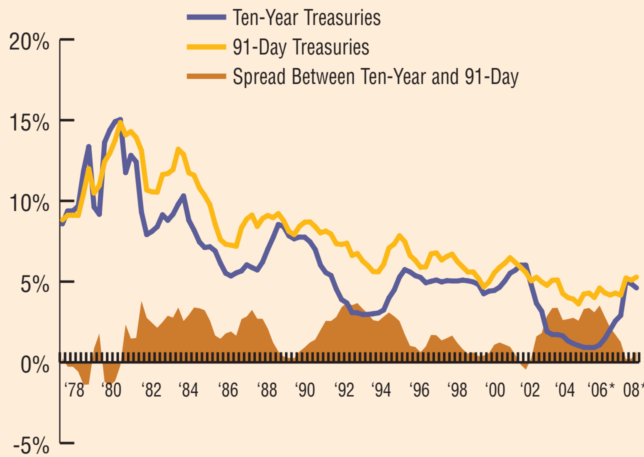
Make no mistake: Wall Street rules by turning real estate "mainstream."

More Fundamentals, Less Frenzy

This mainstreaming and the stupendous "weight of capital" directed into real estate markets over the past decade have driven down capitalization rates and rocketed prices well ahead of actual property revenues and supply/demand indicators. An unprecedented run of property appreciation has attracted more money from new investors and forced down cap rates further. Since our 2005 report, the consensus *Emerging Trends* view has been that rising interest rates would push cap rates up and that property-level net operating income (NOI) would need to increase enough to maintain or increase values going forward. The real estate world anticipated a great race between interest rates, cap rates, and NOI, hoping that revenue growth would prevail.

Until mid-2006, the race had been more like a casual stroll, with cap rates still standing at the starting line. Over the past two years, short-term interest rates increased in modulated steps after a long series of Federal Reserve quarter-point hikes in the Fed funds rate. Long-term rates finally edged up, and NOI

Exhibit 1-5 Interest Rates and Spreads



Sources: Moody's Economy.com, PricewaterhouseCoopers, Federal Reserve Board.

**Forecasts by Moody's Economy.com.*

kicked into gear as vacancies declined across most property sectors. Cap rate compression generally ended during early 2006, but rates steadfastly held their ground or dropped even further in top office markets like midtown Manhattan and Washington, D.C. The biggest questions facing investors approaching 2007 remain: "When will cap rates increase?" and "How much?"

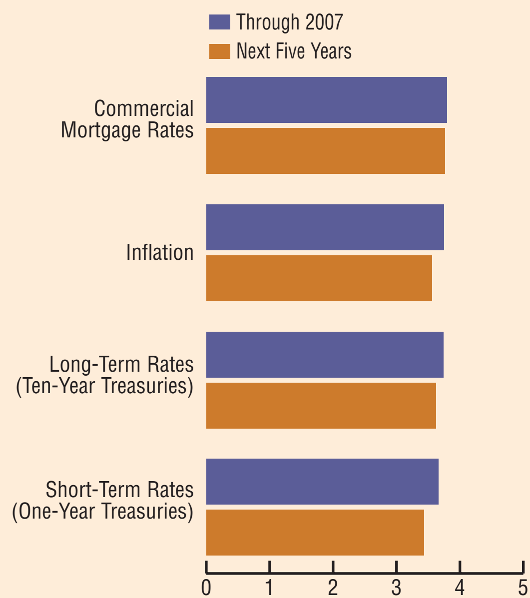
Cap Rates Shift. Well, fire the starting gun . . . again. "Cracks" in the cap rate foundation "have started to appear." Investor fervor for B-quality and especially C-quality properties has begun to abate, and interviewees and survey responses suggest that cap rates will climb modestly—25 to 75 basis points—over the next year in those categories. "There is still a ton of capital, but it is not as aggressively bid," says a broker. Trophy A properties will sustain greater demand and should hold their rates or experience only slight upticks. "There is very definitely a distinction developing between best-quality assets [staying down] and lesser-quality [edging up]" assets.

By late 2007 and into 2008, cap rates will adjust upward more, changing return expectations, but "not necessarily in lockstep with interest rates." Appraisers' "rear-view mirror" approach to data analysis will start to catch up with market activity during the year and show the shift. But most interviewees expect capital supply will "keep cap rates from rising too much."

Interest Rates Jog. *Emerging Trends* surveys anticipate interest rate "creep" in 2007 as well as over the next five years (see Exhibit 1-4). Absent event shock, modest increases should be manageable for investors and have been welcome news for some institutional buyers, who have been priced out of transactions. Interviewees are fairly confident that "improving property fundamentals can provide an offset" to higher rates, which have already taken many leveraged buyers out of the market. "This may allow some more deals to shake out," says a major broker, interested in maintaining high transaction volumes in the face of steep pricing. The Fed, meanwhile, appears to be slackening pressure on raising rates in the wake of mixed economic signals on inflation and housing. "Most of the pop in rates has already happened."

Refocusing on Fundamentals. The real battle for investment performance will take place at the property operating level. "Cap rates have compressed so much you can't be sure what value is," complains an investment adviser. In fact, the

Exhibit 1-6 Inflation and Interest Rate Changes



1 = fall substantially, 2 = fall moderately, 3 = remain stable at current levels, 4 = increase moderately, 5 = increase substantially.

Source: Emerging Trends in Real Estate 2007 *survey.*

unprecedented capital tidal wave had conveniently permitted many investors to ignore actual shortfalls in their property-level business plans. "Most of our deals have underperformed our pro formas," says an investment manager. "Yet our returns have been even better than we expected because of cap rate compression. We have been bailed out repeatedly by dispositions or refinancing." But that good fortune seems to be ending. In a "less overheated" transaction environment expected in 2007 and with cap rates finally advancing, "fundamentals will need to carry the day."

Bullish Sentiment. Most interviewees are "bullish" about 2007 property operating prospects and expect "reasonable yields." "Very good supply/demand metrics will continue to improve occupancies and increase rents, especially in office, industrial, and apartment sectors," contends a prominent researcher. Office and industrial vacancy rates have dropped to levels where concessions stop and rents advance in many markets. Favorable demographics for apartments—namely, the growing young adult cohort—combines with higher mortgage rates and pricey housing to escalate tenant demand for multifamily units and push substantial rent increases. Hotels should have another banner year as long as the economy holds up—new development will not begin to soften lodging markets until 2008. The only consistent notes of doubt sound for retail, where concerns linger over whether consumers can keep spending and construction activity promises to add "more space than necessary" in the lifestyle and power center categories.

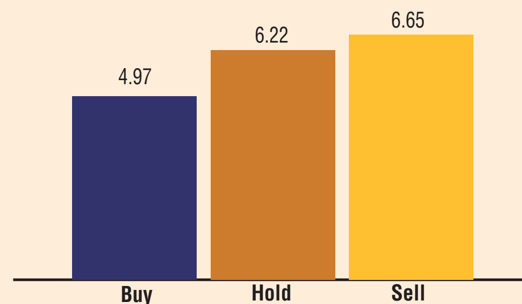
Rising (Taxes) Expenses. Asset managers must confront troubling expense projections, which cloud general optimism about NOI growth. "Many investors haven't considered the impact." Energy costs raise utility bills for common areas, and tenant pass-throughs ultimately limit what they may be willing to pay for space. Insurance expense rises across the board, but especially for buildings near vulnerable coastlines where many carriers have abandoned coverage. Property taxes sting the most. States and local governments, straining to meet needs, see manna from heaven and collect on value gains registered in recent property sales activity. Separately, many jurisdictions add on transaction fees and special assessments, which eat into initial return forecasts.

Tempered Buy-Hold-Sell. After hitting its highest sell rating ever (8.24) on last year's *Emerging Trends* transaction barometer, the survey's sell sentiment declines dramatically to a still-respectable 6.65 (see Exhibit 1-1). Last year's mediocre buy rating rises marginally from 4.56 to 4.97, and the hold rating slips slightly from 6.37 to 6.22. The relative leveling off of buy-hold-sell outlooks suggests that transaction markets will become more measured and less frenzied in line with expectations of rising cap rates and ample capital availability. Investors "sit pretty" if they bought properties in the 2001–2003 period and borrowed at then record low interest rates, or have been longer-term players. They may have missed the best disposition market, but can sell profitably into the cresting capital wave or hold longer to capture expected operating gains. Buyers will continue to endure "fairly unrealistic" pricing hurdles and higher mortgage rates. Narrowed spreads to Treasury bills (see Exhibit 1-2) indicate heightened acquisition risk, approaching levels not experienced since property markets emerged from the early 1990s meltdown. "Buyers should be very cautious." Clearly, sellers retain the upper hand and holders have good options.

Buyers' Remorse. "Investing is easy today if you pay the price." Indeed, one interviewee wonders how much company he will have in five years if he comes to ask himself: "Why did I do that deal in '06?" A top investment banker warns, "Everyone has to reach today to get deals done." And an adviser adds: "People are willing to make assumptions to the max—it's a perfect world with rent spikes, no extraordinary TIs [tenant improvements], no bankruptcies, and no foreclosures." Improving fundamentals will help, but "some properties have

Exhibit 1-7 ***Emerging Trends*** **Barometer: 2007**

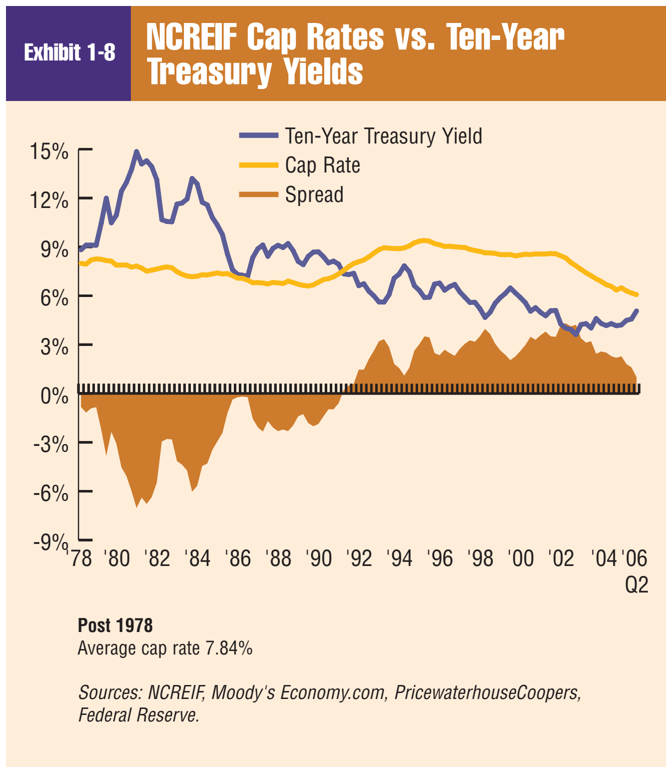
Buy/sell/hold rating prospects on a 1-to-9 (abysmal-to-excellent) scale.



5 = fair, 6 = modestly good, 7 = good, 8 = very good.

Source: Emerging Trends in Real Estate 2007 *survey.*

expectations of rising cap rates.



no chance to perform to their underwriting." Anticipate some fallout eventually when it's time to sell or refinance. "People are fooling themselves."

Less Frenzy. Frenetic sales activity finally shows signs of subsiding. Expect that trend to continue. More properties—"mostly cats and dogs"—go on the market since owners sense the topping out of the pricing cycle. "I used to see three to five deals a day, now it's up to 15 or 20, and only one is really worth looking at," says an offshore fund manager. Buyers necessarily turn more wary. Brokers attract ten bidders today when last year they had 20 or more. Some transactions collapse in due diligence "when numbers don't work." Pricing reverts more often to lower offers from second and third bidders. "There's been a subtle shift away from sellers—more hiccups, remarketing, increased buyer skittishness." Still, ten bidders can make for a robust auction and cutthroat pricing. But property flipping into cap rate compression has no choice but to end. "Owners now must be prepared to shift gears from transaction strategies to asset management, leasing, and enhancements in order to reach their numbers."

Investors relying on heavy doses of leverage were the first to retreat when higher borrowing rates transformed financing strategies from immediately accretive to suddenly negative. As a result, institutional cash buyers now have an edge. Buyers still relying on leverage or owners with adjustable-rate mortgages will need property cash flows to accelerate enough to cover debt service and other expenses. "Their expectations about fundamentals and NOI growth need to become reality."

Definition Creep: Searching for Value

Neiman-Marcus–caliber price tags on office, apartments, shopping centers, and warehouses have encouraged investors to take an expansive view on what they might consider core real estate. "It's still where most of the money wants to go and only passé at today's prices." Most pooled core funds continue to have client queues to invest and more advisers scramble to establish core funds, taking their cues from consultants who insist "even more new core vehicles are needed." Niche sectors like self-storage, student housing, seniors' residences, and medical office move into the core sphere. A few advisers now have the chutzpah to suggest that the more volatile hotel group be considered as core. Cash-rich funds buy operating companies and "do more things on the margin." Acceptable core leverage strategies had once topped out liberally at 30 percent leverage of total portfolio. Now consultants, eager to place client capital, allow up to 50 percent leverage so that fund managers can compete for product, if necessary.

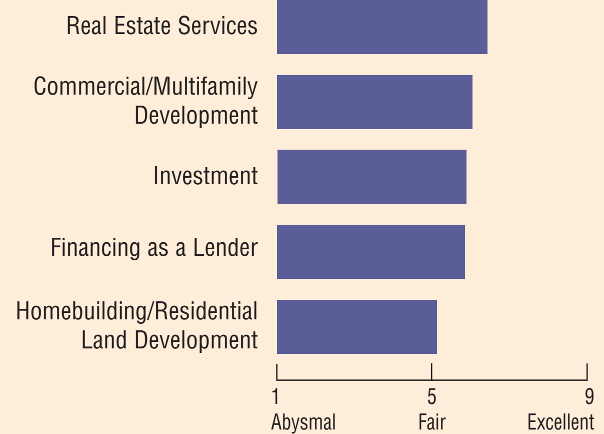
Core's Dilemma. For all the greater allowances, core investors struggle to make transaction numbers work, and face a Hobson's choice in today's market. Long-term holders have been richly rewarded by cap rate compression, but cannot count on those gains any longer. "If I don't sell and hold onto my returns, I am also not a buyer because spreads are too low," says a public fund manager, who up until now has been "a very happy camper." "But now if spreads widen and I start to buy, I'll be writing down my portfolio." At current prices, core buyers are betting on huge market recoveries that may not happen. "Their downside may be cushioned somewhat because of improving fundamentals, but at today's prices their upside is extremely limited." Any leverage strategies turn negative in the current environment. Most buyers fail to factor even the possibility of near-term recession, which would create immediate heartache. Advisers counsel against buying anything today above replacement cost. "Current value versus replacement cost is the key metric." Probably, the

"healthy" strategy for core players is "to take some money off the table." Pension funds desperate to increase allocation targets face an uncomfortable dilemma, especially as the cap rate story tantalizingly turns. Foreign investors can benefit from the weak dollar, but take their chances.

Value-Added's Increased Risk. Priced out of core and eager for yield, many investors turn temporarily to the value-added category—class B or C product often in second or tertiary markets in need of leasing or enhancement strategies. The idea is buy with generous dollops of leverage (up to 75 percent), fix up (cheaper cosmetic improvements are preferred), rent up, and get out as soon as possible, selling to core-oriented investors looking for stabilized assets. "Value-added has had better risk-adjusted returns." In fact, value-add investors have scored numerous home runs flipping assets almost at will into the continuing onslaught of capital, while taking advantage of low mortgage rates. Almost anything moved—"you could get paid as much as or more for investing in riskier assets." But the capital shift into value-add has reduced spreads for more dicey assets. "In some cases, you see more bidders for value-add and even lower cap rates than for core." Expect higher mortgage rates and razor-thin spreads to coax investors into becoming more selective. "Risk premiums are emerging again." "You need to look for quality assets with issues in good markets, not inferior assets in poor markets." For some players, the distinction between value-added and core blurs: "Returns go down for value-added just as core lards on more leverage and invests in more value-add–like deals."

Opportunity Waits. Opportunity funds engorge on "tremendous" allocations, "elephant hunting" for "big deals" to place their money "efficiently." Finding profitable transactions "has been a time-consuming safari" and like core and value-added categories, opportunity returns also fall. "You can't get 20s anymore and people won't believe you can," admits an investment banker. "Maybe we can get mid-teens at best." Opportunity returns require market disequilibrium, which has been in short supply in the United States. Domestically, big funds joint venture development, scrounge for operating companies with unlocked value potential in their portfolios, or secure land for the next wave of homebuilding. Eyes train on distressed condominium developers and converters who may

Exhibit 1-9 **Real Estate Business Activity Prospects in 2007**



Sources: NCREIF, Moody's Economy.com, PricewaterhouseCoopers, Federal Reserve.

bail out of unfinished projects or half-sold buildings. Overseas markets continue to offer "the best alpha," especially in Asia: China, India, and Japan. "Double the money is moving offshore." Some interviewees question the rush to Asia given the lack of transparency, potential for corruption, and the lack of institutionalized rules and regulations. "India is not for the faint of heart." As for China: "Fiduciaries have no business putting money there—the risks are too high, the unknowns too large. Money could totally disappear." Well, that's why they call opportunity "high risk." Only time will tell.

Development Costs Zoom

Higher construction and development costs have helped temper U.S. developer appetites and kept commercial markets from lurching into sudden oversupply, always a risk when a surfeit of capital can't find satisfying yields buying existing properties. Exploding Asian development has led to increased competition for materials, inflating prices for steel, concrete, wall board, and anything else that goes into buildings. High energy costs also increase the price for manufacturing raw materials and shipping supplies to work sites. Labor shortages don't help the cost equation either and land prices keep rising. If that's not enough, everybody complains about more expensive entitlements, new impact fees, and drawn-out planning/zoning board reviews. Get out the checkbook for lawyers and consultants, while higher

mortgage rates boost carrying costs on land. Construction costs "have been sent through the roof," setting off "the worst project overruns since the 1970s," according to a veteran lender. For developers, profits decrease toward "all-time lows." Margins have been cut in half. "You need very high rent levels to get out of projects whole." No wonder most interviewees declare "development is in check." New construction in most markets actually "stays in line with demand."

Condos Collapse. Condominium markets offer some pause in the celebration over newfound industry development discipline. South Florida is littered with stalled construction projects and empty sales offices. Projects in San Diego and other parts of southern California teeter as sales velocity melts down. Postponed projects limit Las Vegas's exposure. Condo markets from Tampa to northern Virginia to Boston and Chicago are oversupplied. Nationally in 2005, builders doubled the average number of new units constructed annually. Developers, investors, and lenders "got caught in a classic herd mentality" fueled by skyrocketing home prices. "The same crowd that invested in the NASDAQ tech bubble moved into condos" with the same disastrous results. "Late [developer] entrants pinning their hopes on speculative-investor buyers will get killed. The full hurt hasn't materialized yet, but will as low caps revert back up." Turning condominiums into rentals won't rescue most projects—the economics don't pencil out—and the vultures are circling.

No Time for Complacency. Despite prohibitive costs and lessons from the ongoing condo debacle, some interviewees warn about growing development momentum in other property sectors. Retail construction never slowed down—lifestyle centers pop up everywhere. Substantial capital pools troll for yield in office and hotels—the development lure is almost too attractive with fundamentals strengthening. Improved office markets and the promise of rent spikes encourage developers to build new product into the demand curve. If owners have land banked sites for development, their economics can be much more favorable. "People scared to death about construction a year ago have started to break ground even in office markets where rents won't support development like North Dallas, Chicago, Atlanta, Charlotte, and Raleigh." Most observers take for granted that hotel markets will soften from new projects in 2008. It's no time for the industry to let its guard down. As cap rates turn up in a higher interest rate environment, investors buying at or near pricing peaks cannot afford oversupplied markets short circuiting rent growth. Just look at the housing markets.

Housing Angst. Not surprisingly, rising mortgage rates and out-of-sight price points finally stopped some homebuyers in their tracks, especially in overheated coastal and resort markets. Homebuilders got ahead of themselves, too. About 1.7 million houses were delivered in 2005, well above the 1.3 million annual average. This oversupply, when combined with high prices and less affordable financing, equals lowered offers and reduced starts. "The wheels have started to come off" in some places. Homebuilders must discount prices to clear inventory and many first-time homebuyers on adjustable-rate or interest-only mortgage schemes may face a cash crunch. Low interest rates and easy credit also attracted the same speculator crowd that infested condo markets. The resale market builds as "for sale" signs litter neighborhood frontyards. "Average sellers who bought three or more years ago will still make a considerable profit, but more recent speculative investors won't." "They could be crushed in some markets." On average, expect prices to decline 10 to 20 percent off market highs—places that gained more will lose more. "I have been to this movie before," says a well-known homebuilder. "This is the classic response to a frothy market. We'll be back to more realistic demand and sales within two years after a shakeout." In the meantime, watch for pain as delinquencies and foreclosures increase.

The Economy and Real Estate: Enough Momentum Amid Uncertainty

Five years into recovery, the economy shows signs of slowing down, undercut by high energy prices and the weakened housing market. Employment numbers still look good, but wage increases for most workers have been anemic. Consumers somehow keep spending—maybe because they don't save. In fact, they have been spending more than they earn since early 2005. Corporations sit on cash, continuing to seek productivity gains. Everybody expects (hopes) companies will step up high-tech spending and increase hiring, but the only consistently extravagant line item in company budgets registers for executive suite compensation as CEOs strive to meet profit targets for stockholders. Inflation has been controlled largely by the Fed's interest rate hikes, but high oil prices remain a threat. And despite the weakened dollar, the nation still suffers large trade deficits thanks to a heavy dose of oil imports.

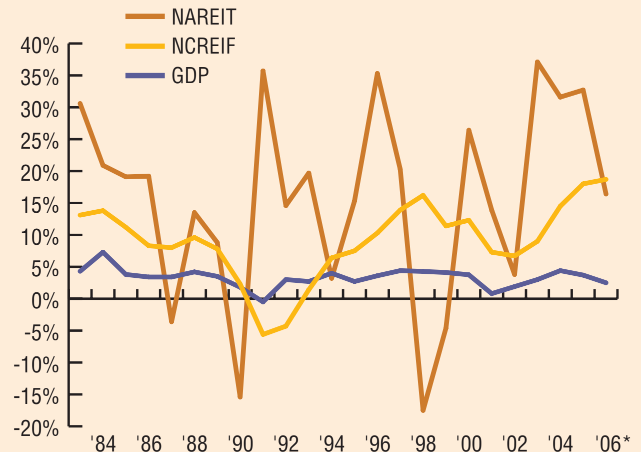
Resilient, Not Gangbusters. *Emerging Trends* interviewees reflect some negativity, but the consensus holds that the economy has enough steam to support demand growth in real estate markets, which seem well positioned "to muddle through" any mild distress associated with a slowdown. "Expect enough economic growth for solid real estate absorption." A minority view shows more concern—"the chances of recession are increasing," "people take the economy for granted and don't factor in much of a slowdown." The naysayers suggest that consumers eventually will "run out of gas" trying to keep car tanks full and homes heated, while stretching to meet debt service on mounting mortgage and credit card bills. Business spending, they contend, may not be able to make up for the homebuilding decline and a slide in retail sales, especially given that consumers constitute about 70 percent of the nation's gross domestic product. "The biggest concern is a more rapid deceleration in the housing market than anticipated." Event risk, meanwhile, shadows everything.

Survey respondents rank job growth, interest rate hikes, inflation, income/wage growth, and energy prices as the key issues facing real estate investors and developers in 2007 (see Exhibit 1-11). Terrorism, deficits, Iraq, and other issues are rated as lesser concerns.

Jobs, Wages, and Productivity. Recent low unemployment has not translated into a surge in wages, and solid profits have given corporate America apparently precious little incentive to stoke HR departments into overdrive hiring. Instead, companies stay lean and mean, focusing on productivity gains and using every trick in the book to use less space. "They want to reduce space per capita below 150 square feet to under 100," says a corporate real estate manager. Office markets see steady absorption, yet not at higher levels of past economic recoveries. Merger and acquisition activity and industry consolidations keep expenses down and eliminate overlapping positions—head counts need to be justified. Technology gains eliminate staff support functions. BlackBerrys, cell phones, and laptops substitute for administrative assistants. Offshoring becomes entrenched—overseas workers are cheaper by the dozen and link seamlessly through the Internet.

Home Substitutes for Office. More workers can stay at home, too, plugging into networks through their laptops and using wireless DSL connections. Freelancers and consultants get more outsourced assignments at the expense of full-time

Exhibit 1-10 **Real Estate Returns and Economic Growth**



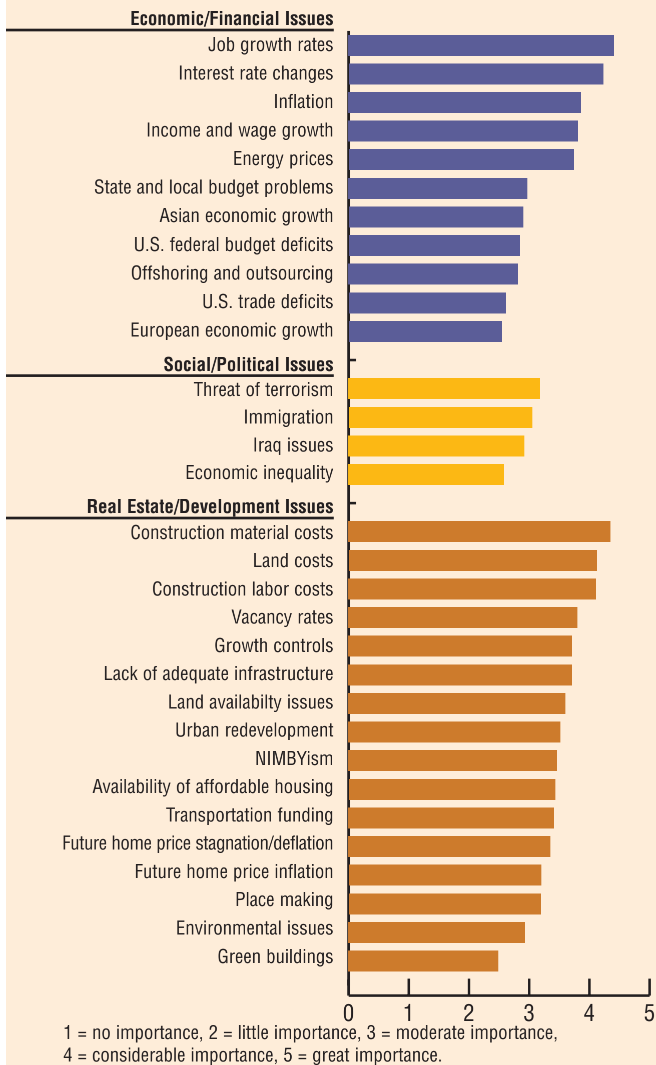
Sources: NCREIF, NAREIT, Moody's Economy.com

**2006 data are annualized from second quarter of 2005.*

employees—no need to pay benefits or provide offices or cubicles. Manufacturing jobs continue inexorably to shift out of the Northeast and Midwest to the Sunbelt states and overseas. Companies flee higher-cost union-dominated areas to right-to-work states. Wal-Mart becomes the bogeyman for a trend to lower-pay/low-benefit service jobs, replacing higher-pay/high-benefit union positions. Across the board, companies place greater burdens on employees to contribute to medical plans and reduce what they pay into worker pensions.

"Brainpower" Industries Advance. High-tech areas rebound and regions dominated by financial industries prosper—executives in these companies enjoy compensation gains. Many observers contend that business spending for technology will accelerate after a long period of holding back, providing a strong shot in the arm to software and hardware makers. Law firms and accountants also expand—they love all that extra work generated from Sarbanes-Oxley. Some high-growth areas, living off the residential housing boom, may see some retrenchment from the homebuilding slowdown.

Inflation, Energy Costs. Real estate pros always have mixed views about inflation. What may encourage the Fed to boost interest rates also helps drive up rents and showcases the value of "real estate's inflation-protected" income streams. On



balance, the industry today shows much more concern about the damage higher interest rates could inflict (rising cap rates, increased finance costs) than finding another relative value argument for why real estate can compete against stocks and bonds. "Inflation is the biggest uncertainty and biggest risk if it forces up interest rates." If gasoline and utility bills level off or decline, the Fed will have more room to relax its monetary policy. Consumers and businesses will have more cash to spend, giving the economy a boost. If energy costs increase, however, and the Fed steadily raises rates, the economy could take a significant hit. Corporate costs would increase, threatening job growth, while consumers grapple with managing strapped budgets. The housing market might sink further. Retail spending could finally nosedive and tourist/business travel would become more expensive, affecting hotels. Any oil supply disruptions cause special worry. "Somehow, it all feels more fragile."

Emerging Trends interviewees complain again this year that government inflation numbers don't adequately reflect rising construction costs, which have zoomed dramatically ahead of monthly government indexes.

Green Buildings. Out of necessity, the impact of high energy costs has renewed industry interest in conservation programs and increasing the efficiency of building systems. The "green building" movement grows in popularity and its impact could be huge: residential and commercial buildings account for 40 percent of total U.S. energy consumption. Among green strategies are insulated glass windows, plant-covered roofs for natural temperature controls, individual space unit HVAC controls, recycling systems typically powered by natural gas, and photovoltaic cells to generate electricity. The U.S. Green Building Council's Leadership in Energy and Environmental Design (LEED) rating system measures the degree to which buildings incorporate environmentally efficient designs and some states, notably California, begin to offer rebates and tax incentives to encourage implementation. While green buildings cost up to 10 percent more to construct, energy savings can approach 35 percent, and tenant demand "grows beyond Fortune 500 companies." Some major pension funds "circle green buildings" for investment due to the "significant operational savings." The green movement could put older buildings in a bind—"it can be very expensive to retrofit." But "buildings will be obsolete" if they don't upgrade. "It's the equivalent of what happened in the 1980s when fiber optics became necessary" for running newfangled computer systems and telecommunications. Some vanguard homebuilders develop "green neighborhoods," marketing to the increasingly energy-conscious homebuyer. Will the hoopla die if oil costs decline and pocketbook pressures disappear? For the marketplace, the new technologies make sense under any circumstances—lower costs and more efficient, healthier environments win the day.

Best Bets 2007

Investment

Hold Core

Sit tight and enjoy increasing cash flows as improving supply/demand fundamentals push NOI. You cannot replicate your investments in today's overpriced acquisition markets. Up the risk spectrum, value-added deals have turned too pricey and often don't provide sufficient risk-adjusted returns.

Sell the Dogs

As long as capital is willing, dispose of marginal properties. Cap rates may edge up, but sellers still have the upper hand, especially longer-term owners who can cash out large gains. The window is closing.

Focus on Asset Management

The easy money days are history—long live cap rate compression. Owners need to concentrate on leasing up buildings and protecting future cash flows through any future economic downturn. Managing rising expenses effectively will protect improved revenues gained from higher occupancies and rents.

Money Market Funds/T-Bills

Stay in cash and wait for disequilibrium to develop in certain markets. Busted condos soon will present opportunities as owners and developers have no choice but to capitulate. Until cap rates ease, property markets are too expensive. Watch for starter-home bargains as recent buyers bail out over rising mortgage bills. The cooling resort home market may also present opportunities—baby boomers will continue to want these properties as they head toward retirement. Get ready to buy in the dip.

Coasts, 24-Hour Places, High-Tech Centers

Coastal cities on global pathways remain the best places in which to invest. Trade, finance, and educated workforces gravitate to these 24-hour centers, which typically benefit from geographic barriers to entry constraining supply: New York, Washington, D.C., southern California markets, Seattle, and San Francisco lead the pack. Resurgent high-tech companies ignite growth in Silicon Valley, Austin, Boston, and the D.C. suburbs. The "have-more" markets gain, while "have-less" markets lose more ground. In particular, the Midwest sags.

Development

Be Cautious

"Hunker down." Cost overruns are common. Profits slip. Demand improves, but maybe not enough to drive rents high enough to score acceptable risk-adjusted returns. Focus on smaller projects with less exposure. The country's property markets don't need much new space. Retail's development pipeline is full just when consumers begin to wobble. Apartment demand strengthens, but failed condominium projects will be reinvented as rentals. Office improves too, but rents in most markets have not spiked enough to justify the higher replacement costs and new hotel projects could soften some lodging markets by 2008.

Develop Infill and Mixed Use

Energy costs add fuel to the fire—people want greater convenience in their time-constrained lives. Far-flung greenfield homes may cost less, but filling the gas tank burns holes in wallets. Both empty nesters and their young adult offspring gravitate to live in more exciting and sophisticated 24-hour places—whether urban or suburban—with pedestrian-accessible retail, restaurants, parks, supermarkets, and offices. Transit-oriented development at subway or light-rail stations almost cannot miss.

Buy Homebuilder Stocks

Company stock prices have more room to drop, but are near bottom after "severe pummeling" on Wall Street. This cyclical business will recover, but needs to take its medicine after overbuilding into interest rate–sensitive housing markets, which had experienced unsustainable price growth.

Build Green

Stop fighting sticker shock on energy bills. Even if fuel prices decline temporarily, the country needs to reduce oil dependence and become more efficient. Global warming issues resonate, too. Tenants and owners want reduced costs and become more environmentally conscious.

Property Sectors

Buy Warehouse

High cube warehouses near port cities meet growing demand from importers. West Coast ports—particularly Los Angeles/Long Beach—cannot handle all the Asian traffic. Gulf and East Coast harbors pick up the overflow. Owners of industrial portfolios strike gold—hold onto these properties. Keep selling obsolete low-ceiling space.

Buy Moderate-Income Apartments

Investor fervor for multifamily limits bargains, but rents catch fire in coastal regions where demand for affordable housing moves off the charts. Rising mortgage rates and favorable demographics kindle tenant demand for B-quality and C-quality apartments.

Hold Office

With rents moving higher, office looks good at this stage. Landlords need to lock in credit tenants, raise occupancies, and secure solid revenue streams as the economic expansion starts to get long in the tooth. Only first-out-of-the-ground developers have a chance to score.

Hold or Sell Hotels

Hotel owners will continue to reap solid gains into 2007 as this volatile sector heads for a revenue and price peak. But slowing GDP growth signals decelerating hotel demand just as new development promises increasing supply, especially in the limited-service sector. Investors should monitor closely and prepare to sell before the daily-room-rate picture levels off or even declines.

Sell or Hold Retail

Owners become charmed with these cash-flowing assets after an exceptional streak of consumer buying and investor demand. People forget that retail ranked as an investment outcast during most of the 1990s. Expect a period of more middling consumer demand. Cash out of weaker properties and retain stronger centers.

Real Estate

"Adequate capital *will remain, period!"*

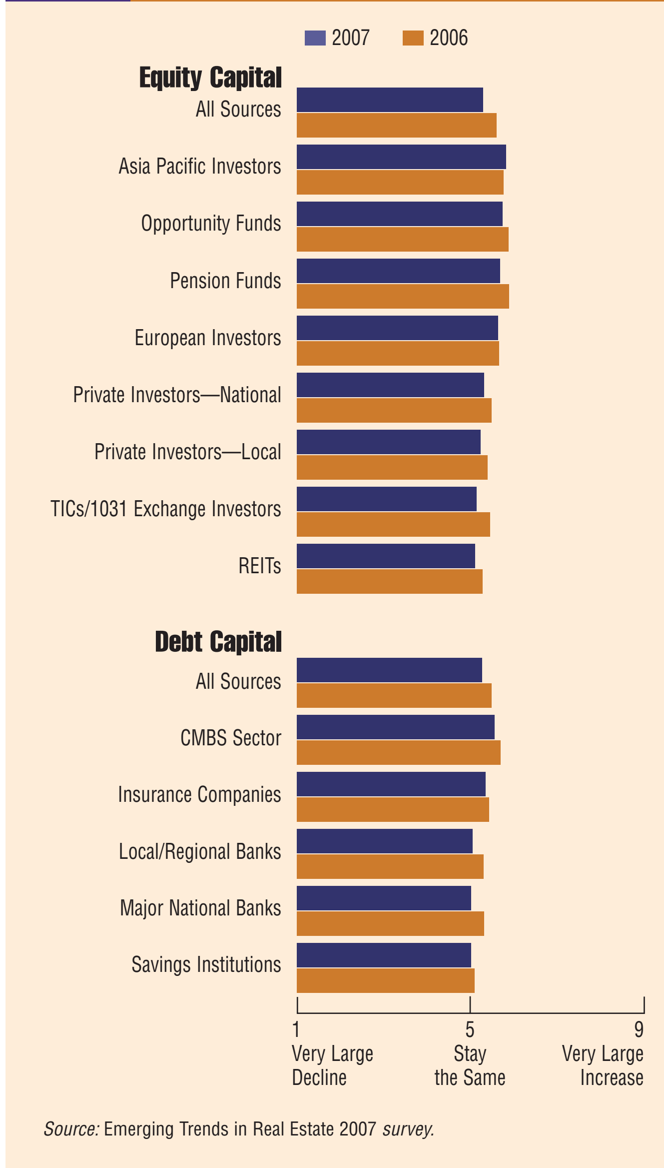
Capital Flows

Giddy real estate players dreamily frolic in deep capital swells. Investors and consultants seek out advisers for new products, offerings oversubscribe before lawyers finish scrubbing prospectuses, open-end funds have queues to get in (not out), portfolios post record returns even though asset managers miss leasing targets, brokers flip the same properties they had sold last year, investors are happy and want more, and best of all fees and promotes fatten wallets. Life is good, really good. "The world has been turned upside down."

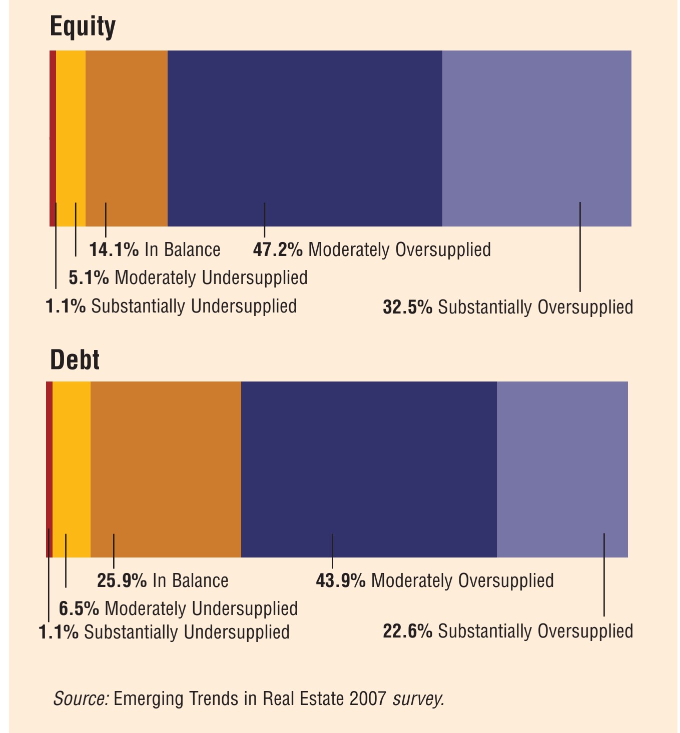
Time to Question?

Now that recently flush homebuilders face the reality of a cyclical correction, commercial real estate investors and developers might wonder whether they have been enjoying too much of a good thing themselves. Have real estate's intrinsic qualities attracted all this capital into U.S. property markets? Or has a temporary aversion to stocks and bonds been responsible? Will real estate still be as attractive if interest rates increase more? And what happens when investors inevitably see mid-single-digit returns again or headlines chronicle some "increasingly likely" property investment collapse or fund debacle? Everyone says they want property cash flows, but income return components as a percentage of total returns have been declining as investors revel in outsized performance from appreciation. And why does capital turn so readily to riskier Asia and value-added funds, which bank on value gains? Do investors really crave income or is the investment orgy about grasping for total returns?

"You can tell clients until you are blue in the face to expect 7 to 8 percent returns going forward when they have been getting closer to 20 percent," says a pension consultant with more money to allocate than Midas. "They say they understand, but they will be disappointed when returns come in under 15 percent. For them, real estate has been an alpha generator in mixed-asset portfolios that have not been providing alpha from poor execution in stocks and bonds." What happens when real estate alpha turns into beta or stocks transform back to alpha stars again?



Source: Emerging Trends in Real Estate 2007 *survey.*



Source: Emerging Trends in Real Estate 2007 *survey.*

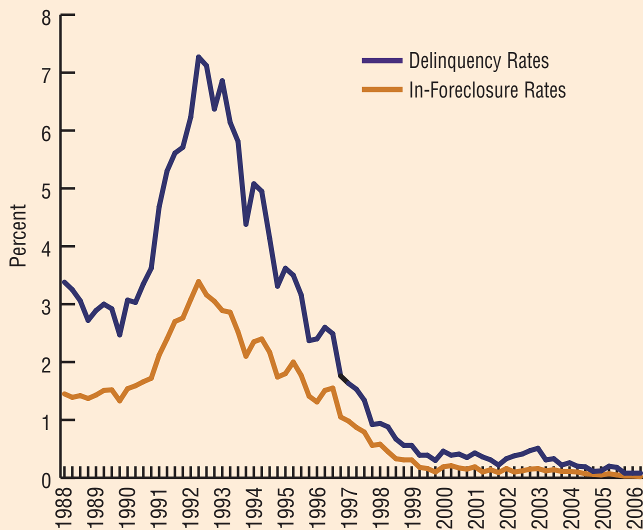
Stalwart Confidence. Most *Emerging Trends* interviewees are convinced that "capital is here to stay" and say they believe investors will readily accept more normal (lesser) returns. "The mind-set has changed for the long term—real estate is a viable asset class." An investor trifecta—baby boomers, pension funds, and foreign institutions—all seek income-producing investments like real estate. Global markets feed overseas capital into CMBS and REIT stocks, helping maintain market liquidity with money flows unimaginable 15 years ago. Now, collateralized debt obligation (CDO) instruments and derivatives promise to attract more capital and provide more liquidity. Leveraged buyers may be exiting because of increased financing rates, but unleveraged buyers—plan sponsors and foreign capital—step up activity. Also, high-net-worth players enter markets through private equity and hedge funds so they can invest faster and more efficiently than on their own. "Real estate is proven—it's been exceptionally stable."

Greater Restraint. For 2007, expect more modulated torrents of capital—both debt and equity—to keep real estate markets comfortably awash in liquidity. Some estimates suggest that $100 billion or more waits from the sidelines to enter the markets and get in on the action. But without question investors will become more restrained and relatively more cautious. "The rush is over, the stampede is subsiding," says a value-added manager. "The velocity is slowing. It's a good thing. It just couldn't keep going the way it has been."

Capital velocity from all investor sources will lessen (see Exhibit 2-1), according to *Emerging Trends* surveys. In the

estate markets comfortably awash in liquidity.

Exhibit 2-3 **Life Insurance Company Mortgage Delinquency and In-Foreclosure Rates**



Sources: Moody's Economy.com, American Council of Life Insurers.

equity sector, foreign investors, opportunity funds, and pension plan sponsors will be most active as leveraged syndicator, tenant-in-common, and 1031 investors withdraw. Well-heeled hedge funds remain the wild card. On the debt side, CMBS conduits will lead the lending charge. Overall, markets will be "moderately oversupplied," down from "substantially oversupplied" (see Exhibit 2-2).

Spreading Risk. Investors continue to gain solace from delinquency and foreclosure rates that barely raise a ripple on line graphs (see Exhibit 2-3). Zealous equity capital gobbles up "hairy" properties before lenders need to confront errant borrowers. Low rates have enabled other landlords to refinance their way out of trouble, too. Thanks to club deals, syndications, and tranche structures, lending risk has been extremely well diversified—"spread out and spread around." It's hard to tell where some transactions and pieces have landed. Many higher-risk, higher-yielding real estate deals "end up in the 5 percent of the basket of some pretty safe money market funds."

Tougher Standards. But the ease in dispersing risk along the securitized capital stack has encouraged lenders to take more gambles and lower underwriting standards. Survey respondents underscore the view that capital sources will become necessarily more discriminating in 2007. Nearly 70 percent expect "more stringent" underwriting standards to take hold during the year, up from 37 percent in the 2006 report. Only 25 percent predict that standards will "stay the same," down from 46 percent last year. The shift should be welcomed. "Lenders have been in a frenzy to gain market share, weakening covenants and lowering spreads," says an insurance executive. "Stress has been ignored and papered over with optimistic assumptions." Adds another interviewee: "Something has to give."

Well, nothing lasts forever.

Private Investors

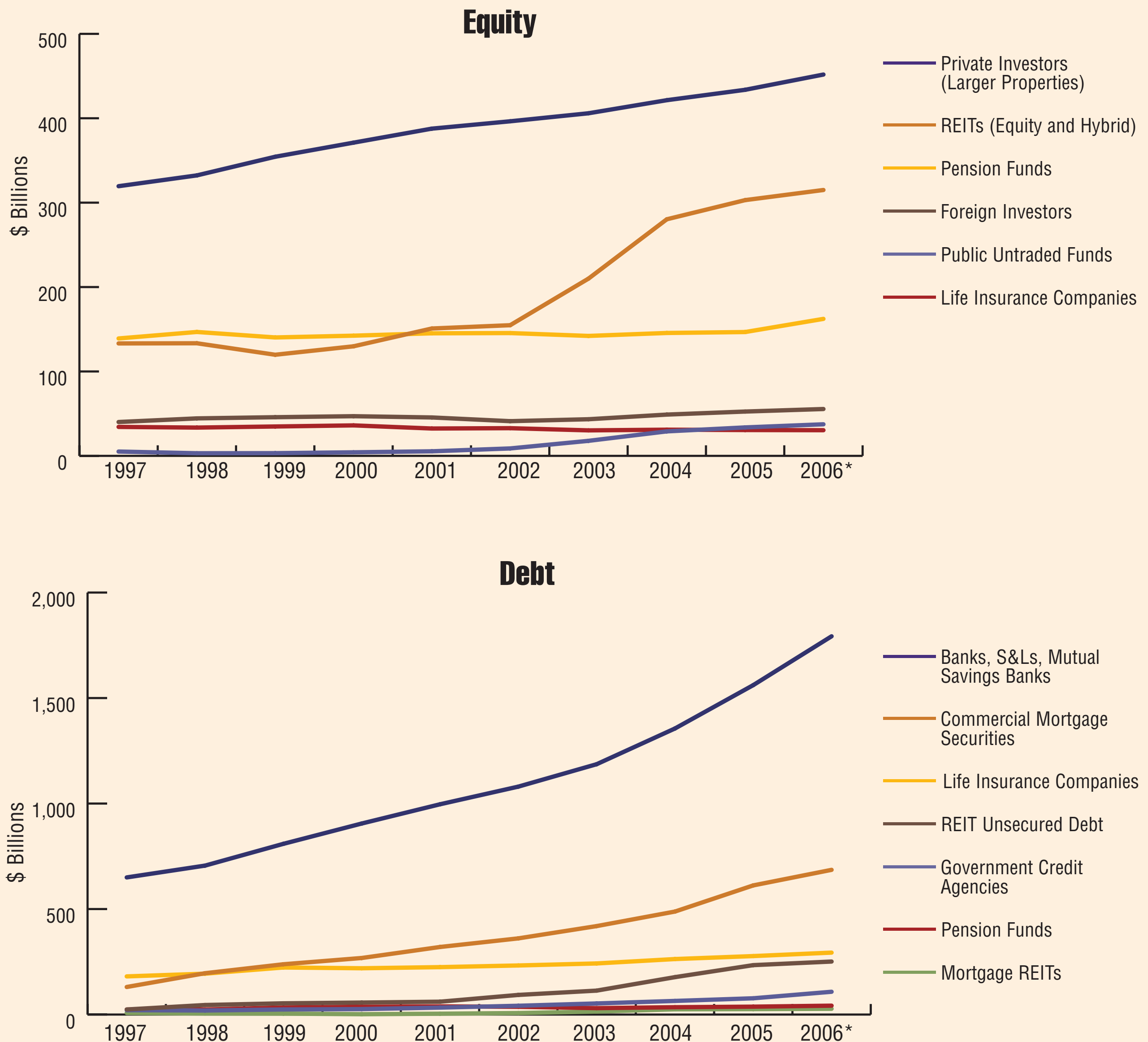
Syndicators. Private syndicators, who led the real estate investment charge after Wall Street's 2001 tech-stock burnout, look increasingly prescient. Pooh-poohed at first for using liberal amounts of leverage and buying core properties at "unjustifiable" prices others wouldn't touch, syndicators' early deals have turned into grand slams given ensuing cap rate compression and now-improving fundamentals. With higher financing rates and lower going-in returns, these investors show discipline by pulling back from acquisitions rather than court negative leverage. "The wind is at our backs, our buying peak was 2003," says an executive who helps manage a leading nontraded fund series. "It's been simple arithmetic that leveraged buyers will drop back over higher cost of capital." Should others be paying more attention?

High-Net-Worth Investors. These investors tend to be secretive and fall under radar screens. Certain family offices and trusts control more money than medium-sized pension funds. Some high-net-worth investors pull back from high-priced markets unable to secure reasonable one-off deals, while others cede direct control of investment strategy and inject capital into hedge funds and private equity firms, which can buy operating companies or source large portfolios. "Giving up control is something new for a lot of these investors, but they can't get the money out effectively." Financial companies opportunistically develop private-label real estate funds tailored to the high-net-worth market.

"Real estate is **proven***—it's been exceptionally stable."*

Capital Sources and Flows

Exhibit 2-4 Real Estate Capital Flows

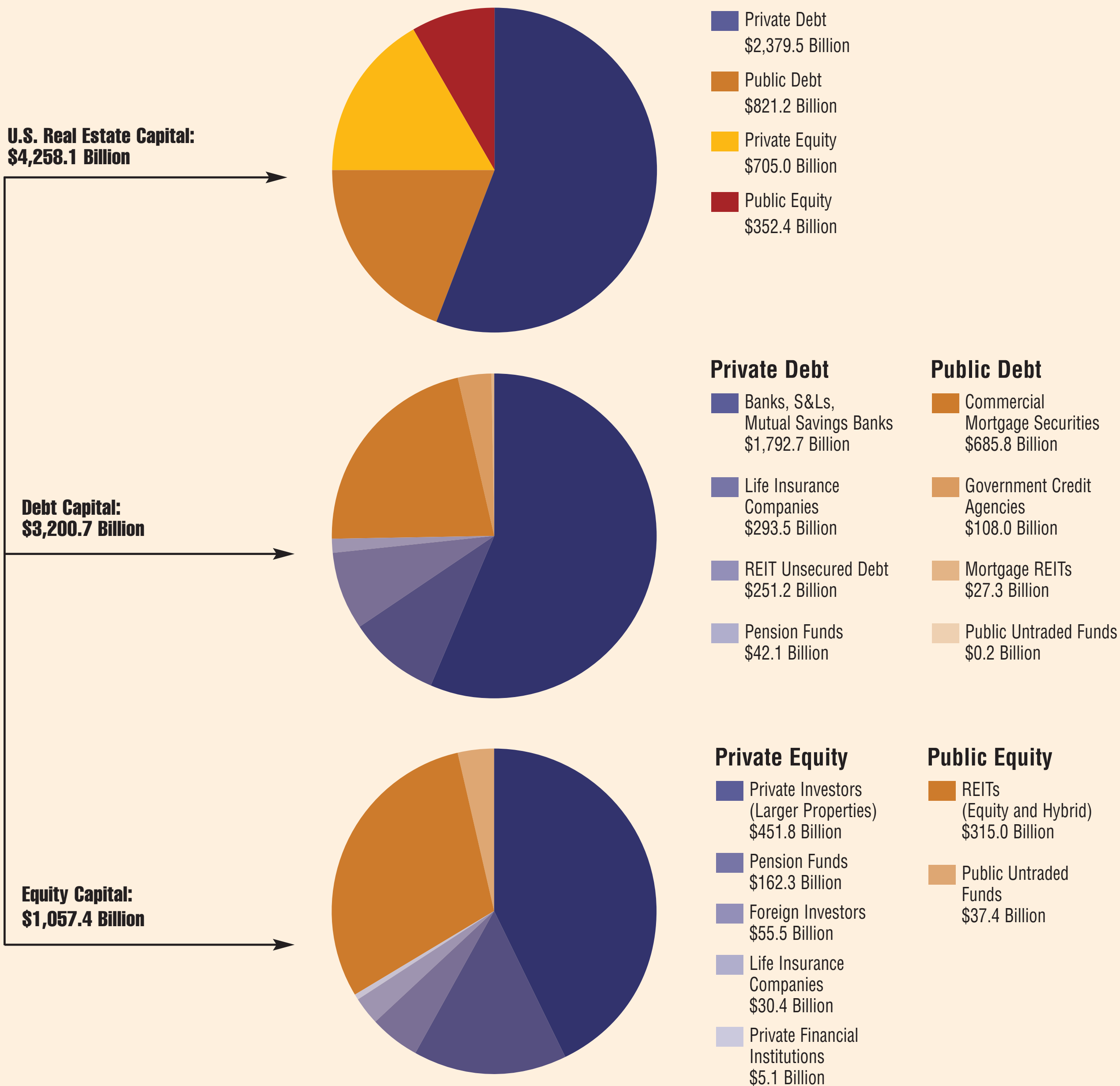


Sources: Roulac Global Places, from various sources, including Amercian Council of Life Insurers, CMSA/Trepp Database, Commercial Mortgage Alert, Federal Reserve, FannieMae.com, FDIC, FreddieMac.com, IREI, NAREIT, PricewaterhouseCoopers, and Real Capital Analytics.

Note: Excludes corporate, nonprofit, and government equity real estate holdings, as well as single-family and owner-occupied residences.

**2006 figures are as of second quarter.*

Exhibit 2-5 **Real Estate Capital Sources**

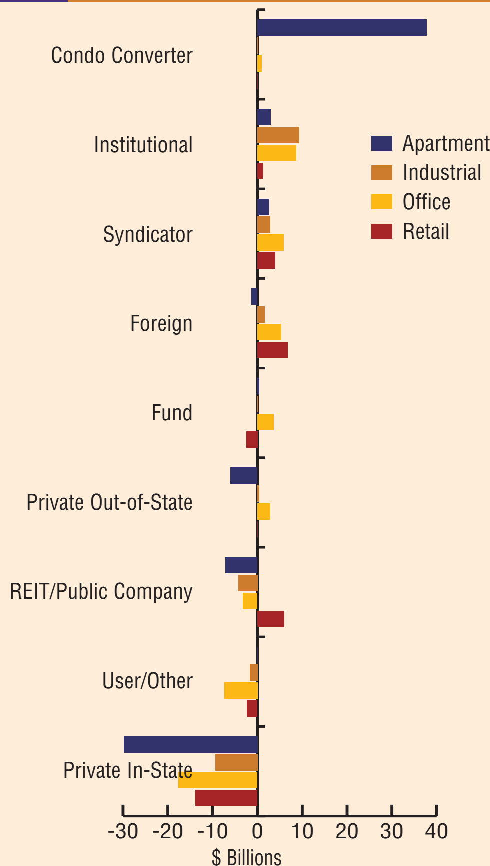


Sources: Roulac Global Places, from various sources, including Amercial Council of Life Insurers, CMSA/Trepp Database, Commercial Mortgage Alert, Federal Reserve, FannieMae.com, FDIC, FreddieMac.com, IREI, NAREIT, PricewaterhouseCoopers, and Real Capital Analytics.

Note: As of second-quarter 2006. Excludes corporate, nonprofit, and government equity real estate holdings, as well as single-family and owner-occupied residences.

Local private investors and developers have been the **big sellers** *in this environment*

Exhibit 2-6 **Buyers and Sellers: Net Capital Flows by Source and Property Sector**



Source: Real Capital Analytics.

Note: Net capital flows from first-quarter 2005 through second-quarter 2006.

Tax-Advantaged 1031 Tenant-in-Common (TIC) Investors. These affluent investors are probably most susceptible to getting scared off by inflammatory headlines over declines in housing markets. They include doctors, lawyers, and less than high-net-worth private investors who are more likely to link what's happening to home prices with commercial real estate markets. High-leverage strategies no longer work for these investors either.

Hedge Funds. Ultra-opportunistic private equity and hedge funds have steadily moved into real estate space as corporate initial public offering (IPO) and merger and acquisition (M&A) activity cannot fully satisfy their needs for outsized returns. The consensus among interviewees is that these mostly non–real estate players "do not know what they are doing" and "just want yield." "It's scary," says an interviewee. "They control billions [of dollars' worth] of equity, plus leverage up four or five times and purchase illiquid assets with little or no management experience." Time will tell about hedge fund acumen in the property markets. For sure, once return prospects ease, this difficult-to-track flight capital will pull back quickly, short-circuiting a prodigious money channel.

Condo Converters. Add to this mix the condo converters, a hard-to-pin-down group that has been a huge player over the past several years. Condo converters have been the leading buyers of property since the beginning of 2005—mostly apartment buildings, but also hotels and even office buildings (see Exhibit 2-6). With the condo bust underway in many areas, their buying appetite will wane.

Private Local Players. Local private investors and developers have been the big sellers in this environment. These players, frequently smaller owner/operators and developers, have been cashing out at the right time, in many cases using the proceeds to start new developments. Selling appetites will likely diminish while buying will remain modest at best in 2007.

Pension Funds

"It's our turn," insists a public pension fund executive, watching the retreat of leveraged investors. "We see more 6 percent and 7 percent cap rates and now we can afford to buy." In classic herd formations, plan sponsors increase real estate allocations from the 3 to 5 percent range to 8 to 10 percent or line up to invest for the first time just as property markets crest. "It's become religion to have real estate in mixed-asset portfolios." They want predictable income and low volatility to match increasing liabilities, but they need higher total returns to bolster underfunded portfolios. Real estate recently has offered both cash flow and ample appreciation, so pensions hungrily want more. They have been strong buyers since 2005 and this should continue through 2007.

Allocation Struggle. Many fund executives are "nervous" about "underweighted positions" and need to feed their allocation models after selling down portfolios. "Desperate for yield," other plan sponsors look overseas, pouring money into global real estate opportunity funds that target China and India.

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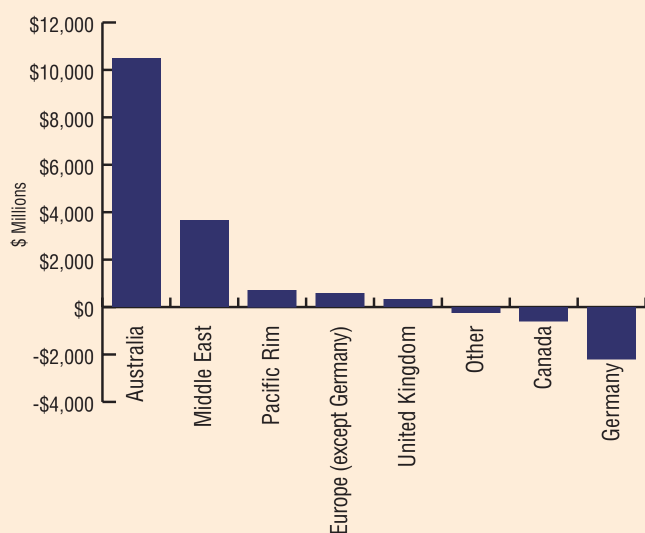
Considerable pension capital remains backlogged—"maybe as much as $60 billion." Investment managers with varying real estate experience and track records eagerly try to suck up dollars and churn out new investment vehicles. Consultant databases track 300 manager funds, up from 125 five years ago. Large public funds give up greater decision-making control on separate account strategies and transfer money into adviser commingled funds to expedite investing. "Managers have relationships to find attractive product, large pools to make deals, and can move more quickly." Still, consultants and advisers struggle to find investments that can meet yield targets. "No asset mix gets to the 8 percent magic bogey today unless plan sponsors put money into venture capital funds and pray to the gods about the results."

Dicey Timing. The pension onslaught buoys confidence that a capital cushion will continue to support real estate markets and ease the slide into lower, more normalized performance. "It could take three to four years to put the money out." In that time "a lot could change," including more opportunities and/or lowered yields that might keep some of that money on the sidelines. "The proliferation of so many new investment vehicles, the high pricing, and the leverage makes you wonder how a few mess-ups could echo through the market." Unlike retreating leveraged players, pension funds "use the rear-view mirror and go up the risk curve."

Exhibit 2-7 **Foreign Net Real Estate Investments, 2005 to Second-Quarter 2006**



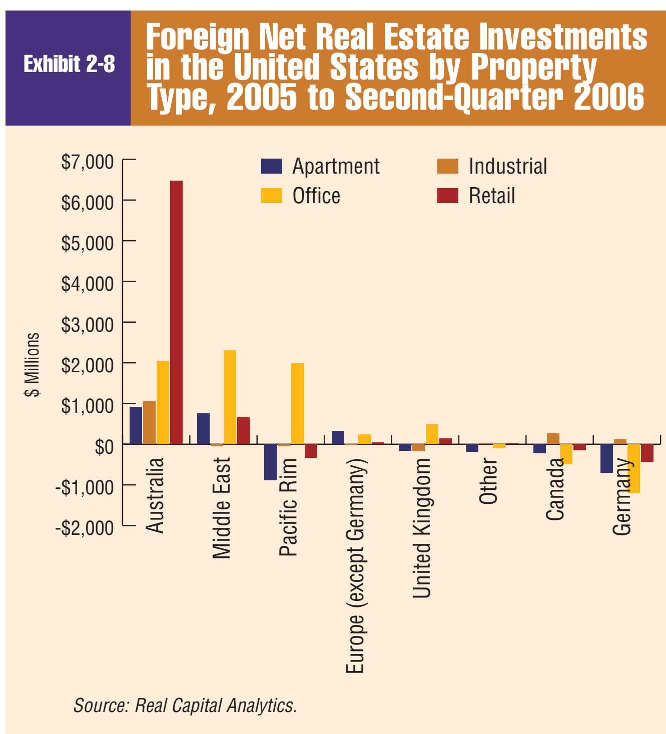
Source: Real Capital Analytics.

Public Preference. Signs point to pension flows gradually orienting more to REIT funds and away from private market vehicles. Looking for savings, many corporations cash out employee beneficiaries from defined benefit retirement plans and substitute defined contribution (DC) plans or 401K investment programs. DC/401K plans place the investment onus on employees and reduce or eliminate corporate exposures for funding liabilities and investment losses. So far, most states and local governments have sidestepped paring back public employee defined benefit plans. Powerful employee lobbies restrain legislatures from attacking the issue, but at some point taxpayers will revolt. Ultimately, the reduction in defined benefits will shift pension capital to public market vehicles (REIT and CMBS funds), which can provide greater flexibility and daily pricing for employees moving money between investment options. Investment managers will continue attempts to create 401K formats that can handle private real estate investments. These may include hybrid REIT/private real estate/cash funds. Small- and medium-sized pension funds, meanwhile, raise investment allocations in REIT stocks to get immediate diversification and avoid delays on private fund investment queues.

Foreign Investors

The lineup changes, but a tide of offshore capital keeps rushing into U.S. real estate, mostly looking for reliable core investments in the familiar coastal 24-hour markets. Foreigners have been key players forcing down cap rates to record lows for office buildings in New York, southern California, and Washington, D.C. These investors continue to find the U.S. safe haven almost irresistible and a weak dollar gives them more buying power. Some active players like the Germans and Australians show signs of souring on "pricey" deals. Asia competes for a larger share of international capital and "distaste for recent U.S. foreign policy" turns off some international investors. "It's not automatic that overseas dollars come here anymore," but the inflows remain ample.

■ Australians supplanted the Germans as the number-one offshore investors and voraciously eclipse all other countries in net acquisitions. A small national real estate market relative to the appetites of brimming superannuation funds force Aussie institutional managers to look outside their borders for property investments. But "they may have pushed the envelope too far



Source: Real Capital Analytics.

in the U.S., buying into noninstitutional deals and bidding up prices." Yields finally look too low to them and they turn their attention elsewhere, particularly China.

- Germans already take a breather. Old-school, long-term players, they can't find core investments with positive leverage in their favorite big-city markets. Cap rates need to move back up "substantially" over debt rates for appetites to recover.
- Middle Eastern investors, namely wealthy Arabs and Israelis, quietly park more money in U.S. properties as turmoil simmers back home. Windfall profits from oil sales need a safe parking place. "Amazing amounts of foreign dollars placed in the U.S. look like American entities but are backed by foreign [often Middle East] dollars."
- Japanese institutions "finally get comfortable" again with U.S. real estate almost two decades after their last ill-fated buying binge. "It must be time to get out," snickers a German. But so far the Japanese have done more "investigating" than investing, getting their feet wet in REIT securities and "patiently" looking at direct investments. Chinese markets also capture their attention.
- Chinese capital, Russian moguls, and wealthy businessmen from former Soviet Republics also test U.S. real estate markets in early forays.
- U.K. investors remain a constant presence, and Irish banks have stepped up activity. Canadians also remain significant players.

REITs

Since 2000, REITs have outperformed all other stock groups and stock indices, notching three straight stellar years of 30 percent–plus returns (2003–2005) and doubling in price. So much for their touted income returns—dividends for many REIT stocks now trail T-bill yields. "Stockholders anticipate huge surges in NOI at these pricing levels that may not happen," warns a bear. But boosters point to improving cash flows and rising replacement costs as justification for the gains. "This is not ethereal appreciation from assets without real revenues like the Internet stocks."

Inevitable Correction? The last time REITs morphed into total return investments (circa 1998) they stumbled badly, but rebounded into the current extraordinary upcycle. Over time, REIT performance should correlate with a lower-return/more-income-oriented hybrid model of private real estate and bonds. In either case, REIT prices appear to have more downside risk than upside potential over the short term. If these stocks don't correct in 2007, expect prices "to shuffle along," generating more modest returns from improving fundamentals and operations.

Public to Private. Recent public to private arbitrage and merger activity has helped energize REIT prices. Private equity groups and large investment funds jump at opportunities to acquire large "wholesale" property portfolios and flip individual assets at retail premiums. Buyers make "net asset plays" and may obtain attractive development pipelines as well. Private equity tactics "hype returns" by paring management expenses and using leverage strategies unavailable to REITs. Mid-sized companies have been welcome targets. Many CEOs long to escape the grip of costly and burdensome Sarbanes-Oxley regulatory "straitjackets" and reap gains from private equity–geared compensation or attractive buyouts. They won't miss quarterly analyst conference calls either. Smaller REITs will also continue a long-term trend of consolidation into larger companies,

prompted by economy of scale advantages and pushed by Sarbanes-Oxley. Most interviewees expect public to private transactions to run their course: "Premiums on more recent deals are declining and the tide is changing." Private market advantages "aren't sustainable" and eventually "IPOs become more lucrative again and provide exit strategies for these deals."

Solid Operations. Large REIT companies consolidate sector positions and implement income growth strategies. "Strong management teams aren't doing anything stupid," says a leading REIT analyst. "They concentrate on renovations instead of paying up for properties; increasingly look to joint venture [JV] with institutional partners, lowering equity exposures but gaining management fees; and patiently wait until acquisitions become more accretive." Some sector-dominant REIT giants look overseas to export their expertise and management skills. Retail and industrial companies find greater traction, working with familiar American tenants who have entered offshore markets. Office and apartments require more local sophistication to deal with quirks and customs. "Local JV partners are a must." More countries enact laws enabling REIT structures and global REIT markets emerge, "promising greater exposure and capital for U.S. REITs."

Banks and Insurers

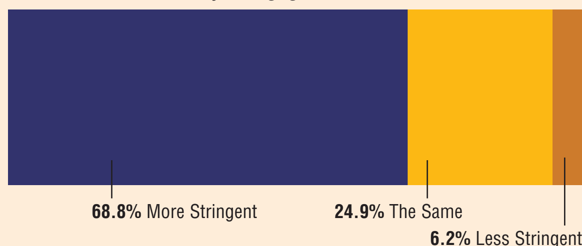
Substantial capital, aggressive new conduit competitors, a crush of borrowers, and shrinking margins put lenders in a quandary. "It's not hard to make mortgage loans today, it's hard to make good mortgage loans." Many interviewees conclude that urgency to maintain or capture more market share has severely weakened lender resolve and underwriting standards. "Where can you go after ten years [of] interest only?" Thinner fees require mortgage companies to increase volumes for profits to grow, and everybody takes cover behind infinitesimal default rates. Underwriting quality "looks like 1985 or worse," says a veteran executive, who once made his share of fractured bullet loans on low-credit, low-coverage master leases. Narrowed spreads, weakened covenants, no escrows, and little or no equity down have become hallmarks of the recent lending environment. "We have reached generational lows in underwriting."

Poor Vintage. Improving market fundamentals should "paper over" issues on aggressive underwriting in 2007. The "stress test" will occur when loans need to be refinanced. "2005 and 2006 vintage loans executed on low cap rates and high debt will face refinancing hurdles." If growth projections and cost savings at the property operating level don't materialize or when takeout analysis doesn't work on LIBOR, borrowers will struggle to maturity "and then you will see defaults." Already some aggressive loans written in the 2003–2004 period look shaky without interest rate hedges. "Deals done when [short-term] rates were 1.5 percent look a lot different at 5.5 percent." Some interviewees "wait for the other shoe to drop" and predict that lenders will start to "reassess spreads" to avoid more potential problems.

More Discipline. For starters, many banks tighten loan standards in their residential mortgage business as housing markets deteriorate and now signs appear that a more sober approach grips the commercial side as well. Bankers "begin to play it safer," requiring more collateral and shying away from nonrecourse loans. "They have started to impose stricter appraisal standards, too," says a developer. Interviewees agree that life insurers have been "more conservative," avoiding bidding against conduit lenders, especially in larger $100 million–plus deals. Bank and life company exposure to potential bad loans

Exhibit 2-9 Underwriting Standards Forecast

Predicted Change in Stringency of Underwriting Standards for Commercial/Multifamily Mortgages in 2007



Source: Emerging Trends in Real Estate 2007 *survey.*

has been reduced through expansive secondary market securitization strategies that pool loans into CMBS and take them off their books. But a touch of unease alters "what-me-worry" attitudes and behaviors. These multifaceted financial companies also buy CMBS for their own portfolios and for asset management clients.

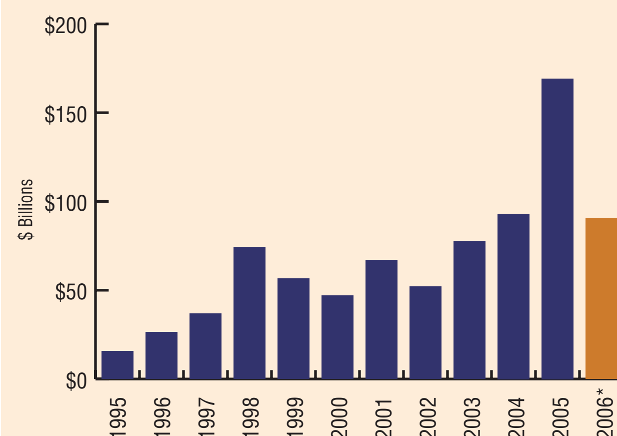
CMBS

Lender competitors conveniently and appropriately blame some CMBS conduits and mezzanine debt providers for pushing the envelope on licentious underwriting. "Subordination is down, spreads are down, and the credit cushion is less, but these standards are not necessarily wrong for this point in the cycle," counters a conduit lender. "Securitized markets price and shift risk efficiently, and hedging techniques have become more sophisticated. Balance sheet lenders have been careful not to misprice loans and get stuck with something they can sell only at a loss. Nobody is doing anything stupid."

Mortgage bonds ultimately depend on their underlying collateral. "We're counting on increasing tenant demand," says another conduit executive, "and that's certainly not indefensible given improving markets and controlled development." Adds another interviewee: "Let's not forget there is plenty of capital to backstop weak borrowers."

Pain Ahead. Still, a day of reckoning looms at least for some loans. If cap rates increase, aggressively written recent vintage conduit mortgages "will be under water when they balloon" unless "rents go way up." The Wall Street view advises that any pain will be limited and delayed. BBB investors and below "could get hurt in five to seven years" at refinancing, but such losses would affect "only a small percentage" of the entire CMBS market. The overall universe of loans has performed and will continue to perform well. "Stuff rolling over now has performed fine and the industry has never had a credit event." "We may not be regulated, but we are highly scrutinized" by rating agencies and the cartel of B-buyers. "Red flags go up if you're doing anything dumb—the industry is highly transparent." "Everyone knows what everyone else is doing." The prospect

Exhibit 2-10 CMBS Issuance



Source: Commercial Mortgage Alert.

**Issuance total for 2006 covers the first half only.*

for any future hurt will begin to get the market's attention. "Razor-thin" risk premiums in spreads between CMBS B-pieces and AAA tranches diminish demand for the lower-rated bonds. "B-piece buyers of three to five years ago wouldn't touch today's deals." Expect more discriminating capital to force wider spreads and eventually level offering volumes.

Expanding Markets. New CMBS markets developing in Europe and Japan are destined to attract more global investors to U.S. mortgage securities. In addition, the advent of collateralized debt obligations—the latest twist on CMBS—promises to provide another channel of financing, drawing more capital into ever-expanding secondary commercial mortgage markets. CDOs leverage pools of CMBS tranches, whole mortgages, and mezzanine debt to generate "equity-like" returns. Proponents tout a "cheaper and more stable" form of financing using index- and maturities-matched structures, which reduce cap rate and interest rate risk through diversification and Wall Street sleight of hand. Doubters worry about leverage on top of leverage and structures that lose touch with underlying assets. "They are accidents waiting to happen." "Does anyone know what they are really buying?" No doubt finance MBAs or, better yet, PhDs are best equipped to master these schemes. Bone up, since synthetic bonds and derivatives are coming next. Soon,

real estate investors will be able to go short or long on appreciation and income returns, and mitigate risk through complex hedging strategies used in other asset classes. Even math-challenged observers understand these Wall Street vehicles translate into more capital for property markets.

Mezzanine Debt

"Mezz" lenders love the new secondary market that CDO issuers have created for their loans. They can pawn off loan risk in securities just like other debt issuers. "Investment bankers move paper and keep pushing the envelope until someone goes under," says a mezz lender. "So far investors have done well." Interviewees say the same about increasingly aggressive and competitive mezz lenders, who push spreads down to 100 basis points over LIBOR from 400 in 2003. "The worst thing you can do is [under] price a mezz loan like equity," but that's happening. There could be a train wreck ahead—"spreads are just too narrow" and "boatloads of money" chase fewer deals. "We need some moxie and good fundamentals to keep going," admits a lender.

For 2007, improved occupancies and higher rents become more essential in both investor and lender return equations. Capital is depending on it.

Markets
to

"Growth-constrained coastal cities closely aligned with the advancing global economy *have turned into the nation's investment property meccas."*

Watch

Location becomes ever more important in real estate investing as the transforming global economy increasingly determines where companies and people need and want to be. Brainpower eclipses manpower in burgeoning technology, medical/health care, and financial companies, which now constitute America's vanguard industries. Places that can attract these companies and the educated elites they employ have the greatest chance to prosper while regions dependent on waning labor-intensive manufacturing jobs struggle to remain relevant. Healthy 24-hour cities still number only a small handful and Sunbelt suburban agglomerations continue to attract growth. But energy prices and suburban congestion shift lifestyle priorities to embrace greater urban convenience. Better schools keep families in traditional suburbs, while unmarried individuals, young couples, and older adults gravitate increasingly to more pedestrian-friendly 24-hour places where cars are not essential to access shopping, leisure, and work activities. As a result, more suburban places will assume urban characteristics and mass transportation becomes even more critical for regions to manage future growth.

Global Gateways

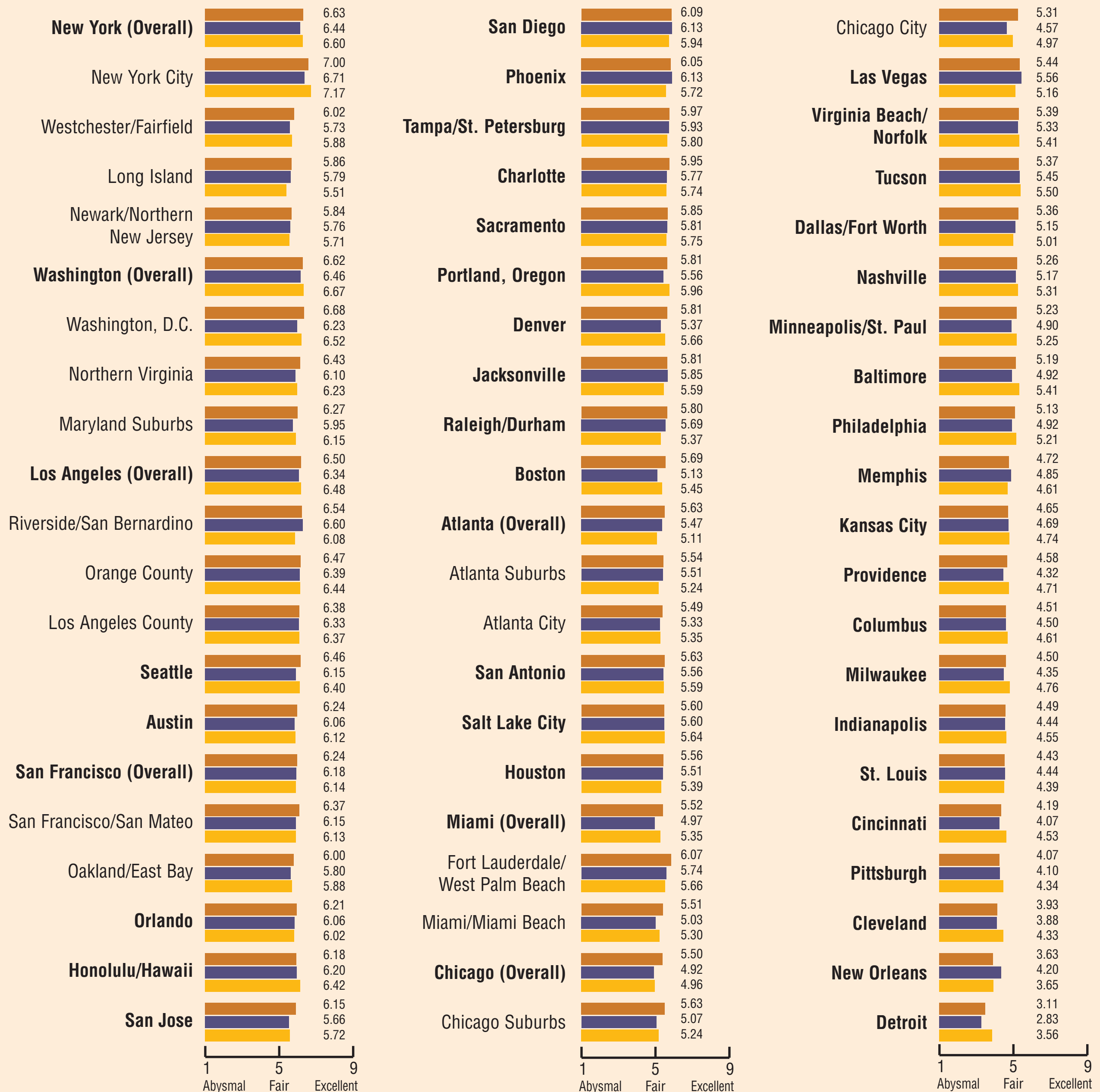
Over the past decade, *Emerging Trends* interviews and surveys solidify views about the leading real estate investment markets and the characteristics that help determine the best long-term prospects. While high-growth suburban agglomerations in the South and Southwest tend to offer better development opportunities and more affordable lifestyles, growth-constrained coastal cities more closely aligned with the advancing global economy have turned into the nation's investment property meccas. These global gateways tend to feature the following attributes that set them apart:

- Locations along global pathways with major international airports and harbor ports, providing easy access for international business and trade.
- 24-hour characteristics. Attractive neighborhoods easily accessible to office cores; pedestrian-friendly neighborhood retail (supermarkets, pharmacies, cleaners, restaurants); multifaceted entertainment/arts/recreation environments (theaters, museums, concert halls, arenas, parks); mass transportation connecting

Exhibit 3-1 Markets to Watch

Prospects for Commercial/Multifamily Investment and Development

Investment Development
Supply/Demand Balance



Source: Emerging Trends in Real Estate 2007 *survey.*

but stay near the top echelon.

neighborhoods to the commercial center and providing access to entertainment venues; and relatively low crime.

■ Attractive settings along water or near mountains in reasonably comfortable climates. Warm beats cold, but temperate can trump all.

■ Barriers to entry. Typically, the same geographic characteristics that make for attractive locations also provide natural barriers to entry that constrain development, husband property values, and encourage better planning through growth management.

■ Brainpower jobs. The combination of 24-hour characteristics and attractive settings lures highly educated people who provide the wellspring for today's growing industries—technology, health care, and financial services. Nearby top universities and research centers supply a steady stream of energized graduates.

Dynamic Affluence. The global gateways are expensive and elitist—people pay a premium to live in them. But ascendant brainpower companies compensate accordingly for worker talent, so their employees can afford these places, generating service businesses and jobs to support all the activity. Affluent populations also underwrite various arts institutions that create more stimulating and interesting intellectual settings and diverse 24-hour environments. All these dynamic interplays attract substantial business and tourist travel to buttress local economies, creating more jobs. These gateways also are natural landing points for immigrants who can provide less expensive labor as well as cultural diversity. As these places become more affluent, mass transit networks will become even more essential to transport lower-wage workers to and from less expensive surrounding neighborhoods and cheaper suburban areas.

The global gateways are mostly built-out, slower-population-growth 24-hour cities along the East and West coasts as well as southern California markets.

■ **New York** dominates world finance and anchors the nation's arts/culture scene; its local ports are the largest along the East Coast; ocean and rivers establish geographic barriers; and three major airports provide entry from six continents, connecting to all significant domestic markets. No American city offers greater 24-hour diversity or more tantalizing urban landscapes. Another ace is the nation's largest and most efficient subway system.

■ **Washington, D.C.** Global politics lies at the heart of the city's core; the federal bureaucracy draws all forms of lobbyists and special interest groups. Defense contractors as well as software and technology firms crowd near the Pentagon and Dulles Airport, and biotech gathers around the National Institutes of Health. D.C. is a magnet for the best and brightest, who eagerly network their way through the halls of power. This singular city with familiar monuments and national symbols lures tourists, business leaders, and potentates. Museums crowd the mall. Attractive neighborhoods now spread beyond the well-heeled northwest quadrant and the subway system ("Metro") moves people in and out of the downtown center from nearby suburbs.

■ **Los Angeles/Orange County/San Diego** is lacking in strong 24-hour urban centers and comprehensive rapid transit systems, to its detriment, but southern California has everything else: near-perfect year-round climate, spectacular mountain and ocean boundaries, gateway harbors, and LAX. The area attracts the country's most regionally diverse corporate base, ranging from entertainment and finance companies to defense contractors and technology firms, and the L.A./Long Beach port is the primary destination for goods shipped from the Pacific Rim.

■ **San Francisco.** The nation's most beautiful city rises on pool-table green hilltops overlooking a protected harbor by the ocean. Pacific trade, technology, and finance intersect there and it's the only city west of Chicago with a full-blown mass transit system including subways, buses, ferries, and, of course, cable cars. Just due south, Silicon Valley beckons as the world cynosure for high tech. Comfortable year-round weather completes this most desirable picture.

Secondary Gateways. Seattle strengthens considerably as a gateway while Boston and Chicago weaken, but stay near the top echelon. Miami grows in prominence as the Latin America gateway even as it struggles with some overbuilding. **Seattle's** harbor is not as magical as San Francisco's, but its nearby mountains are more dramatic. The city gains a 24-hour footing, fueled by local high-tech billionaires from Microsoft and a bevy of other brainpower firms. Pacific Rim trade pours into the port. The region benefits from one of the nation's most educated workforces. **Boston** husbands a treasure chest of leading universities and colleges, foremost Harvard and MIT, which feed local enterprise with top talent. Prominent financial companies, software firms, and biotech businesses are local mainstays. Geographically, Boston is the closest major U.S. city to Europe, but its port and airport are second rate, and the climate doesn't remind anybody of southern California. **Chicago** suffers from frigid winters and the declining fortunes of its surrounding region. But the city captures all the 24-hour elements and benefits from its dramatic overlook

onto vast Lake Michigan. O'Hare stands out as one of the nation's busiest airports, anchoring transport into the country's midsection from all points. Up-tempo **Miami** strategically stands out as the U.S. business and trade gateway to Latin America. Ocean and Everglades create natural barriers, while near-tropical weather and prime beachfronts attract a constant flow of worldwide visitors. Airport and harbor constitute a substantial trade center, but the area lacks mass transportation.

Climatic Threats. Ironically, much of the nation's most-coveted real estate appears extremely vulnerable to looming natural threats. Global warming fears and recent hurricanes stir concern about prime coastal areas along the East and Gulf coasts, including Miami, New York, and Boston. At the very least, insurance bills become an expensive reality. Hurricanes don't frequent colder Pacific waters, but all the prime West Coast investment citadels lie along earthquake faults that hold devastating promise of a strike by "the Big One." Rising sea levels would produce havoc from San Diego to Seattle too. Unless and until inconvenient truths turn into realities (like Katrina and New Orleans), most people will tempt fate and stay put or keep coming to coveted places, if they can afford to live there. Eighty percent of Floridians live within ten miles (16.1 kilometers) of the coast. "It's ring around the collar." "The beach will always be a magnet."

Resurgent Crime? Over the past 15 years, the nation's premier cities have curbed violent crime to remarkably tolerable levels despite entrenched poverty. Without a relative feeling of safety, New York, Washington, Chicago, and other 24-hour cities would not have marked their resurgence. Police officials and mayors have touted new crime-fighting techniques, but demographics may have played more of a role. And demographics trends are shifting. Young adult males—the primary cohort for committing violent urban crime—declined markedly in the 1990s due to the post–baby boomer baby bust. But now prodigious numbers of echo boomers enter their late teens and early 20s, with more on the way. There is growing concern that urban violent crime may intensify and push police back on their heels. In fact, murder rates have increased in some cities. If residents turn fearful, 24-hour lifestyles will be compromised severely, and the move-back-in could reverse.

Development Havens

Mushrooming Sunbelt development havens consistently fall behind global gateways for investment prospects even as their economies continue to grow. Places like Atlanta, Dallas, Houston, and now Phoenix have lived off hot growth—they are more affordable for service businesses and workers who moved to them in droves, especially in the 1980s and 1990s—but their tendency toward oversupply compromises their standing with investors. Cheap land fuels commodity construction and expanding populations. Still popular and relatively affordable, these metropolitan areas have lost some of their edge in poor planning and resulting congestion. In particular, the absence of strong 24-hour cores and minimal mass transit dog their prospects, while interior locations make them more secondary destinations for international business.

Dallas and Atlanta. These two cities have exceptional international airports at interstate crossroads, and both have seen improvement in investment prospects this year. Neither city has a 24-hour core, although Atlanta's evolving Midtown/Buckhead district projects 24-hour possibilities. Both metropolitan areas sprawl and depend on car transport across serpentine road systems. Atlanta's MARTA subway is a start, but falls short of providing commuting alternatives for most area residents. Dallas's light rail is so far a drop in the bucket. Neither city offers distinctive geographic lures or boundaries—Atlanta settles in gentle, rolling leafy landscape while Dallas sits in a flat, treeless plain. For people who want a reasonable cost of living in suburban subdivision lifestyles and mild winters, these agglomerations still work well. But neither city has the "bright lights/big city" qualities or location advantages to become a major global gateway, and consistently higher energy prices could make them more expensive for car-dependent populations.

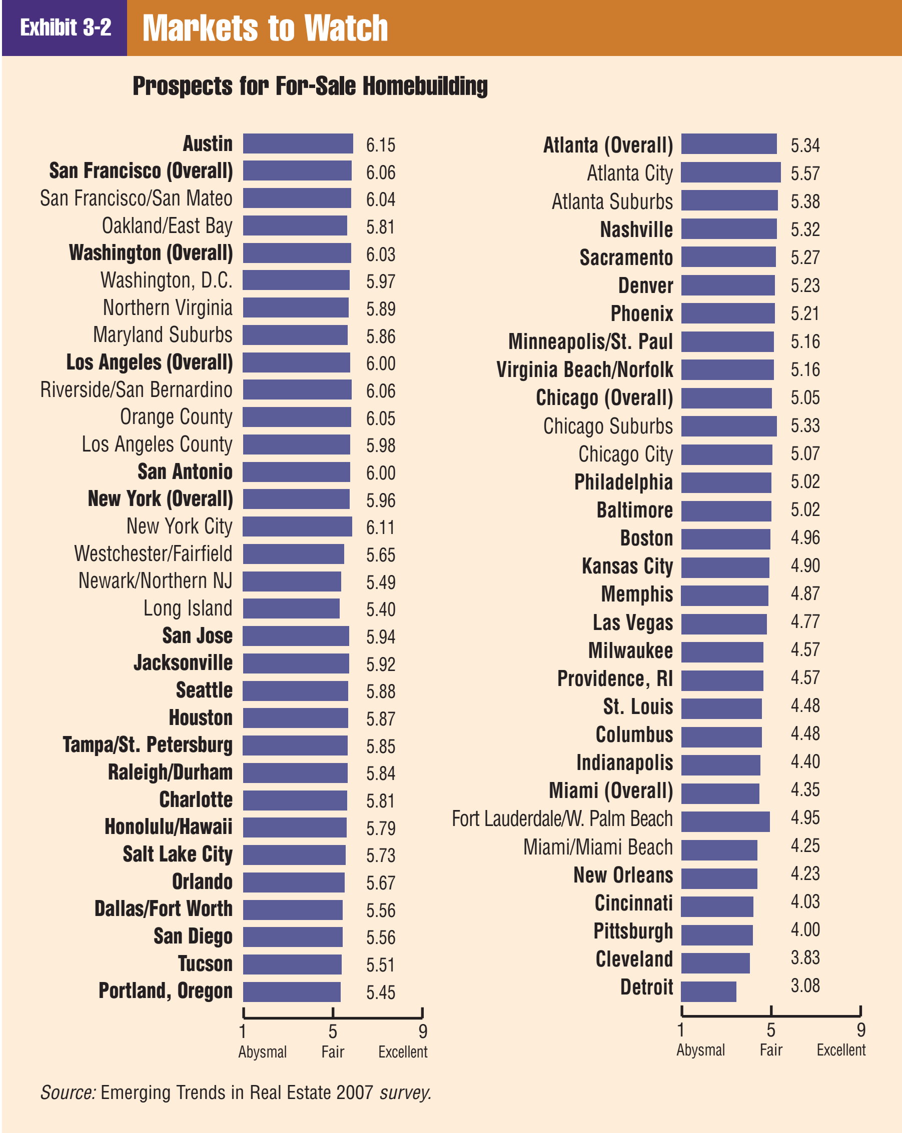
Other Sunbelt Leaders. **Austin** has brainpower magnets—a cluster of high-tech companies as well as the estimable University of Texas—and is buttressed by a state government engine. But the city stands to the side of global pathways. **Denver** lies close to spectacular geography and has an international-scale airport, but is surrounded by near-empty agricultural states to the east and other population-poor mountain/desert regions to the north, south, and west. It faces neither Pacific Rim trade destinations nor European financial centers, and stands too far removed from Latin American trade routes. Its budding light-rail system and evolving 24-hour LoDo district will be a boon. **Phoenix** follows the path of

place for investment prospects and first place for homebuilding prospects.

Atlanta and Dallas—commodity sprawl suburban development without 24-hour elements. It's affordable, warm, and especially wonderful if you crave an unlimited choice of golf courses. Economically, the city evolves into a lower-cost satellite of southern California. **Houston** showcases some of the worst elements of coreless sprawl. But its economy diversifies beyond energy—a vast medical center and NASA attract IQ talent, and its gulf port grows in strategic importance, especially since New Orleans's travail. As with Dallas and Atlanta, investment ratings for all of these cities improved measurably over last year.

Energy Cost Impacts. Prolonged high energy costs spell trouble for suburban agglomerations—"people will not be driving 100 miles a day to commute." The country has become "too exposed" to high energy costs because of suburban expansion and car dependence. The momentum intensifies behind the move back to infill neighborhoods around commercial centers. "It's not only lifestyle considerations, but also pocketbook." Planners come to accept that "you cannot expand highways enough to handle sprawl." Developers focus on mixed-use projects near mass transit stops along evolving light-rail lines in places like Denver, Houston, and Seattle. Mixed-use development booms around Metro stop locations in the Virginia and Maryland suburbs near Washington, D.C.; ditto along MARTA routes in Atlanta. "For regions to compete, mass transit becomes increasingly important." "Winning markets will have light rail and/or subway."

More Vertical Looks. Infill development turns generations-old suburban areas into more vertical-looking urban centers. Townhouses and apartments



replace strip malls and some past-their-prime single-family subdivisions. Multifamily high rises spring up on pads around regional malls. Markets and drugstores mix into residential projects on abandoned industrial sites and town planners make sure to save space for parks. Buckhead in Atlanta, uptown Dallas, the Galleria district in Houston, and South Lake Union in Seattle transform into more vertical communities.

Moving Out. Traffic and congestion issues may have "binary impacts" in some suburban areas. The move back into core neighborhoods will not abate, but some businesses may continue to move farther out along preferred corridors and the edge of the suburban envelope to places where their employees can cluster affordably nearby. Reverse commuting may also offer more palatable options for some workers. Alpharetta prospers north of Atlanta, likewise Frisco

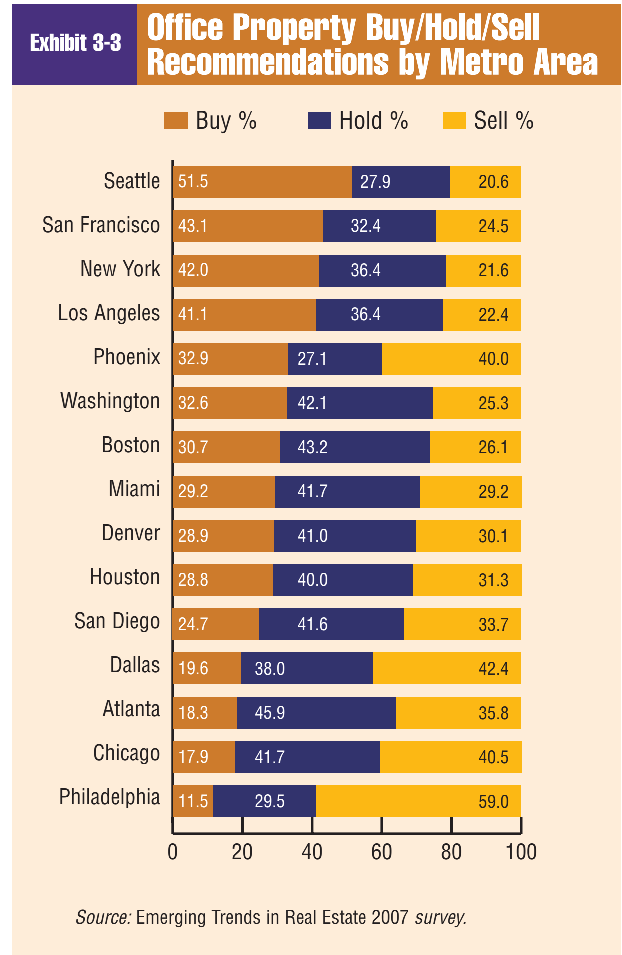
Sunbelt **agglomerations** *still lag the coastal elites, but show typical survey gains*

northwest of Dallas. But for investors overall, “infill is better than edge.”

School Concerns. While increasing numbers of childless adults—younger singles and older empty nesters—roost in more urban 24-places, better public schools keep families rooted in the suburbs. Even considering modest test score improvements, urban school districts uniformly fail miserably in comparison with their suburban counterparts. Parents can afford to take little chance with their children’s education and expensive private schools don’t pose an option except for a wealthy sliver of households. If they can, moms and dads head to suburban school districts that promise tickets to college and greater opportunity to secure coveted brainpower jobs. Improving urban schools remains an imperative for defeating inner-city poverty, tamping down crime, and improving the quality of local workforces.

Major Market Review

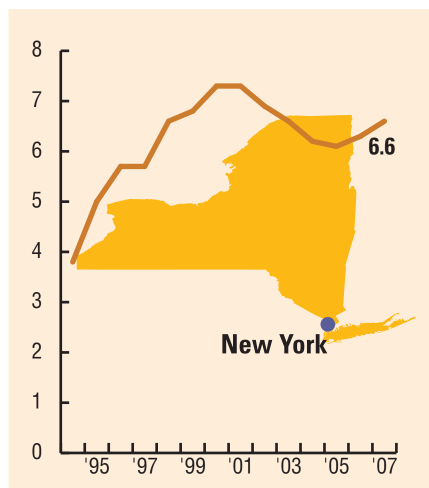
Emerging Trends 2007 rankings of metropolitan area investment and development prospects generally track longer-term outlooks for these markets, and have not materially changed from the last several years. Most notably, interviewees continue to show a clear “bicoastal” preference. “It’s a herd mentality.” New York, Washington, D.C., and southern California markets cement their top ratings. Seattle vaults into the top four just behind Los Angeles and ahead of San Francisco. Markets with condo problems drop—San Diego gives up its number-one ranking, falling to sixth position among major markets and Miami slides from ninth to 13th. For investors, Sunbelt agglomerations still lag the coastal elites, but show typical survey gains during the mature phase of economic cycles when growth resumes, leasing starts to pick up, rents advance, and development follows. Denver, Atlanta, Houston, and Dallas all improve. In the Midwest, Chicago and Minneapolis/St. Paul attract some investor interest, but their ratings are down from last year. Except for Columbus, Ohio, and Milwaukee, Midwest market ratings unfortunately sag further. Struggling to the side of global pathways and beset by colder climates, these cities strive to attract brainpower jobs in the wake of ongoing manufacturing losses.



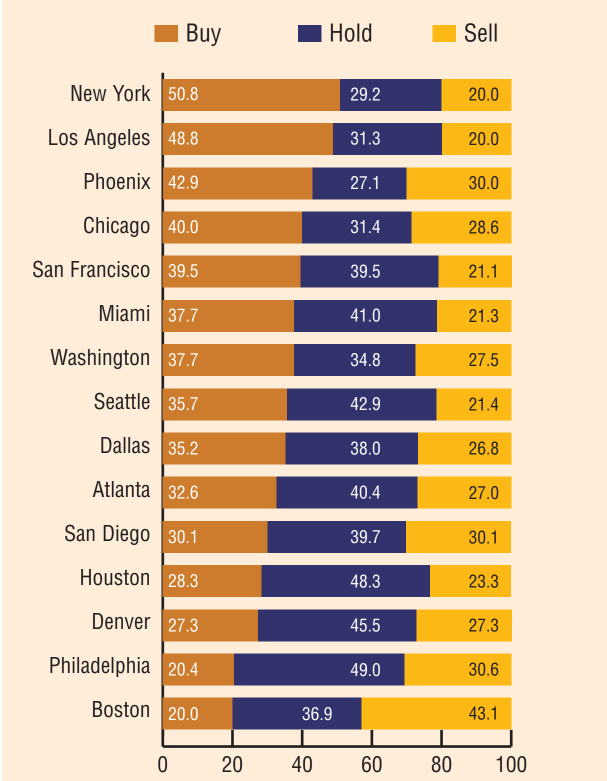
Source: Emerging Trends in Real Estate 2007 *survey.*

New York City

Back on top, midtown prices and rents soar—“the office market is tight as a drum,” some leases exceed $100 per square foot ($1,075 per square meter) in prime buildings. “Rents spike everywhere.” Few sites and off-the-charts land prices make development extremely difficult. Office cap rates can compress further there—below 4 percent, record territory. Banks and Wall Street investment houses fuel “phenomenal” demand; law, accounting, communications, and other professional firms expand in their wake. “Downtown is like another city—firms squeezed out of midtown head south for lower rents, 25 percent to 40 percent off. Economizing firms will consider moving back-office operations to Jersey and other cheaper suburban locations. The new Freedom Tower sputters to a ground breaking and additional



during the mature phase of economic cycles when growth resumes.

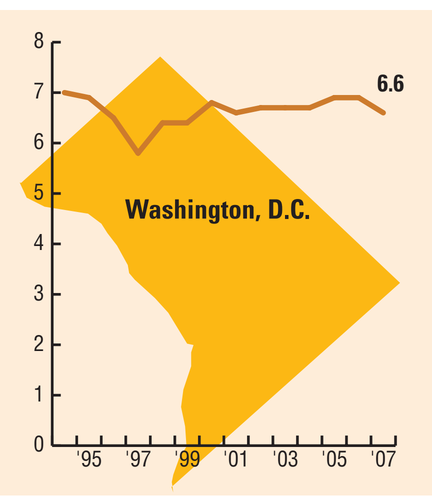


Source: Emerging Trends in Real Estate 2007 *survey.*

office space is planned near Ground Zero. More residential development in keeping with Battery Park City would help improve the area's 24-hour dynamics. Older office buildings around Wall Street convert into condos for investment banker pieds-à-terre at IPO asking prices. Don't confuse this for family-friendly affordable housing. Can all these multimillion-dollar units sell out? Well, maybe in New York. Wealthy foreigners also park money in rooms with a view. Condo conversions shrink hotel stock—lodging occupancies approach bellhop-boggling 85 percent averages and room rates follow up. No surprise retail prospers and northern New Jersey industrial markets sit near the top on most buyers' lists. The market looks too frothy and probably nears a peak, but absent a stock market debacle the Big Apple should hold its own.

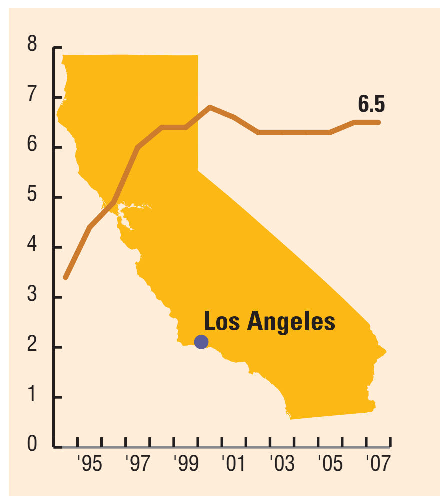
Washington, D.C.

The District of Columbia slips a notch. Short-term caution lights flash for local office markets. "Pricing is nuts" and new construction starts up. Rents and demand drivers justify some projects, but expect vacancy rates to move up from extremely healthy high-single digits. Homeland security and defense contractors lap up space in northern Virginia, spawning plenty of cranes. This suburban market historically gets overbuilt. "But it's not out of control like the early 1990s." Bethesda looks strong, though outer Maryland suburbs—such as Gaithersburg and Germantown—"plod." The bloom is off the condo market, with pricing dropping 20 percent or more. Some conversions revert back to apartment rentals—middle price points "are dead," and some buying continues at low and high ends. Signs of overheating aside, interviewees remain "extremely bullish." The Federal government keeps growing and more businesses want to feed from the taxpayer trough, a traditionally potent combination for limiting downside risk when this market hits a cyclical zenith.



Los Angeles

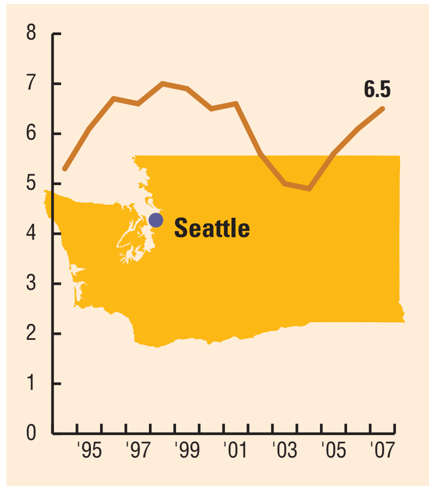
Record pricing "sets on fire" west L.A., Pasadena, Glendale, and Burbank office markets. Rents take off. Constrained development helps vacancies sink toward 10 percent. This market has rock-solid fundamentals and good job growth. Even "the surprisingly more vibrant" downtown performs "fairly well" and "light years ahead of the recent past." New residential has "changed [ingrained] perceptions" about a moribund nine-to-five core. Existing office tenant growth improves occupancies, although new tenants



remain "difficult to attract" from markets closer to high-end bedroom communities. Some investors bet on a further downtown recovery—relatively "moderate square-foot pricing is very attractive." People cannot afford "over the top" sales tags for single-family homes, so apartments are undersupplied except in areas with condominium stock reverting to rental units. Some businesses grow concerned about attracting and keeping employee talent given nosebleed cost of living unless home costs level off or decline. That seems to be happening after an unsustainable run-up. "White hot" warehouse markets and rents in the L.A./Long Beach port and Inland Empire don't phase tenants—"rents are secondary" to location and functionality. " 'Where do I sign?' takes priority over 'what is the price?' " Buyers at ridiculously low cap rates "can't lose" given the demand. Orange County worries about layoffs at residential mortgage companies with new office construction underway. Hotels surge on increased business and tourist travel. Maybe a touch of smog, but "no clouds appear on the horizon."

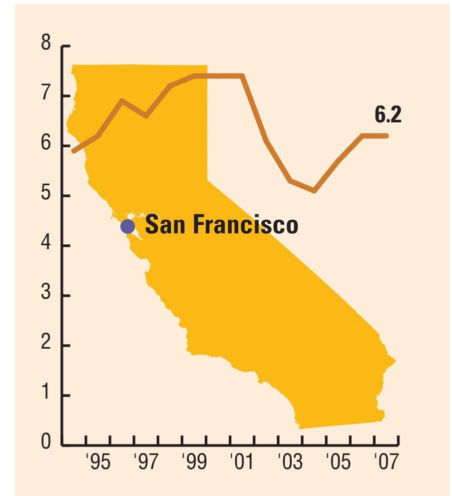
Seattle

Sitting squarely on prime global pathways to exploding Pacific Rim economies (the nation's shortest shipping lanes to Asia), Seattle jumps into the top tier, sustained by tech and logistics wellsprings. Its corporate roster diversifies well beyond software and aerospace giants Microsoft and Boeing to other industry leaders like Washington Mutual, Starbucks, and Costco. Bio and life sciences build a niche. Quality of life—dreary winters aside—attracts engineering and computer grads. Scenic mountain ranges and Puget Sound provide barriers to entry that discourage oversupply. A progressive growth management plan also helps. The downtown steadily adds high-rise residential—this city has a better chance than any other wannabe to become a new 24-hour center. Office vacancy tracks into single digits—rent spikes loom. The top-rated office buy market in the survey, "It's on everybody's shopping lists." Warehouses are largely built out. The few industrial development opportunities concentrate to the south near Tacoma. Retail zooms. The region struggles with traffic congestion and vestigial mass transit. Out of necessity, Bellevue develops quickly into a competing office center on the east side of the bay. Suburban areas will grow more dense and urban as population grows. Greenfield options are limited.



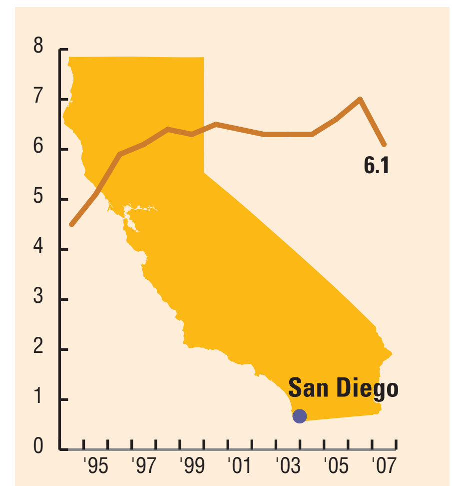
San Francisco

Back from the dead in the 2001 tech wreck, the City by the Bay makes a "tremendous" surge. Interviewees rate strong buy recommendations for apartments and office in a continuing recovery. Office vacancies drop into low teens and "view space spikes." Apartments tighten. Local ports play second fiddle to L.A. and get strong competition from Seattle, but congested Pacific shipping lanes provide plenty of business for the warehouse market. Hotels show renewed vigor—occupancies skyrocket above 70 percent and room rates advance toward 2001 highs. Silicon Valley simmers again as technology businesses reenergize. Any resurgence in high tech will spill over into the entire metropolitan area.

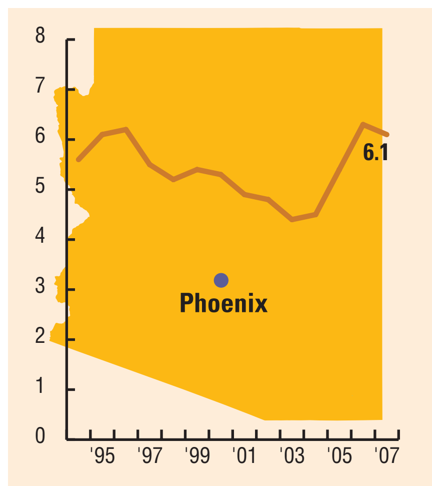


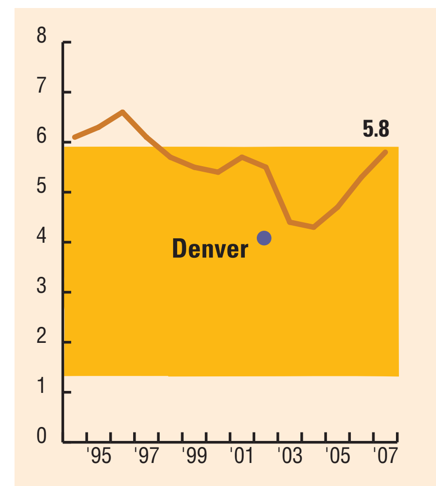
San Diego

A deflated condo market and "severe" housing price declines sour overall sentiment. The correction may offer a silver lining—enormous housing costs were pushing some businesses and employees



out of the area. "It's hard to attract new businesses in." The office market, retail, and hotels continue to excel. Scarce development sites leave few opportunities for new construction. The city is hemmed in by ocean, military bases, mountains, and Mexico. Downtown strengthens—office vacancy holds near 10 percent and rents inch up. Properties have been flipped to cap rate breaking points. Gaslamp Quarter, Seaport Village, and Horton Plaza anchor the popular convention district. Deprived of mass transit, more people look to live near the city center as traffic congestion worsens. La Jolla and other affluent suburban nodes north of the city remain biotech and aerospace hotbeds. The city stands to the side of global pathways, which lie just up the coast. A smallish airport limits direct flights, while the navy controls the harbor. "It's a super place to live—high costs and excessive traffic are the price of popularity."





Phoenix

This metropolitan area expands rapidly, impelled by potent job formation (near national highs). Lower cost of living and a favorable tax environment draw people and business from ultra-expensive southern California. The "hot growth" economy gets its biggest boost from residential and commercial construction as well as mortgage banking. It's reminiscent of Atlanta or Dallas circa 1987. The good employment picture favors apartments and retail—both strong performers. The office market lacks tenant depth. The best submarket, Scottsdale, benefits from proximity to prime neighborhoods; downtown still lacks residential underpinnings. Growing pains surface—traffic congestion worsens, "forcing people to consider working closer to home." Locals are particularly sensitive to the water issue: "We have plenty!" Well, at least for now. And utilities struggle with delivery capacity. Speculators may have inflated the housing market. "Tons of for-sale signs appear" and inventories grow. Cancellations skyrocket for new houses and condos, too. "But we can bounce back quickly, given growth trends." Plans for new light rail "may be too little too late" in this budding "sprawldom." Congestion in southern California warehouse markets creates opportunity for local redistribution centers—"it's as easy to offload in Phoenix as the Inland Empire if goods are shipped further east." Growth, growth, and more growth.

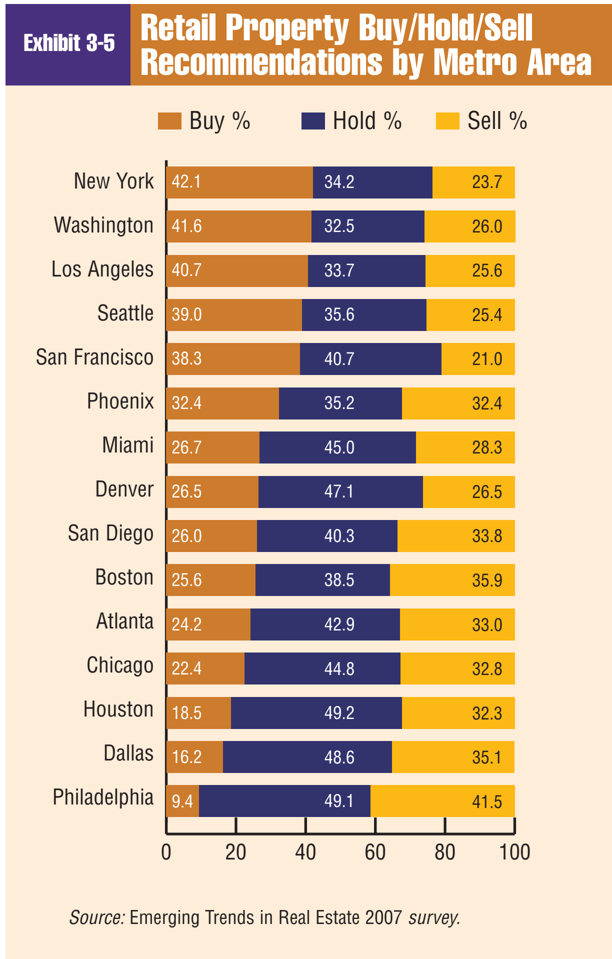
Denver

The Mile-High City wisely gets on the light-rail bandwagon—planning six new lines, covering 120 miles (193 kilometers), the nation's largest comprehensive mass transit development. "People here like to drive, but get fed up with the traffic." All lines will flow into downtown, further boosting its 24-hour prospects, which have been blossoming since the popular incarnations of the Sixteenth Street pedestrian mall and LoDo sports arena district. Companies located downtown will be able to draw on workers from throughout the metropolitan area, a big advantage over suburban nodes. Developers lick their chops at prime infill spots along transit corridors, particularly to the north along I-25. Denver enjoys a big advantage over other more built-out Sunbelt agglomerations—namely, plenty of wide-open space in which to build lines and new mixed-use projects. Office vacancy rates hover in the mid teens. Employment numbers still trail 2001 peaks, but contiguous space blocks are "dropping like a stone" and "mountain-view space is gold." Mid-cap companies spur job growth. Locals worry about the "elephant in the room"—what happens if Qwest merges or is acquired? "That could be a headshot." Rents start to move up on multifamily, which had been oversupplied. Some construction resumes in office and apartments. Denver is in the sweet spot of an upcycle—good absorption and increasing rents. "We're coming back, but then we build too much and fall down again."

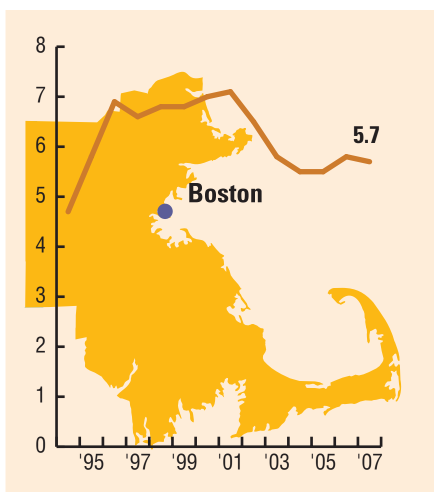
Boston

"About to come out of the woods," Boston lags well behind New York and Washington, D.C. Substantial post-2001 area employment declines reverse and

South Florida's largest city hits the **shoals** *of condo market collapse.*



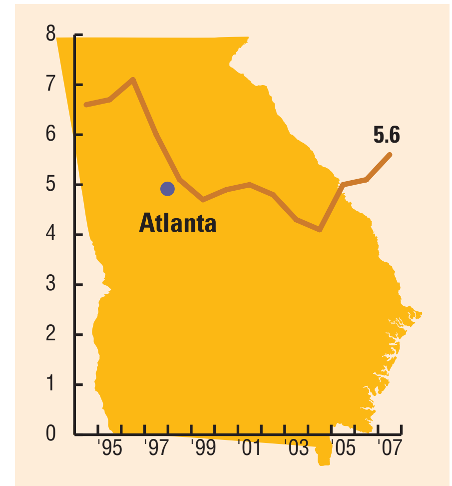
Source: Emerging Trends in Real Estate 2007 *survey.*



office vacancy rates fall from mid to low teens. Office rents start increasing as harbor-view space banks top dollar. Backbone financial and Route 128 tech companies expand. Professional firms follow suit. Landlords gain the upper hand finally as tenants realize it's time to make deals in the market recovery. "Concessions start coming off the table." Hotels also bounce back. An ultra-expensive housing market shows signs of ebbing and condo converters overshoot here, too. Expect further housing price drops in a definite correction. Apartments rate a solid "buy." Warehouses are a "sell."

Atlanta

Employment growth accelerates in the "Southeast's big engine," but below fast-paced levels of 1980s and 1990s, and new development activity promises to mire the market in perpetual softness. "Normally this is an early recovery market, but there have been no pops." Rents don't grow—"they're the same as 15 years ago" and owners "never get control." The warehouse market also builds ahead of increasing demand. The good news concentrates in "exploding" Midtown, which combines office and new high-rise residential with a cosmopolitan restaurant/shopping scene. The nearby mixed-use Atlantic Station project provides another shot in the arm to a city sorely lacking 24-hour dynamics. Ultimately, Midtown could conjoin with uptown Buckhead and form a true 24-hour core held together by the city's MARTA subway system. Downtown continues to suffer without any meaningful residential spine. Other regional cities try to learn from Atlanta's mistakes. Charlotte, Birmingham, Louisville, and Nashville focus on planning more multifaceted city centers.



Houston

Somewhat under the radar screen, this huge boom/mostly bust market shows heady improvement in its office sector.

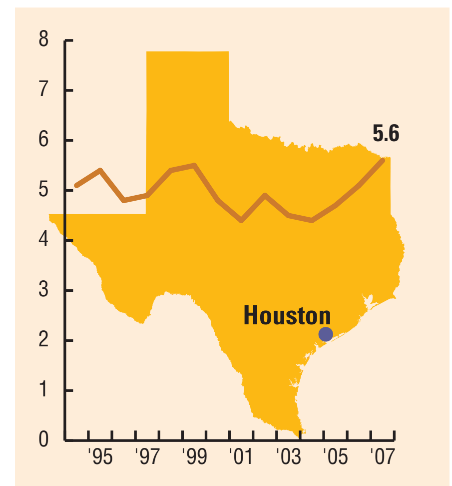
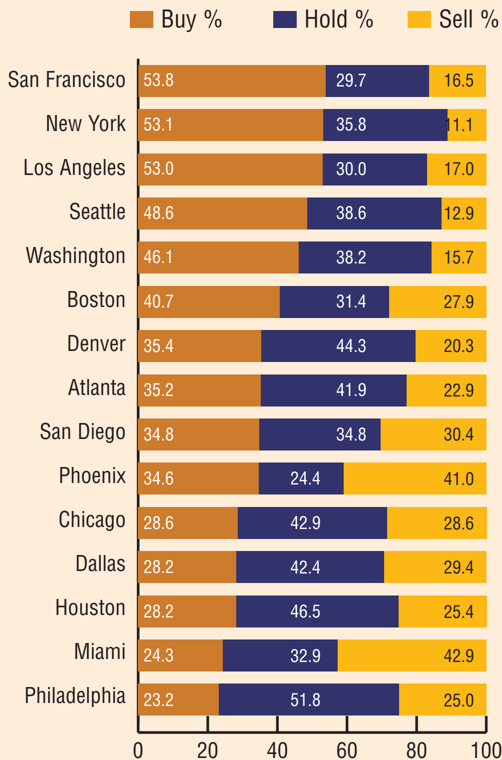


Exhibit 3-6 **Apartment Property Buy/Hold/Sell Recommendations by Metro Area**

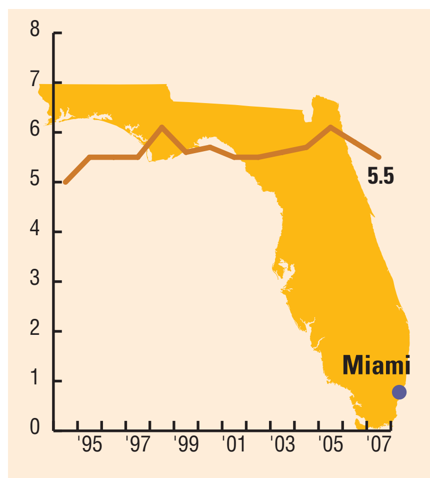


Source: Emerging Trends in Real Estate 2007 *survey.*

The city survived Enron's demise and diversifies beyond core oil and energy firms. The burgeoning medical center, expanding port, and proximity to Mexico all play positive roles, but fat oil company profits haven't hurt either. Buyers place bets that energy prices will stay high. The warehouse market gains momentum at the expense of the New Orleans debacle and overloaded West Coast terminals. Immigration and steady in-migration from folks seeking affordable (low) cost of living spells good news for apartments. Forget about traffic and sprawl—they're out of control in this zoning-free metropolis. A nascent light-rail system has minimal impact.

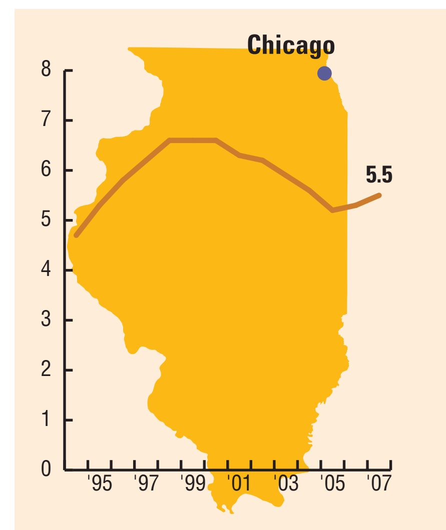
Miami

South Florida's largest city hits the shoals of condo market collapse and housing prices are off their highs as well. "With speculators gone, the residential market heads back to reality." Middle-market projects suffer the most. Apartment supply will increase as condominiums revert to rental units. Housing distress distracts from the hale-and-hearty office market and its sub–10 percent vacancy rate. Recent developer fixations on residential opportunities fortuitously had restricted appetites for office construction. The warehouse market, buttressed by Latin American trade, remains exceptionally sound. Local players hope for a quick convalescence. "Fundamentals are strong, so the correction should be short." They suggest that the city's internationally oriented business base and barriers to entry will combine with prodigious Florida in-migration trends to promote absorption of empty space in a more rational market. "It's hard to get hurt here for long." Hurricanes inflate insurance premiums, raising business and ownership costs.



Chicago

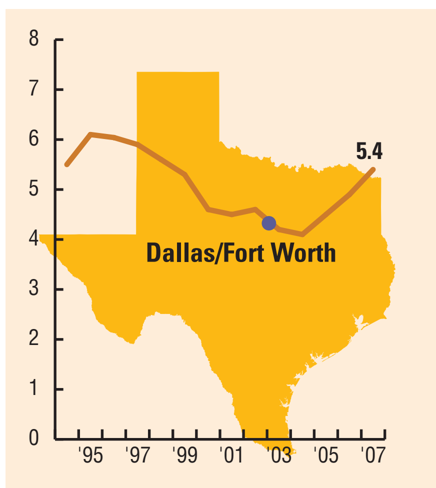
"Dead." "Slow." "Flat as a pancake." Office developers bemoan "lack of demand," but keep building anyway and steal tenants from older stock. "Tenants play musical chairs." Vacancy rates stagnate in the mid teens as some B-office buildings convert to residential. That helps soften the condo market despite

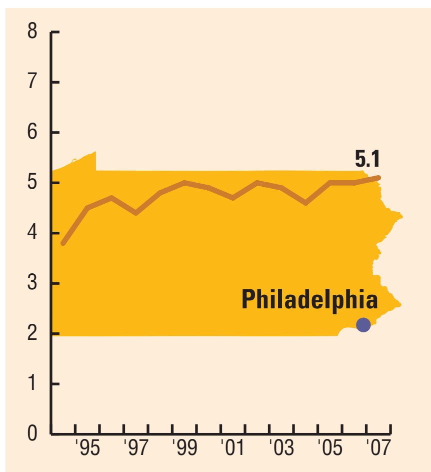


strong move-back-in trends. A general "Midwest malaise" saps Chicago's vigor. "The city is 18 to 24 months behind most other markets in a recovery." As for the suburbs—"It's ugly." Warehouse markets around O'Hare still rank among the nation's best.

Dallas

Building resumes, although the Metroplex office vacancy rate hovers above 20 percent. What more do you need to know? Wide-open Texas markets favor developers, but "they are never good places to invest." No barriers to entry and a constant supply of new space keep appreciation down. Signs of infill activity finally begin to appear: residential high rises in uptown Dallas "change the market fabric." But at the fringes more housing goes up. Industrial "disappoints."





Philadelphia

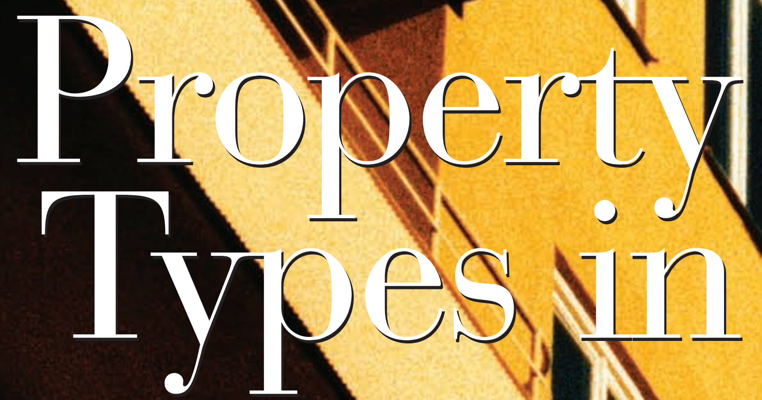
Mid-teen office vacancies slowly decline—downtown shows greater strength than the suburbs. Investors question market growth potential since global pathways bypass this city to the north and south. The metropolitan area's future could lie as a lower-cost alternative, convenient to New York and Washington along a high-speed train corridor. More Center City residential would help build 24-hour attributes, but riverside gambling casinos offer no solution to offset corporate torpor.

Smaller Market Prospects

The surfeit of capital has pushed greater numbers of investors into secondary and tertiary markets searching for yield. "They offer better value in shorter holding periods." Concern about exit strategies in these traditionally more thinly capitalized markets will linger. Indeed, some recent buyers wisely may seek to flip sooner rather than later. Expect investors increasingly to turn more guarded and choosy in smaller markets, and cap rate spreads there will begin to widen compared with those in major cities. Like the best major markets, the top smaller markets may be nearing peaks.

Austin tops the list of smaller markets; it rebounds from its tech-wreck collapse, showing double-digit rent increases (off a low basis). **Orlando** continues to grow strongly. Higher insurance rates help keep the lid on development, but the area can't escape condo problems. **Honolulu** revels in gangbusters tourism, thanks to the improved Japanese economy, weak dollar, and domestic preference to stay home during a time of global uncertainty. "It's too late to buy into hotels." **San Jose** solidifies—its volatile R&D markets start to take off. Likewise, **Tampa/St. Petersburg** office may be underrated and Jacksonville's port stands to benefit from rising shipping traffic along the East Coast. **Charlotte** loses some top Bank of America executives to New York, but Wachovia stays put. These megabanks remain an important economic anchor. Condominiums may get overbuilt downtown, but office looks healthy. **Sacramento** picks up with the rest of northern California. Attractive **Portland** sits in Seattle's shadow off the beaten track. Like Charlotte, **Raleigh** stands to benefit from retirees moving down south away from cold and expensive Northeast metros. The Research Triangle and college cluster boost the area, which can't link into global pathways without a major airport. **San Antonio** improves over last year,

with strong homebuilding prospects. **Salt Lake City** attracts an exodus of middle-income Californians, escaping inflated cost of living exigencies. Local apartment and housing markets energize. **Las Vegas's** hand cools down in missed condo bets. **Minneapolis** "needs to get used to slow growth." The Twin Cities are too removed to take advantage of Sunbelt and coastal demographics trends. But "it's the one place in the country where people like cold climate." **Nashville** touts its new Nissan plant—blue collar goes country. **Detroit** suffers from "secular [not cyclical] downward growth shifts" as body blows to the auto industry afflict Rustbelt markets. Upside investment potential is limited with "real downside risk." Relative value exists—"Detroit isn't going away." **New Orleans** faced tall hurdles even without Katrina. The hurricane leveled what remained of a shrinking corporate base. A viable plan for recovery remains elusive, but reenergizing tourism and the antebellum French Quarter as a unique Jazz-flavored tourist attraction seems the Crescent City's best hope.


Property
Types in

"Cap rates will rise modestly from recent cyclical lows across all property sectors."

Perspective

For 2007, *Emerging Trends* interviewees expect all property sectors to perform relatively well, with investment and development prospects tracking similarly to last year. Investment performance ratings continue to cluster in the fair to modestly good range, led by moderate-income apartments, full-service hotels, and warehouses (see Exhibit 4-1).

■ The apartment category takes back its familiar number-one position from hotels, which last year captured the top spot for the first time in the survey's history. Rising mortgage rates and pricey housing discourage homebuying in favor of renting. Investors also fancy demographic shifts, which show increasing numbers of young adult renters entering multifamily markets.

■ Full-service hotels slip slightly. Interviewees expect another strong year from these properties, but sense an approaching market top. The limited-service category gets lower ratings—a full development pipeline suggests some near-term softening—but the ratings and ranking for this sector are up from recent years.

■ Warehouse/industrial maintains its perennial standing as a property sector leader—core investors cannot buy enough of these consistent, cash-flowing properties. Vacancy rates slowly decrease and rent increases are expected.

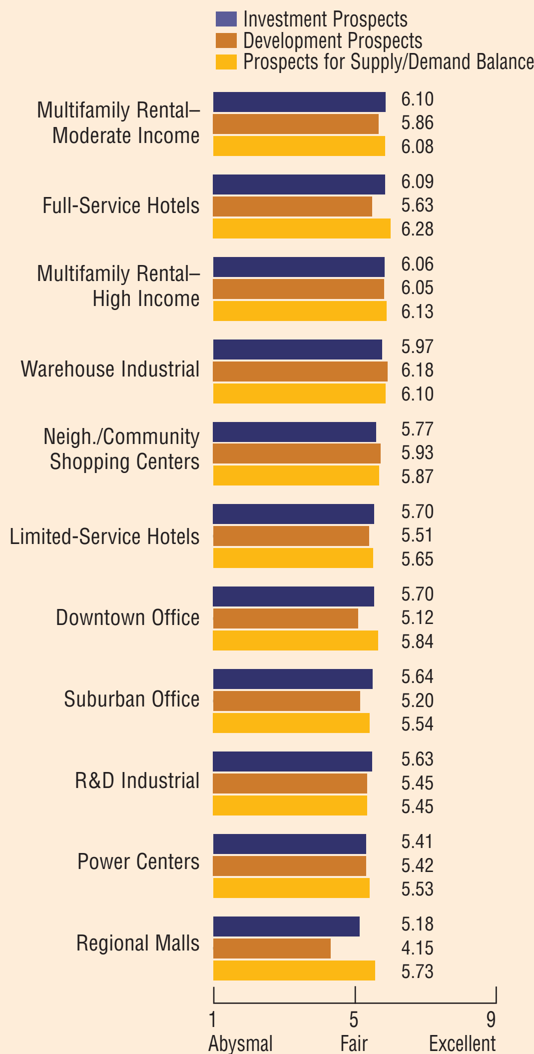
■ Both downtown and suburban office showed improvements over the 2006 survey—respondents expect higher occupancies and rents to enhance income streams.

■ Retail categories—neighborhood centers, power centers, regional malls—registered marginal declines over rising concern about consumer fatigue in the wake of rising energy costs, higher borrowing rates, and flagging housing markets.

Significantly, survey respondents raised clear signals that cap rates will rise modestly from recent cyclical lows across all property sectors (see Exhibit 4-2). Anticipated increases range from 29 basis points for warehouses to 50 basis points for community centers and 69 basis points for high-income apartments. Unleveraged internal rates of return (IRRs) are expected to range from 10.3 percent for limited-service hotels to 8 percent for regional malls.

Although overall survey responses favor selling, respondents lean toward holding properties over dispositions in most individual sectors. Regional malls and downtown office score the highest hold ratings, while power centers top sales lists. Buyers

Exhibit 4-1 Prospects for Major Property Types in 2007



Source: Emerging Trends in Real Estate 2007 *survey.*

focus on favored core apartment and industrial categories, while acquisition interest in office remains low and wanes for hotels. Buying appetites for power centers and regional malls sink further (below 10 percent) and improve only marginally for normally favored grocery-anchored centers.

Exhibit 4-2 Prospects for Capitalization Rates and Internal Rates of Return

	Cap Rate July 2006 (Percent)	Expected Cap Rate December 2007 (Percent)	Expected Cap Rate Shift (Basis Points)	Expected Unleveraged IRR*	Expected Leveraged IRR*
Apartments–High Income	5.66	6.25	+69	8.49	11.49
Regional Malls	6.03	6.44	+41	8.04	9.94
Apartments–Moderate Income	6.21	6.87	+66	8.56	11.44
Downtown Office	6.44	6.90	+46	8.53	10.92
Power Centers	6.58	7.06	+48	8.61	10.86
Neighborhood/Community Centers	6.59	7.09	+50	8.77	11.21
Warehouse Industrial	6.87	7.16	+29	8.69	10.89
Suburban Office	7.07	7.45	+38	9.07	11.43
R&D Industrial	7.32	7.61	+29	9.09	11.43
Hotels–Full Service	7.35	7.77	+42	10.23	13.83
Hotels–Limited Service	7.93	8.38	+45	10.30	13.11

Source: Emerging Trends in Real Estate 2007 *survey.*

**During holding period.*

Many niche sectors continue to score better for investment prospects than major property categories (see Exhibit 4-3), reflecting a consensus view that these more thinly traded segments may offer better yields given run-ups in pricing among the major property food groups. Seniors' housing, mixed-use projects, and student housing top the niche list.

Development prospects also rate fair to modestly good across all commercial/apartment property types, according to survey respondents. Warehouses, apartments, and neighborhood centers lead the field again—these sectors all enjoy reasonably good supply/demand equilibrium. Given recent cap rate compression, existing properties in these categories continue to achieve pricing above replacement cost, goading developers and their capital partners into action. But given mixed economic signals and restraints on demand drivers, developers should be wary about rapidly oversupplying some markets:

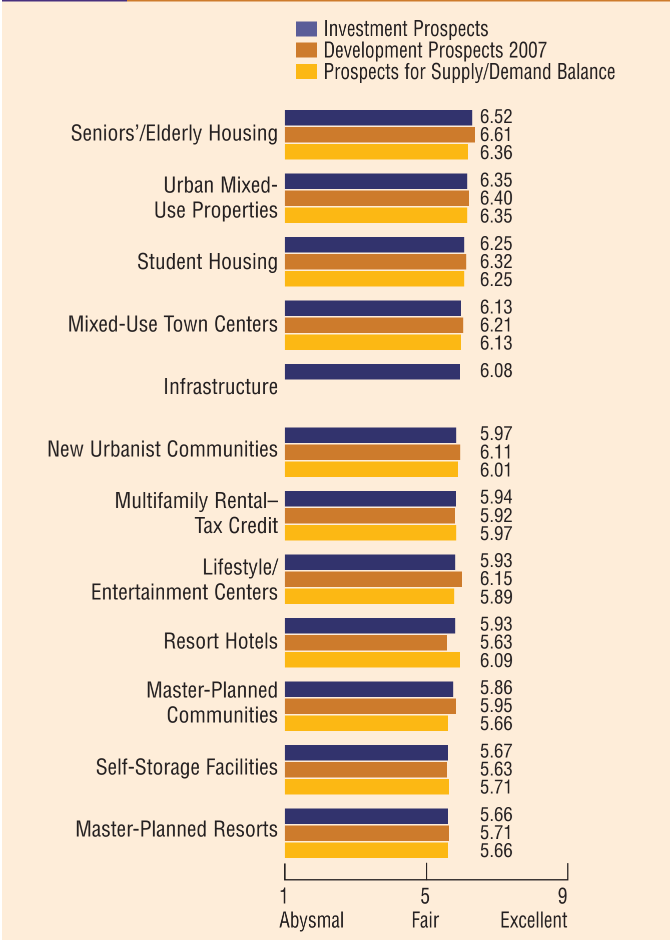
■ New warehouse development has kept national vacancy rates slightly higher than would be expected after a five-year economic rebound. Major port markets with few developable sites show low vacancies, but development-friendly Sunbelt markets experience high levels of new construction and stubbornly elevated availability rates.

■ Apartment developers need to monitor flagging condominium sales—worry increases that new condo projects and conversions will be forced to morph into rentals that would compete directly with any new apartment construction.

■ Retail construction has increased over all categories, except regional malls, and vacancy rates have stayed level. Pace-setting lifestyle centers rate most new attention, but builders busily add

Exhibit 4-3

Prospects for Niche and Multiuse Property Types in 2007



Source: Emerging Trends in Real Estate 2007 *survey.*

neighborhood retail near new housing, just as some of these projects suffer declines in sales velocity.

■ Office projects also increase—interviewees warn that shallow demand will not support a wave of new projects in most markets, but agree that early entrants can do well.

■ Ditto for hotels in some undersupplied cities like New York. But stepped-up construction in limited-service hotel segments threatens to constrain revenue growth by late 2007.

Ratings for single-family home development drop from last year's report, but stand well above the dismal score registered by multifamily condominiums. The most recent sales, price, and inventory data suggest even these lowered ratings may be too optimistic. Residential developers face prospects for sharply curtailed activity in markets where speculators had been active in boosting sales.

Apartments

Strengths

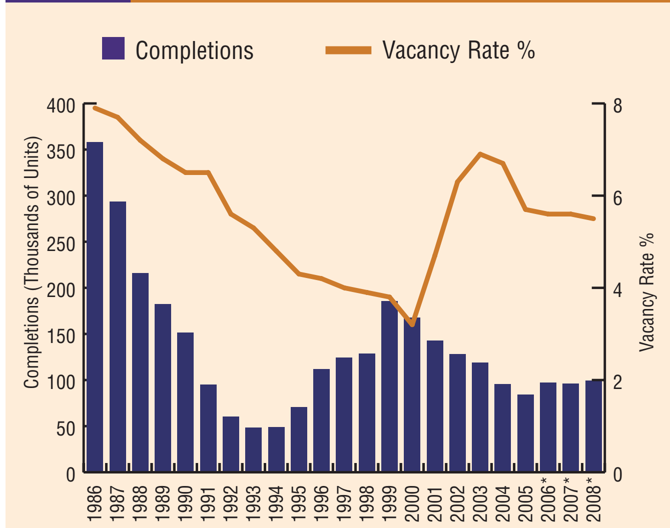
Bullish trends abound—higher mortgage rates make housing less affordable even in correcting markets; long-anticipated "fantastic" demographics kick in as baby boom progeny finally grow up into renters; and employment growth helps. More jobs mean less doubling up and recent college graduates can afford to leave parental nests to rent on their own. Rents take off and occupancies tighten. If new homeowners begin to default on adjustable-rate mortgages, they will return to the renters' pool. For buyers, cap rates begin to rise. Condo converters had bid up prices to unsustainable levels.

Weaknesses

Recycling of failed condominiums into rental units creates short-term angst for recent buyers counting on a continuation of sharp lease rate hikes to escape negative leverage. The turn in cap rates hurts, too. Conversion reversions and condo project blowups could soften rent increases, especially for upscale apart-

Exhibit 4-4

Apartment Completions and Vacancy Rates: Top 50 Markets

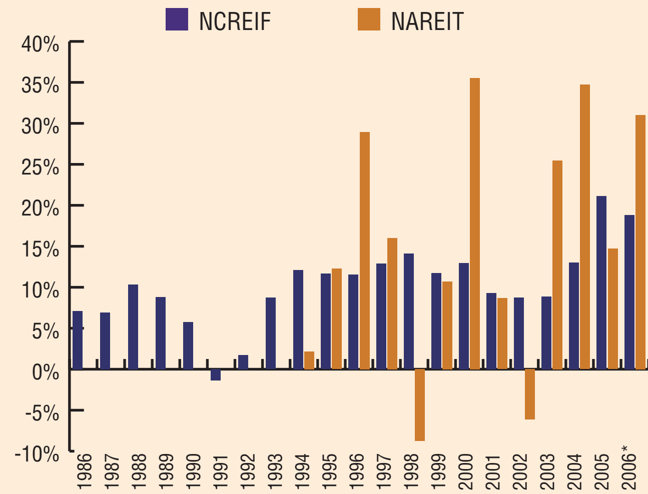


Source: REIS (includes top 50 U.S. markets).

**Forecasts.*

The **"smart money"** *buys moderate-income B-quality apartments on the coasts.*

Exhibit 4-5 **Apartment Property Total Returns**



Sources: NCREIF, NAREIT.

**2006 data annualized from second-quarter 2005–second-quarter 2006.*

ments. Condo stock leans to more high-quality construction and higher-finish amenities and would compete more directly with existing A-quality rentals. Immigration politics raises some concerns—a widespread crackdown on new arrivals could chill gateway markets, but Congress makes little headway.

Best Bets

The "smart money" buys moderate-income B-quality apartments on the coasts. Target the nation's most expensive housing markets where condo conversions avoided frenzied levels—San Francisco, New York, Los Angeles, and Boston. Seattle rates a strong buy, too. Be careful around Washington, D.C., and in Chicago. The B-segment caters to necessity renters, who grow in lockstep with generation Y adults and higher interest rates. Low cap rates may be a concern, but NOI growth eventually can save the day. Traditional job growth markets—Atlanta, Houston, Dallas, Denver—offer lesser potential.

Sellers missed cap rate nadirs, but still can reap generous gains. Core holders can relax and enjoy solid revenue growth.

Opportunity funds lurk to buy broken condo properties. It may be difficult to score bargains with all the money hunting these deals.

Exhibit 4-6 **Prospects for Moderate-Income Apartments in 2007**

	Prospects	Rating	Ranking
Investment	Modestly Good	6.10	1st
Development	Modestly Good	5.86	4th
Supply/Demand Balance	Modestly Good	6.08	4th

Expected Capitalization Rate, December 2007	6.9%
Expected Unleveraged IRR During Holding Period	8.6%

Buy	Hold	Sell
42.1%	34.4%	23.4%

Source: Emerging Trends in Real Estate 2007 *survey.*

Avoid

Better to sidestep acquisition of properties that may compete against failed condo developments or conversions. Florida markets, Las Vegas, San Diego, and Phoenix may need a rest. Value-added buyers also see diminishing returns in many "priced to perfection" markets. Those investors counting on converting rental units to condominiums realize that recipe is cooked. Early birds scored with conversions, but late entrants have been nailed by bad timing: "Those strategies just haven't panned out." Value-added investors can still try "plan B," their traditional apartment gambit: "Buy B-minus/C-quality units in the right location, clean up, add some paint, relandscape, and sell the stabilized core assets as soon as you have leased up at higher rents. The problem here is that everyone is doing it." Profits aren't what they used to be.

Exhibit 4-7 **Prospects for High-Income Apartments in 2007**

	Prospects	Rating	Ranking
Investment	Modestly Good	6.06	3rd
Development	Modestly Good	6.05	2nd
Supply/Demand Balance	Modestly Good	6.13	2nd

Expected Capitalization Rate, December 2007	6.3%
Expected Unleveraged IRR During Holding Period	8.5%

Buy	Hold	Sell
28.3%	37.3%	34.4%

Source: Emerging Trends in Real Estate 2007 *survey.*

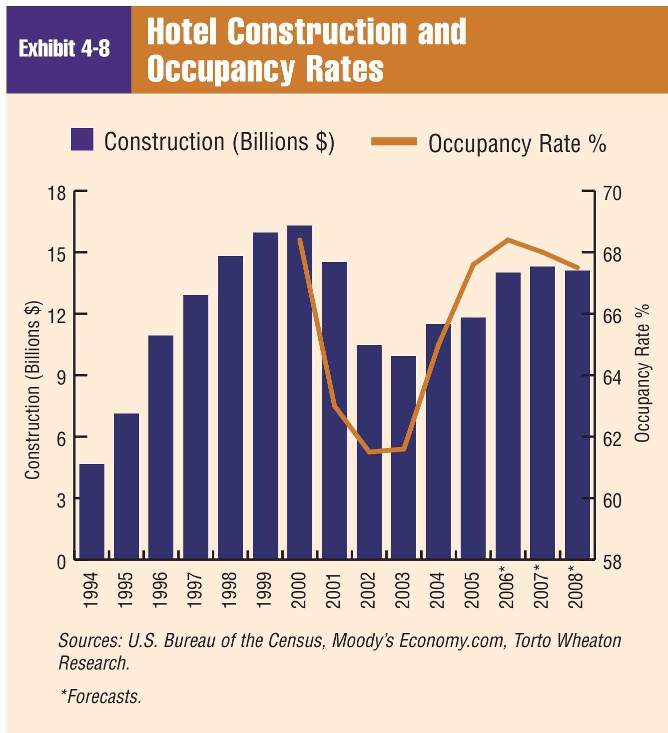
Development

Condo reversions may stymie development prospects in some markets. Nationally, rental construction has been controlled. In overheated markets, investors find it may be cheaper to build than buy, even with construction costs rising. "Development offers initial rates of return 100 basis points over existing cap rates." Escalating land costs and drawn-out entitlement processes temper enthusiasm. Jitters increase about rents supporting costs.

Outlook

Cap rates edge higher. Occupancies and rents improve. The race is on! For 2007, NOI growth takes the lead, but development and oversupply from broken condos could slow revenue gains before year-end. Longer-term, sustained demand will keep most markets in equilibrium, propelling solid returns until housing becomes a better value again. Immense investor appetites for multifamily properties promise to temper upward cap rate moves. Apartments seem poised for a good long run.

Exhibit 4-8 **Hotel Construction and Occupancy Rates**



Sources: U.S. Bureau of the Census, Moody's Economy.com, Torto Wheaton Research.

**Forecasts.*

Hotels

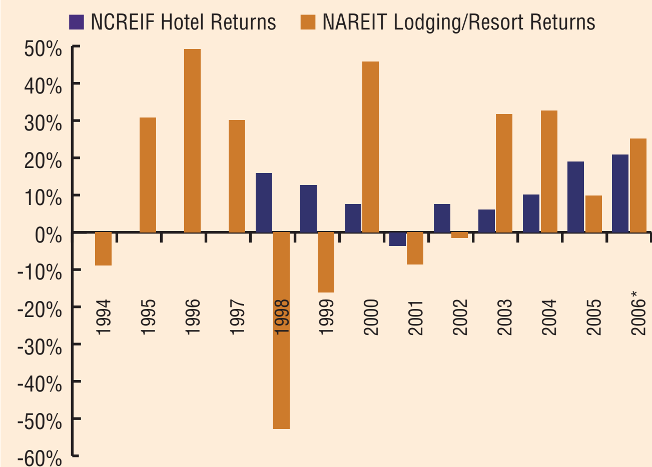
Strengths

Lodging markets have experienced "amazing recoveries" since 9/11-induced heartache, tracking general economic improvement (GDP growth). "Demand outstrips supply," producing "record profits." Thanks to solid corporate bottom lines, business travelers are back in full force—in the big cities executives barely blink at $500 a night room tabs, thankful they found a place to stay. "Corporations have let go of the spending reins." Hotel conversions to condominiums in major urban markets like New York have shrunk room supplies in full-service segments as demand intensifies; and all those suburban suites hotels at interstate exits never seem to have vacancies during the week either. Hotels have successfully implemented various surcharges to boost revenues further in the midst of economic good times. Owners who bought in the downturn have been richly rewarded by revenue gains and heady appreciation. Luxury properties should continue to benefit from steadily increasing demand from wealthy aging baby boomers, enjoying more leisure time. Difficult to replicate, these "one-of-a-kind" upper-upscale hotels can stay better insulated from competition, especially in urban markets with high barriers to entry.

Weaknesses

New construction gets underway just as the economy retrenches, signaling an approaching peak in the hotel markets. "Zillions of hospitality loan deals are out there with high leverage, especially for limited-service development. You need to worry about overreaching and lots of risk." Room rates continue to increase, but occupancies have crested in some markets. As new room supplies come on line in 2007 and 2008, revenue growth will slow. High energy costs cloud prospects—any increased fuel expenses for airlines and higher jet fares could curb corporate appetites for business trips and inflating gas pump costs curtail leisure travel. "Hotels are dependent on GDP growth—any whiff of recession would precipitate a fall back." High property prices, meanwhile, have driven down yields for prospective buyers. "Spreads look more like core than they ever have—there's no risk premium in the pricing." In some union markets, labor disputes increase expenses and "amenity creep" raises costs—all those high-thread-count sheets. Cell phones and BlackBerrys torpedo revenues from in-room phones.

Exhibit 4-9 **Hotel/Lodging Total Returns**



Sources: NCREIF, NAREIT.

**2006 data annualized from second-quarter 2005–second-quarter 2006.*

Best Bets

Selling sentiment should increase for limited-service categories where projects ramp up quickly and are easier to build. Hold full service in major global business markets—supply will take longer to increase and demand trends should sustain occupancies near peaks through the year and well into 2008. The large publicly traded hotel companies husband their trophies, "holding keys to major properties in major cities." But don't fall in love. Hotel markets are notoriously volatile.

Avoid

Condo hotels—the 21st-century equivalent of resort timeshares—seem ripe for oversupply in some markets. Sponsors take advantage of the affluent baby boomer wave, but overdo it. Full construction pipelines threaten near-term equilibrium; lenders need to cut back on construction loans in the limited-service category. "In the next downturn, they will be vulnerable to high amounts of debt and low amounts of equity on deals." Buyers need to "cool it," too.

Exhibit 4-10 **Prospects for Full-Service Hotels in 2007**

	Prospects	Rating	Ranking
Investment	Modestly Good	6.09	2nd
Development	Modestly Good	5.63	5th
Supply/Demand Balance	Modestly Good	6.28	1st
Expected Capitalization Rate, December 2007		7.8%	
Expected Unleveraged IRR During Holding Period		10.2%	

Buy	Hold	Sell
32.9%	39.8%	27.3%

Source: Emerging Trends in Real Estate 2007 *survey.*

Development

Some markets can sustain new full-service development—New York stands out. In general, new hotels can be risky bets, especially upscale projects. Better to let the major hotel companies take the lead. Details and amenities increase costs and construction time. Compared with office or apartment projects, "they take twice as long and cost twice as much." Development is underway in some mid-priced and upscale segments. "This business is so cyclical, it's only a matter of time before some projects look like dogs."

Exhibit 4-11 **Prospects for Limited-Service Hotels in 2007**

	Prospects	Rating	Ranking
Investment	Modestly Good	5.70	6th
Development	Modestly Good	5.51	6th
Supply/Demand Balance	Modestly Good	5.65	8th
Expected Capitalization Rate, December 2007		8.4%	
Expected Unleveraged IRR During Holding Period		10.3%	

Buy	Hold	Sell
22.7%	43.2%	34.1%

Source: Emerging Trends in Real Estate 2007 *survey.*

product to satisfy investors.

Outlook

Hotels should perform well again in 2007 and enjoy solid operating returns. But the profit curve will flatten and squeezing out RevPAR gains will become more challenging. Development softens limited-service markets by 2008. Full-service segments have legs—"everything is fine until '09" as long as the economy holds up, terrorism doesn't roil the markets, and menaces like the avian flu never materialize. Never count on clear sailing.

Industrial

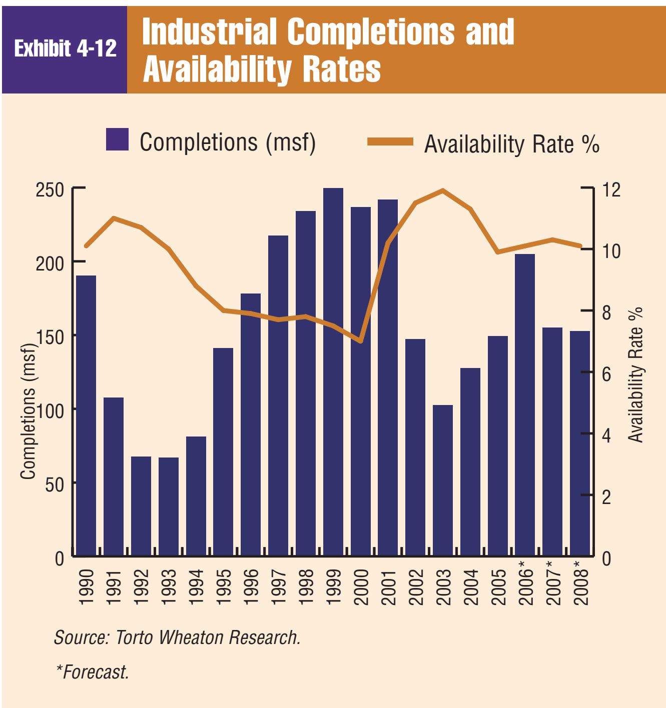
Strengths

The good news for owners is that warehouse markets never supply enough for-sale product to satisfy investors, especially institutions that covet these properties' consistently solid income flows. In the near term, "you won't see much cap rate expansion." In fact, recent record returns reflect colossal capital demand and cap rate compression despite historically mediocre occupancy rates. Property appreciation has been unprecedented. Vacancies trend down slowly, hovering near 10 percent, and begin to push rents . . . finally. During the mid-1990s, industrial vacancies averaged closer to 8 percent. Increasing import traffic, mostly from manufacturing juggernauts in China and Korea, boosts market fortunes for owners with properties near seaports. Larger coastal "big box" markets, especially L.A./Long Beach, San Francisco, and Seattle along the Pacific and New York/New Jersey on the Atlantic, attract outsized tenant demand and investor attention. But the deluge of global trade activity spills over into Houston and smaller East Coast ports—Jacksonville, Charleston/Savannah, Norfolk, and Baltimore, among others, benefit. Phoenix transforms into a longer-haul alternative to the Inland Empire, feeding off L.A./Long Beach.

Weaknesses

The bad news for buyers—they continue to have trouble assembling scale in portfolios since not much sells relative to demand. Owners tend to hold for the long term. High acquisition prices above replacement cost have pushed developers into action to meet buyer interest. Construction has been measured, compared with past building cycles, but new space has kept occupancies from increasing above 90 percent except in the red-hot port markets. As a result, rent growth has been "disappointing." Logistics technologies continue to remove distribution links from the supply chain, reducing growth in tenant demand for space in interior regional markets along interstates. Container trucks, guided and tracked by global satellite positioning technology, head directly to end users. Major distribution hubs like Atlanta, Dallas, and even Chicago lose some luster compared with coastal counterparts.

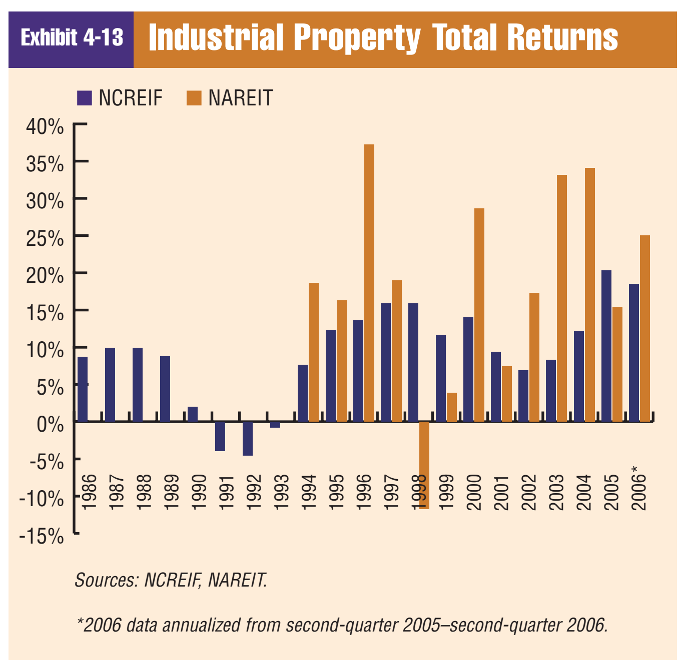
Exhibit 4-12 Industrial Completions and Availability Rates



Source: Torto Wheaton Research.

**Forecast.*

Exhibit 4-13 Industrial Property Total Returns



Sources: NCREIF, NAREIT.

**2006 data annualized from second-quarter 2005–second-quarter 2006.*

Best Bets

Investors concentrate on intermodal locations that serve global shipping lanes: L.A./Long Beach, San Francisco, Seattle, and New York/New Jersey. These jumbo terminals feature deep-water ocean ports, international airports linked to major domestic destinations, railroad access, and interstate connections. Megatenants, which orchestrate distribution from these key markets, demand big-box space to move goods quickly to plants or retail stores. "It's all the rage." These buildings range from 500,000 to more than 1 million square feet (46,511 to 93,023 sq m). They have super-flat floors for forklifts to move shipment palates with embedded computer tracking chips from unloading docks to loading docks in seamless logistical symphonies. Loading zones must accommodate the turning radii of supersized tractor trailers.

Contrarians focus on older, smaller warehouse properties in infill areas suitable for redevelopment as retail, office, or even apartments. Fewer people compete for these low-ceiling warehouses that verge on obsolescence and trade at discounts—"you can get much better value." In the major hubs, older buildings can be bulldozed for new big-box projects. Older space still works in regional markets where many smaller tenants continue to actually warehouse supplies and goods. "Everybody isn't acting like Wal-Mart."

Exhibit 4-14 Prospects for Warehouse Industrial in 2007

	Prospects	Rating	Ranking
Investment	Modestly Good	5.97	4th
Development	Modestly Good	6.18	1st
Supply/Demand Balance	Modestly Good	6.10	3rd

Expected Capitalization Rate, December 2007	7.2%
Expected Unleveraged IRR During Holding Period	8.7%

Buy	Hold	Sell
40.9%	40.5%	18.7%

Source: Emerging Trends in Real Estate 2007 *survey.*

For smaller investors, buying REIT stocks may be the best way to gain exposure to the sector. "It's just too difficult to assemble" diversified holdings in small one-off transactions.

Avoid

Older, smaller boxes in the larger big box–oriented distribution centers. Absent compelling reuse strategies, these properties ride against the market tide. They may be cheaper, but not worth the greater risk. Institutions tend to steer clear and exit strategies may be difficult to execute. Time is not on their side.

Development

New warehouse construction almost always stays under control—short project time frames allow developers to gauge market demand and pull back if necessary. Development has been justified in the low-vacancy, growth-constrained intermodal ports. Merchant builders have "made big bucks" in California's Inland Empire on the few sites where they have been able to build. But in markets with vacancies in the mid teens like Atlanta and Dallas, some developers have built into capital demand, delaying market recoveries and holding back rent growth. They profit in the spread between their costs and higher "for sale" prices. Buyers get brand-new, state-of-the-art buildings, which are more attractive to tenants than older stock. Rising construction costs may limit development upsides, but continued strong capital appetites may continue to fuel new construction. Of course, higher rents would boost development prospects, too.

Exhibit 4-15 Prospects for R&D Industrial in 2007

	Prospects	Rating	Ranking
Investment	Modestly Good	5.63	9th
Development	Fair	5.45	7th
Supply/Demand Balance	Fair	5.45	11th

Expected Capitalization Rate, December 2007	7.6%
Expected Unleveraged IRR During Holding Period	9.1%

Buy	Hold	Sell
27.5%	43.9%	28.7%

Source: Emerging Trends in Real Estate 2007 *survey.*

Warehouse Outlook

Read the economic tea leaves. Continued moderate expansion will keep shipping channels humming, push vacancy rates into single digits, and lift rents modestly. "There's not a lot of room for NOI growth." Noncoastal markets with higher vacancy rates would be more vulnerable in any slowdown. Capital seems to know no bounds when it comes to warehouses. Expect appreciation to ebb from mammoth gains, but institutional demand will maintain pricing pressure. For core owners who favor bondlike returns, they sure beat T-bills.

R&D Outlook

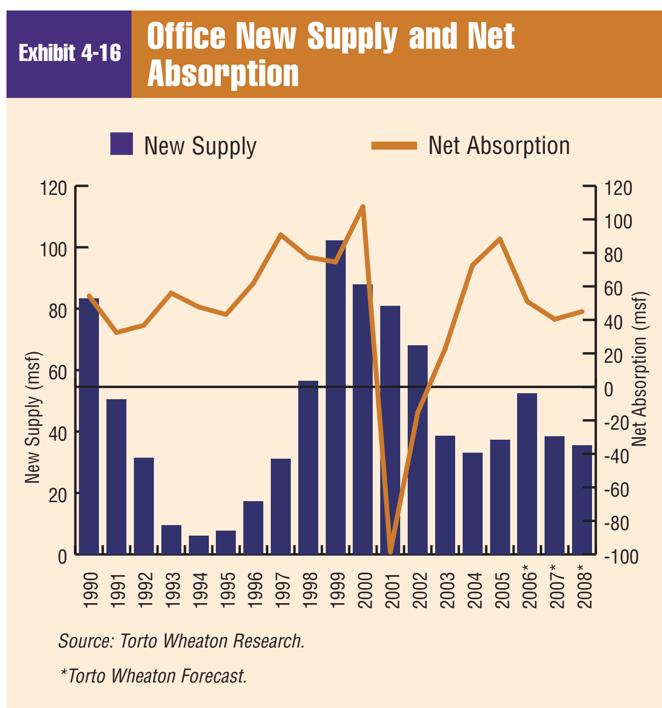
While warehouse markets offer steady year-in, year-out growth and consistent income, R&D properties track the fortunes of the more volatile tech industry, providing opportunistic bursts of appreciation that can quickly flame out in value losses reminiscent of the 2000–2001 tech wreck. If chip maker and software designer prospects continue to improve, as expected, R&D markets may be poised to accelerate again. Certainly, R&D hotbeds—Silicon Valley, Silicon Forest (suburban Seattle), Austin, and the Route 128 corridor (suburban Boston)—have revived. Hiring steps up and vacancies decline. If corporate America increases IT buying after an extended lull, these markets could rocket again. What they really need is the new, new thing, which hasn't materialized yet.

Office

Strengths

"Stars seem to be aligned" for strong absorption, burned-off concessions, real rent growth, and increased earnings (NOI growth). The timing seems right: office tends to bloom late in economic cycles when owners "can ride the recovery." Development is bridled in the better barrier-to-entry markets—"projects in larger cities are a drop in the bucket." Downtown office catches job growth and lease renewals start adding value. New York and Washington, D.C., enjoy substantial rent increases. View space in other markets captures premiums. The capital "feeding frenzy" for Class A acquisitions continues unabated in 24-hour markets. Owners who bought core assets in the "no-brainer" period after 2001 hit the jackpot. Appreciation has been incredible and now rents start moving.

Exhibit 4-16 **Office New Supply and Net Absorption**



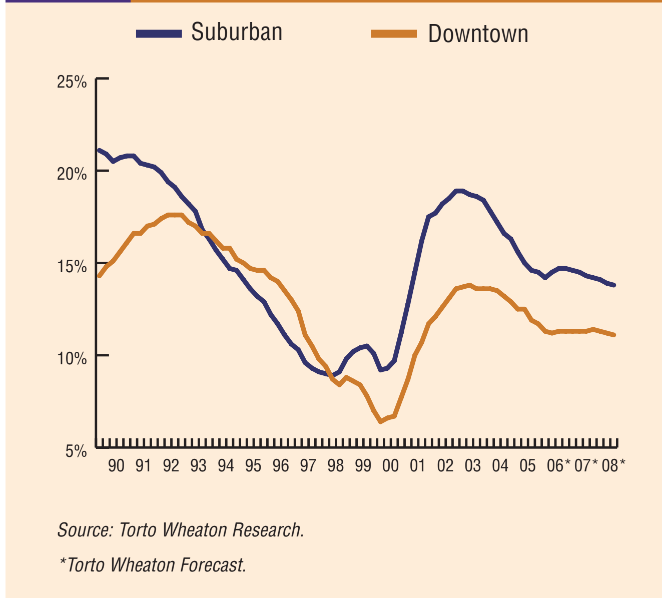
Source: Torto Wheaton Research.

**Torto Wheaton Forecast.*

Weaknesses

Office can be very cyclical. Away from 24-hour cities and prime subcities, "If you hold too long you won't make anything." Tenant demand is spotty "outside major markets." More people work from home, hooked into company Internet networks. Corporations continue to shrink per-capita space requirements, dampening tenant expansion needs even as hiring increases. At the margins, offshoring hurts too. Even five years into recovery, net absorption fails to approach late 1990s' cyclical peaks, with forecasts tailing off. National vacancy rates linger in the mid teens without signs of strong momentum. "People get excited about vacancy rates under 15 percent, but rents don't increase much unless vacancies reduce below 10 percent." New development underway in weaker suburban agglomeration markets and easy-to-build cities like Chicago could keep rents from increasing appreciably. Rising expenses cut into earnings—taxes, utilities, and insurance add up.

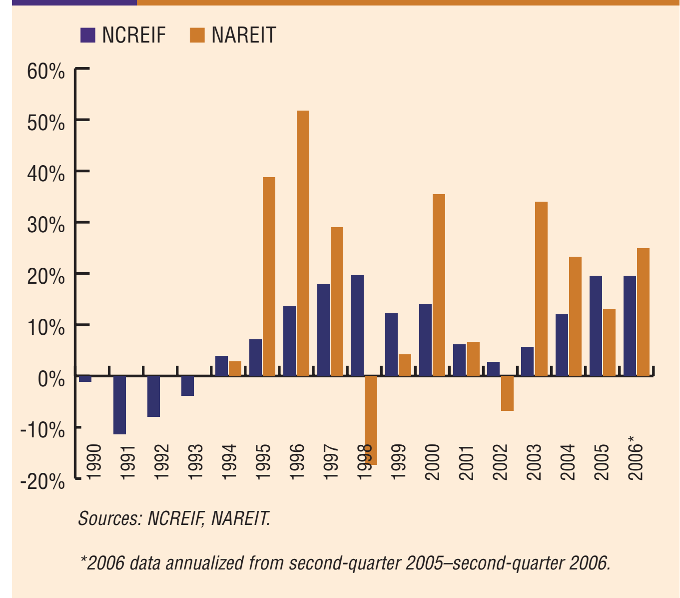
Exhibit 4-17 **Office Vacancy Rates**



Source: Torto Wheaton Research.

**Torto Wheaton Forecast.*

Exhibit 4-18 **Office Property Total Returns**



Sources: NCREIF, NAREIT.

**2006 data annualized from second-quarter 2005–second-quarter 2006.*

Best Bets

Hold prime office in 24-hour cities and tight southern California markets. These properties will benefit immediately from increasing revenues as leases roll over into higher rates. Tenants will begin looking outside prime downtown cores for rent relief in the suburbs. Among the places to benefit: Walnut Creek and Mountain View outside San Francisco; Rosslyn (in Arlington County), Alexandria, and Bethesda near Washington, D.C.; Jersey City (across the river from Manhattan); and Bellevue, Washington. If you are in the mood to buy, Seattle, San Francisco, New York, and Los Angeles offer the best prospects.

Some interviewees bless that old chestnut, the "catch the rising star" strategy. Buy in higher job growth markets, lease up in the hiring phase, and sell out within three years before new supply hits the market. They target the usual suspects: places like Atlanta, Phoenix, and Denver. Be careful—the development pipeline fills in these areas despite uncomfortably high vacancies. And outside of Phoenix job growth isn't what it used to be. The star may be rising, but how high in the sky?

Sellers can't be faulted for taking gains.

Exhibit 4-19 **Prospects for Downtown Office in 2007**

	Prospects	Rating	Ranking
Investment	Modestly Good	5.70	6th
Development	Fair	5.12	10th
Supply/Demand Balance	Modestly Good	5.84	6th

Expected Capitalization Rate, December 2007	6.9%
Expected Unleveraged IRR During Holding Period	8.5%

Buy	Hold	Sell
25.8%	47.2%	27.1%

Source: Emerging Trends in Real Estate 2007 *survey.*

Avoid

Buyers need to back off in prime markets where cap rates have plunged near record lows. Solid NOI growth may not be enough to make rich deals work, especially with large doses of leverage in the mix and expenses rising. Wait until you get the new property tax bill with those high sales prices factored into assessments. Ouch.

Development

Go slow. Most office markets are not exactly undersupplied. "First office buildings out of the ground in markets with sub–10 percent vacancy will score home runs." But how many developers get started too late in the cycle or build in softer suburban markets where today's new projects seem to be concentrated? They count on leaching tenants from older buildings. Worst case: "a double-whammy recession hits in 2008 or 2009, just when new space comes on line."

Exhibit 4-20 Prospects for Suburban Office in 2007

	Prospects	Rating	Ranking
Investment	Modestly Good	5.64	8th
Development	Fair	5.20	9th
Supply/Demand Balance	Modestly Good	5.54	9th

Expected Capitalization Rate, December 2007 7.5%
Expected Unleveraged IRR During Holding Period 9.1%

Buy	Hold	Sell
27.8%	39.8%	32.4%

Source: Emerging Trends in Real Estate 2007 *survey.*

Outlook

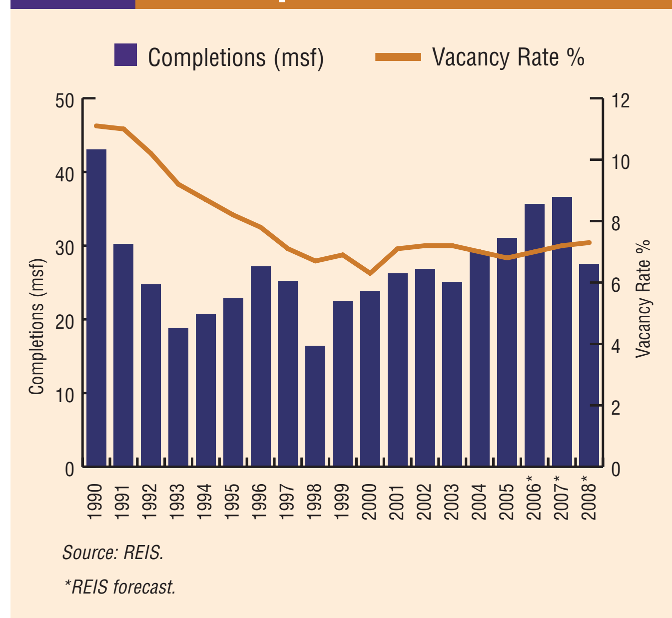
Expect greater bifurcation in pricing to appear between supply-constrained, low-vacancy markets on the coasts and higher-vacancy suburban-oriented markets. Investors also start to discriminate more between trophy and commodity properties. Cap rates already increase for office in secondary and tertiary markets. Hothouse pricing takes a thermostat check without as much low leverage to stir fevered appetites. The rent growth window may be narrower than hoped, given generally high vacancies and an easing economy.

Retail

Strengths

Retail owners continue to celebrate Americans' passion for buying stuff. "We can't believe consumers spend as much as they do," says a prominent mall executive. Decent job growth means people have enough confidence to keep pulling out their credit cards for just about whatever suits their fancy, and investment returns have been formidable. Vacancy rates oscillate around 7 percent, forcing tenants to swallow higher rents. Leases will protect owners from "an immediate pinch" if a downturn strikes, although percentage rents would decline. Fortress malls and Class A grocery-anchored retail with top-rank supermarkets seem impregnable (the Wal-Mart threat fades for them), while lifestyle centers in upscale markets score. They fit suburban shoppers' insatiable desires for "something different" as well as greater convenience—you can drive right up to stylish, in-vogue retailers and dine at trendy restaurant chains near the cineplex without traipsing through sprawling regional malls. What could be better than dinner at P.F. Chang's after finding that feather pillow at Bed, Bath and Beyond?

Exhibit 4-21 Retail Completions and Vacancy Rates: Top 50 Markets



Source: REIS.

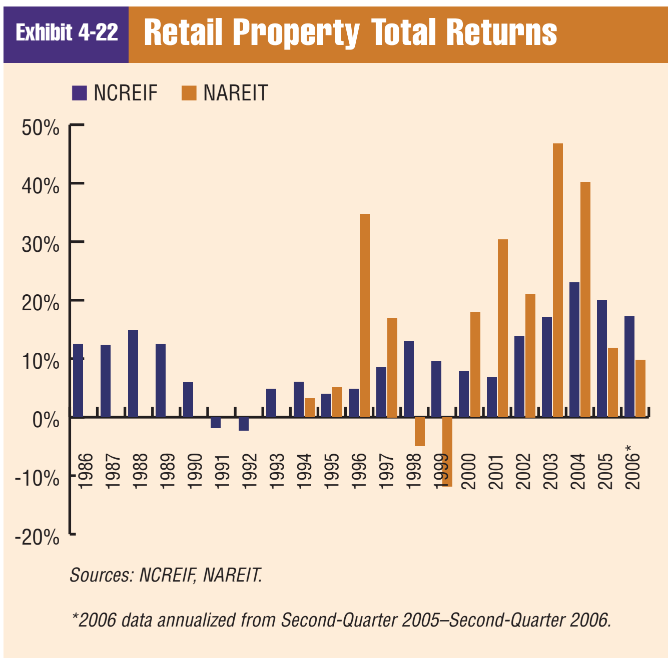
**REIS forecast.*

Weaknesses

We've heard this broken record: "It's only a matter of time" before consumers retreat in the face of high energy costs and slumping housing values. But it's within the realm of possibility that slowing retail sales could finally thump the consumer-dependent economy, exacerbating problems. Extended consumer euphoria has prompted a surge in new construction,

which delivers new space just as bullish sentiment may peter out. Forecast retail center completions for 2006 and 2007 will be higher than at any time since 1990 on the eve of retail's last collapse. New supply would amplify the impact of any demand declines. Wisely, "investors start to back off." Everybody forgets booming e-retail sales will ultimately translate into a need for less new retail space. High gas prices discourage discretionary shopping trips and encourage more Internet purchasing.

Exhibit 4-22 **Retail Property Total Returns**



Sources: NCREIF, NAREIT.

**2006 data annualized from Second-Quarter 2005–Second-Quarter 2006.*

Best Bets

Hold fortress malls and neighborhood centers with first-rank grocers. Sell weaker grocery-anchored retail while you can and cash out of second- and third-tier power centers before possible retailer declines lead to a shakeout among some big-box tenants.

Institutional investors may have an opportunity to partner with neighborhood shopping center REITs that want capital and retained management in exchange for shares in healthy portfolios. Mall REITs greedily show no signs of sharing regional center jewels, which they redevelop "to squeeze out every ounce of value." Buyers will find the best prospects in New York, Washington, Los Angeles, Seattle, and San Francisco.

Exhibit 4-23 **Prospects for Neighborhood/Community Shopping Centers in 2007**

	Prospects	Rating	Ranking
Investment	Modestly Good	5.77	5th
Development	Modestly Good	5.93	3rd
Supply/Demand Balance	Modestly Good	5.87	5th

Expected Capitalization Rate, December 2007	7.1%
Expected Unleveraged IRR During Holding Period	8.8%

Buy	Hold	Sell
24.9%	42.3%	32.8%

Source: Emerging Trends in Real Estate 2007 *survey.*

Exhibit 4-24 **Prospects for Power Centers in 2007**

	Prospects	Rating	Ranking
Investment	Fair	5.41	10th
Development	Fair	5.42	8th
Supply/Demand Balance	Modestly Good	5.53	10th

Expected Capitalization Rate, December 2007	7.1%
Expected Unleveraged IRR During Holding Period	8.6%

Buy	Hold	Sell
8.1%	41.9%	50.0%

Source: Emerging Trends in Real Estate 2007 *survey.*

Avoid

Overpriced B/C grocery-anchored retail. The Wal-Mart/Target/Whole Foods incursion threatens strip centers dependent on ailing supermarkets. "Grocery-anchored retail has become a less stable platform" as the shakeout of chains continues. Investors have not been discounting for quality, location, and credit, assuming all these centers are "bullet proof."

Anchor closings will whack weaker malls if and when shoppers pull back. The ravages of ghost mall syndrome have subsided during the consumer binge, but B-minus/C malls would be susceptible to bouts of rapid decline. As Federated consolidates its Macy's brand and closes weaker outlets from the May merger, malls with anemic drawing power could lose out. In-line stores will jump ship next and centers can expire rapidly. "It's hard to recoup unless you find a church or police station to fill the voids."

Development

The industry needs to focus more on redevelopment than new construction, given the tide of projects set for delivery. Traditional regional malls will continue to shrink in number, while alternative concepts increase and evolve.

- If locating and entitling adequate sites hasn't been daunting enough, consolidation of department stores makes mall development "next to impossible."
- Redevelopment of ghost malls into big-box power centers or town centers holds more promise.
- New store concepts constantly replace old ones as retailers seek to catch shoppers' fickle tastes. Mall owners divide abandoned anchor space into lifestyle center boxes or try to lure discounters.
- Urban infill offers opportunities for retooled lifestyle concepts to attract the move-back-in crowd, looking for something familiarly suburban.
- Lifestyle centers enlarge in vanguard southern California, where lackluster malls transform into hybrid, all-in-one power/grocery centers with big boxes and giant supermarket/drugstore components. "For convenience sake, people don't need to drive to different centers." This concept may spread.

Outlook

Will wages grow enough to offset higher household credit and energy expenses, keeping consumers in the pink? Will homeowner confidence hold up if housing values begin to slip? Odds grow that shoppers take a breather, if for no other reason than exhaustion. Expect retail to push core sector returns back into mid- to high-single-digit territory, offering scant appreciation in the near term. Capital will exercise greater selectivity on commodity properties, recognizing the higher risk from potential economic turbulence and increasing supply. If housing really tanks, watch out!

Exhibit 4-25 Prospects for Regional Malls in 2007

	Prospects	Rating	Ranking
Investment	Fair	5.18	11th
Development	Modestly Poor	4.15	11th
Supply/Demand Balance	Modestly Good	5.73	7th
Expected Capitalization Rate, December 2007		6.4%	
Expected Unleveraged IRR During Holding Period		8.0%	

Buy	Hold	Sell
7.2%	55.8%	36.9%

Source: Emerging Trends in Real Estate 2007 *survey.*

Housing

Strengths

Interest rates remain low by historical standards—"I'd be thrilled to do business in a 6 percent mortgage environment anytime," says a homebuilder, searching for a silver lining after checking his company's shattered stock price. Homeowners need to take heart, too—houses have more than doubled in value in some markets over the past decade and nationally have increased by nearly 60 percent in the 2001–2006 period. Refinancing at historically low rates, moreover, has reduced long-term borrowing costs when fixed terms were locked in. With speculators out of the market, trading froth has been eliminated. "It just couldn't keep going." If prices decline, after leveling off, values will

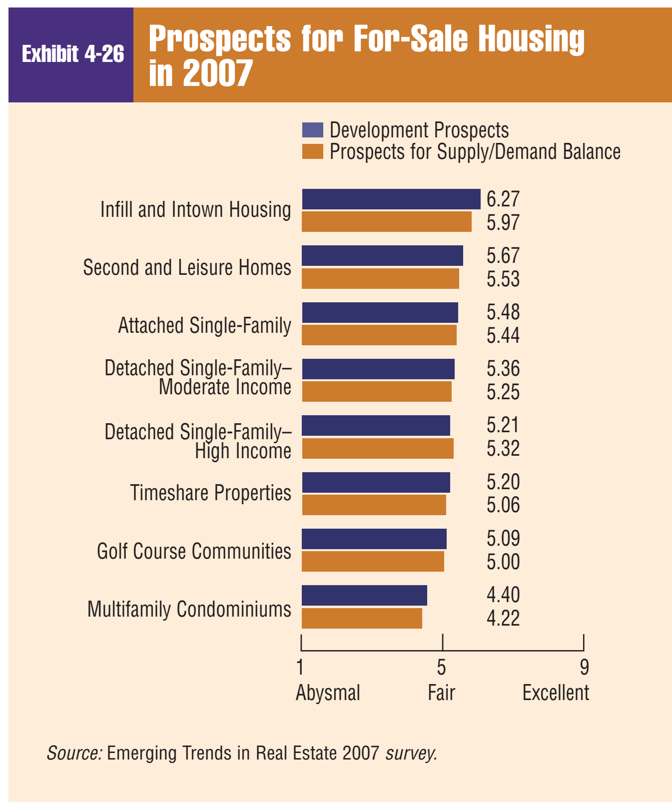


Exhibit 4-26 Prospects for For-Sale Housing in 2007

Source: Emerging Trends in Real Estate 2007 *survey.*

remain substantially above most owners' original purchasing prices. "Housing is a long-term asset, not a trading asset." Most people are well ahead of the game and will stay there.

Weaknesses

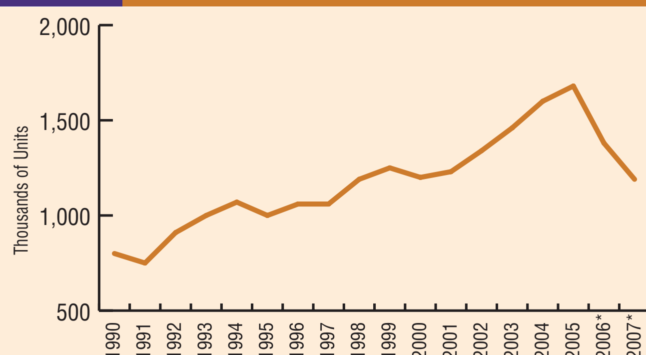
"Bublettes" burst. Contractors kept building into rising mortgage rates and markets increasingly dominated by traders. Unsold inventory of houses rises to record levels, new homes get discounted as canceled orders increase, and bargain-hungry buyers gain the upper hand, negotiating down asking prices. Local governments in many regions have reassessed properties and raised taxes on higher-valued homes, stretching owners' budgets. Borrowers see adjustable-rate mortgage (ARM) costs ratchet up as much as 25 percent and property insurers jack up premiums to pay for hurricane red ink. Speculators hold out, but face mounting carrying costs and the prospect of investment losses. Widespread bailouts by traders and increasing mortgage defaults could worsen any correction. The second-home market, meanwhile, has slowed to a crawl—"enormous price increases got ahead of themselves." Buyers figure if they wait, that discretionary beach house or mountain chalet will cost them less. "The entire psychology has changed."

Best Bets

Volatile homebuilder stocks may take more licks. Sometime in 2007 they hit bottom for a great buying opportunity. Infill and intown housing still looks reasonably good for development.

Individual buyers should look to take advantage of any declines in the second-home market. Over time, baby boomer demographics will drive prices up again. Buyers should also anticipate corrections in expensive coastal markets where prices overshot. Wait for speculators to cave and watch for some overextended owners to default on their ARMs. Not everybody locked in fixed rates when they should have.

Exhibit 4-27 **Single-Family Building Permits**



Sources: U.S. Census Bureau, Moody's Economy.com.

**Forecast.*

Avoid

Let's just say 2007 won't be a standout for the housing sector. Odds favor pricing declines or, at best, stagnant markets. Especially avoid developing condominiums in saturated markets such as Miami and Las Vegas.

Development

Time out! Housing is overbuilt and homebuilders have no choice but to curtail starts. "Traffic is very slow, not a 17-car pileup, but conditions could last into 2008." Not only has demand receded and pricing softened, but material costs also escalate. Large profits have quickly faded into cost squeezes. Homebuilders who bought land at peak prices must pay the carrying costs until inventories clear. Some companies could be "at high risk."

Regionally, Gulf Coast and Florida markets slowly rebuild storm-damaged coasts and Sunbelt areas must continue to accommodate population in-migration. Subdivisions keep developing in Florida, Texas, Arizona, Georgia, the Carolinas, and other higher population growth regions, but second-home markets take a siesta.

Outlook

Anticipate an uneven housing shakeout. "The piper gets paid in markets" where speculators and investors bid up prices, "thinking real estate is like the stock market." Condo market anguish will be a leading indicator. Less frothy markets just level off for a while. Some homebuilders had started to believe their historically seesaw business was not so volatile anymore. Somehow, it wouldn't matter if interest rates started to increase again or price points over reached.

Well, nothing lasts forever.

Niches

Niche fervor—"when you have to get money out, nothing is out of bounds"—will subside. Investors have done extremely well in small sectors where capital recently sought better value compared with favored core categories. In fact, the investment

overflow sent cap rates into core territory for self-storage, seniors' housing, medical office, and student housing. Now discovered, it remains to be seen what happens when capital recedes at the margins. Certainly, demographic trends suggest strong ongoing tenant demand for these property types and opportunity for steadily increasing revenues.

Mixed Use. Comfort levels continue to grow among investors and lenders for mixed-use developments—both infill and suburban. High-end grocers and even some national retailers get on the bandwagon. People want greater convenience and less dependence on their cars. They gravitate to well-planned residential projects with supermarket and drugstore components near transit stops. Pedestrian-friendly suburban town center projects gain appeal. Finding adequate sites can be a problem and sound planning makes a difference. Plopping a high-rise apartment building with a Whole Foods store next to a mall doesn't necessarily create a desirable mixed-use neighborhood.

Seniors' Housing. The gray wave approaches, but it's not here yet. Active adult communities for the 55 and above crowd make more sense today given the baby boomer set is still ten to 15 years away from ripening into full-fledged retirement mode. Medical advances, drugs, and healthier lifestyles suggest that this generation may delay its entry into assisted living and nursing facilities. But demand will steadily increase for all forms of facilities for seniors.

Medical Offices. An aging population augurs greater demand for health care facilities and doctors services, too. The geriatric cohort commands the lion's share of medical spending, which will steadily grow nationally. Just look at forecast Medicare budgets. Demand for medical offices near hospitals will increase. And can you ask for better credit tenants than physicians? Just make sure their malpractice premiums are paid up.

Student Housing. Universities don't mind outsourcing their housing headaches now that the echo boom generation arrives on college campuses in full force. Demand outstrips supply in many places and some pampered preppies are willing to pay more thanks to parental largesse. But all those keg parties and Animal House antics can be a downside.

Resorts/Resort Hotels. Second-home markets in resort areas and condo hotels show signs of overbuilding. They need to take a break. These markets will rebound as increasing numbers of 50-something executives and prosperous empty nesters contemplate where they want to enjoy the golden years. In this hiatus, resort hotels should do well—guests bide their time in the for-sale markets by scoping out areas while they vacation in luxury accommodations.

Self-Storage. More apartment renters and weakened housing markets suggest stepped-up demand for self-storage units so people have a place to keep all the junk (family heirlooms?) they probably should be throwing out or giving to a thrift shop. Rents exceed apartments or warehouses on a square footage basis and owners avoid day-to-day tenant hassles—grandma's albums and those musty twin beds don't complain about the heat shutting off at night. Operators make extra income selling packing boxes and tape or handling moves. Few barriers to entry exist for developers.

Manufactured Homes/Mobile Home Parks. "Love these investments." Owners only need to worry about providing their tenants with curbs and streetlights. It's a great way to bide your time with land until development opportunities strike. If you have to foreclose, you get the trailer home. What a great business! Increasing numbers of retirees bode well for mobile home purchases. The "air-stream" lifestyle lets seniors move back and forth between winter sunspots and old homesteads. With housing at steep pricing even in slowing markets, the mobile home alternative looks good.

Infrastructure. Is this real estate investing or a fixed-income financial scheme that involves managing and funding highways, bridges, tunnels, and potentially all forms of public facilities? Such arrangements have been common in Australia and parts of Europe. So much money needs a home that financial innovators join with state and local governments to create private bondlike vehicles to tap into toll-road revenues, airport franchises, and convention centers. Their steady income returns seem perfectly tailored for pension funds and other institutional investors looking for predictable cash flows to align with their future liabilities. You can be sure that more asset managers will glom onto this opportunity, finding welcome partners in public officials looking for budget balancing solutions. But ensuring that these facilities and roadways are properly managed and maintained to the public's satisfaction over long holding periods has particular challenges that extend well beyond the purview of traditional property investing and money management.

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