

Emerging Trends *in* Real Estate®



2004

25th Anniversary Edition

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Emerging Trends *in* Real Estate®

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Emerging Trends in Real Estate 2004® represents a consensus outlook for the future and reflects the views of more than 350 individuals—a record-breaking industry response—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. A partial list of the participants in this year's study appears at the end of this report. The people listed there include all of those who were interviewed and many of those who returned surveys. To all who helped, PricewaterhouseCoopers and ULI extend sincere thanks for sharing their time and expertise. Without their assistance this report would not have been possible.

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Emerging Trends Highlights

- Today's weak real estate fundamentals will improve very slowly. Office markets, in particular, will erode further before turning around. Corporations' overseas outsourcing and reliance on operating efficiencies to spur profits are restraining U.S. job growth and deepening the hole for most property sectors.
- Interest rates will rise, putting modest upward pressure on real estate capitalization rates.
- Capital flows into real estate debt and equity markets will lessen, but will remain strong enough to sustain liquidity.
- Core property performance will muster returns in the mid to high single-digits—comfortably in the black. But portfolios overweighted in office properties with mounting vacancies could face sizable writedowns.
- Foreclosures, delinquencies, defaults, and workouts will multiply during the year, yet remain manageable.
- Real estate's cyclical recovery over the next three to four years will be lackluster. Current returns—propped up by interest rates and capital flows—are borrowing from future performance.
- Development activity will be limited. Most markets and sectors are oversupplied.
- Developers will find expanding opportunities in urban and suburban infill, as decades of sprawl argue against green-field development.
- Washington, D.C., southern California, and New York are the best metro areas for investment. Other markets languish.
- Of all property sectors, investors favor grocery-anchored retail, warehouses, and apartments—the cash-flow leaders. Office lags, and retail performance will slack off from recent highs.

A hand holding a crystal ball over a background of financial documents. The scene is bathed in warm, golden light. The crystal ball is highly reflective, showing distorted images of the surrounding environment. The background consists of various financial papers, including what appears to be a stock certificate with the words 'THE FINE YIELD' visible, and other documents with numbers and text. The overall composition suggests a theme of financial forecasting or investment.

Borrowing
from

“Low cap rates and huge capital flows could be fleeting phenomena. Poor fundamentals may stick around.”

the

Future

To be sure, sustained improvement of commercial real estate markets isn't likely until 2005 or later, and a shallow, but protracted downturn promises to stress some investors in the meantime. Even as the overall economy signals modest growth, punctuated by a presidential election year of inevitable pump priming, real estate performance in 2004 could continue to erode, especially for office investors. “The worst is behind, but recovery isn't imminent.”

For 2004, the moods of *Emerging Trends* interviewees range from “cautiously pessimistic” to “at best, less sanguine.” Cheerleaders rightly tout the industry's “resilience”: real estate has delivered positive returns through an entire cycle, surpassing stock and bond performance for the last decade. But optimists must temper their hopes of surfing the cyclical bottom unscathed—despite Alan Greenspan's largesse and investors' lingering doubts about Wall Street alternatives. America's economy hasn't shown enough potency to inspire confidence or deflect uncertainty. Where are the job generators? Will corporations continue to outsource jobs to overseas locations? How do we factor in the nation's looming deficits and perilous entanglements in Iraq, Israel, and Korea?

Sturdy Performance Continues

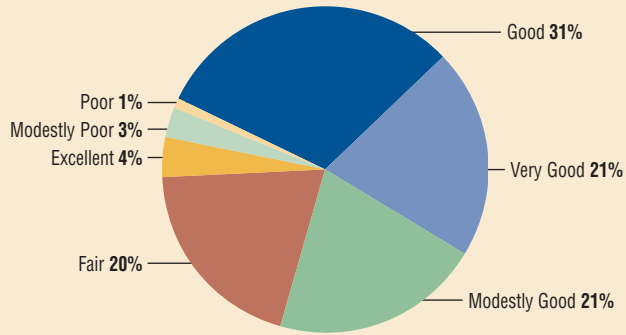
In the near term, annualized core real estate returns will be quite acceptable—surprisingly good in fact—remaining in the mid to high single-digits for portfolios concentrated in well-leased, cash-cow apartment, retail, and warehouse holdings. Results will be better—in the low teens—for core investors who have strategically used cheap debt to leverage up rent revenues locked in from recent market peaks. But lower-quality office properties suffering high vacancies will likely register value writedowns—“as much as 25 percent”—and dwindling cash flows. Tenants in all property sectors have substantial bargaining power, and will trade up for quality space at favorable rents.

Overall, returns continue to belie those “stinky” market fundamentals: the near-record vacancies, falling rents (plummeting in some office markets), hefty renewed concessions, mounting property taxes, and inflated operating expenses. The only property sector that hasn't deteriorated is retail—kept afloat by consumers flush with added buying power from refinanced mortgages and federal tax cuts. Grocery-anchored retail, fortress

*“It’s hard to have much **near-term conviction.**”*

Exhibit 1-1 Real Estate Firm Profitability Forecast

Prospects for Profitability in 2004 by Percent of Respondents



Source: Emerging Trends in Real Estate 2004 survey.

malls, and power centers have fared particularly well, as America’s passion for shopping continues unabated—for now.

For the most part, real estate investors, property companies, developers, and lenders are effectively adapting to this changing market, and a majority of *Emerging Trends* respondents are expecting that the profitability of their firm will be good to excellent in 2004. (See Exhibit 1-1.)

Facing Facts

At some point, reality sinks in. The heady elixir of seemingly low-as-you-can-go interest rates and ample inflows of capital, steering away from turbulent stock market, can’t camouflage property markets indefinitely—or offset declining revenues. Some fallout is inevitable, and investors will need to refocus on replacement cost and exit risk, not just current returns based on transient cash flows.

Challenges loom. In a general economic recovery, property values could actually drop if interest rates surge before job growth can boost leasing activity. Office markets always lag economic rebounds by as much as 12 to 18 months, and that could mean big trouble in the current environment. Especially vulnerable are borrowers holding floating-rate debt; they’ll get whipsawed if interest rates rise and net operating incomes drop further—or even stagger. “A lot of guys are just hanging on.” There’s no doubt that office performance is headed for a rough stretch. The survivors will be buildings with minimal tenant rollover and strong credit rosters to sustain rent levels above market-rate declines.

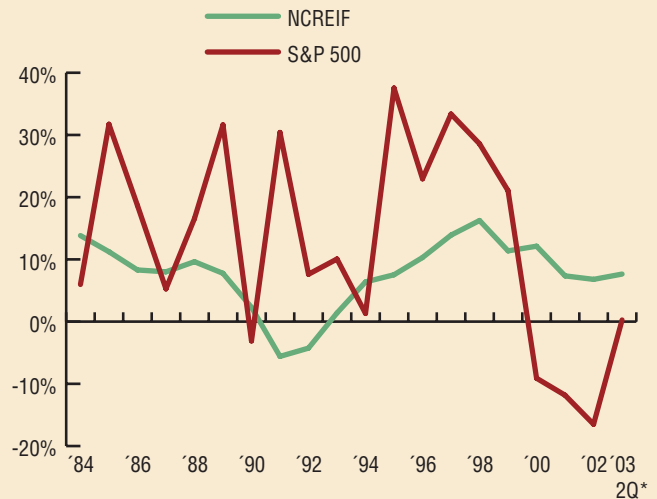
Warehouses and apartments both suffer from uncharacteristically high, though still manageable, vacancies. But these sectors usually rebound more quickly in economic turnarounds and are less exposed than office. For hotels, the key will be businesses’ willingness to loosen their travel-budget pursestrings. Absent a surge in corporate profits and a decline in CFO nickel-and-dime accounting, that’s a questionable prospect.

Most developers, meanwhile, have been forced uncomfortably to the sidelines. “We’re back to the early 1990s.” Although investors are relieved that recent construction has remained in relative check and lenders appear to have been disciplined, “considerable overcapacity still exists in the markets. That’s another way of saying we’re overbuilt.” Right now, “this country doesn’t need anything new for a while.” Surprisingly, the one unrestrained sector has been apartments—lusty construction activity has continued even in the face of slackened demand. But investors continue to pay premiums for multifamily, expecting favorable demographics to propel future leasing and rent growth.

A Postponement Effect

Of longer-term concern is the consequence of declining capitalization rates propping up returns during an extended market trough. The “unprecedented” anomaly of high prices and outsized returns in an otherwise troubled market could rob investors of any robust upside when properties move closer to

Exhibit 1-2 Returns: NCREIF vs. S&P 500



Sources: National Council of Real Estate Investment Fiduciaries, Standard & Poor’s.

*Annualized figure.

supply/demand balance in 2006 and 2007. “Current returns may be borrowing from future gains, making the next cycle very lackluster,” says a noted REIT stock manager.

“It’s a postponement effect,” adds a leading researcher. Instead of a more typical sharp decline during the cyclical nadir, markets will clear “in a slow painful adjustment.”

“Pricing hasn’t corrected as you’d expect. Buyers have already anticipated a recovery in their cap rates, getting ahead of current fundamentals. Future returns will focus mostly on property cash flows—you won’t see much appreciation. No spikes like there were in the last cycle.”

As markets bump along toward an anemic recovery, 2004 will be a transition year. Cash flows will key performance. Returns will be income driven. “It will all be about keeping up cash returns.” Buildings with solid tenant rent rolls will be fine. Properties hobbled by declining cash flows will struggle unless interest rates stay low. The bifurcation between “have” (tenants) and “have not” properties will become more apparent. Downside risk clearly outweighs upside potential until the economy reignites—and that means substantial job growth. “You may wait a long time.” Expect moderate returns, with more distress and a few horror stories. Real estate will continue to attract investors, but bad-news headlines may dim some of its “safe haven” luster.

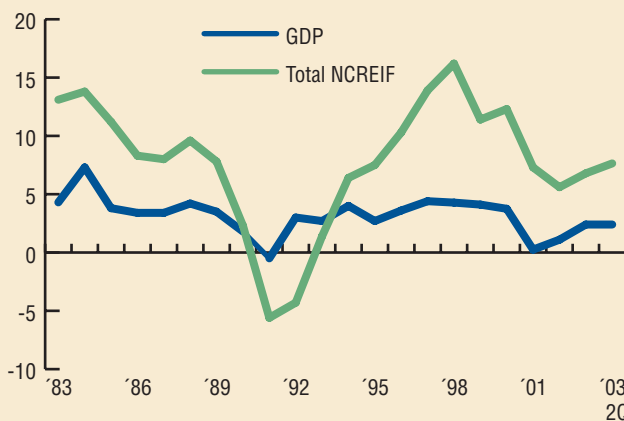
“It’s hard to have much near-term conviction.”

The Economy: Concern about Job Growth

The dream for 2003—that the economy would rebound before crummy real estate fundamentals could take their toll on investors—has been painfully slow to materialize. The industry’s fortunes are inextricably tied to recovery. “Real estate is the tail of the dog. In the early 1990s, we were a drag on the economy; this time it’s dragging us.”

Emerging Trends interviewees are guardedly hopeful about steady economic improvement in 2004. Nearly 90 percent expect “low to medium growth.” Last year, close to 85 percent correctly predicted “no to low growth.” While concern over a possible double-dip recession is negligible, none of our more than 200 survey respondents predict high growth for the year ahead.

Exhibit 1-3 Real Estate vs. Economy



Sources: U.S. Department of Commerce, Economy.com, National Council of Real Estate Investment Fiduciaries.

*2003 GDP data are projected; 2003 NCREIF data are annualized.

Got a Job?

Economic expansion without significant employment gains is interviewees’ leading concern. “Job growth will be the key to 2004. Period.” If corporations expand their U.S. workforces, vacant office buildings will begin to fill. Expanded production and distribution will benefit warehouses, and increased business travel will buoy hotels. More wage earners—cashing bigger paychecks—will rent more apartments and spend more in malls. That hasn’t been happening.

Low interest rates and a flood of capital from investors fleeing the equities’ tech wreck bought time for the property markets, but any recent upticks in economic performance and corporate earnings have come mostly through productivity gains—at the expense of jobs. “Corporations have become very good at doing more with less.” Since early 2001, when the recession began, the United States has lost more jobs than at any time since the Great Depression. Payroll jobs continued to be shed well into 2003, more than 18 months into supposed recovery, and pay raises have been puny—only slightly ahead of inflation and well below averages in the 1990s. “Companies have learned to be lean,” says an interviewee, who works in a global money management firm. “It takes an act of Congress to get new people in the door.”

Overseas Outsourcing—A Thorny Issue

The jobless recovery has roots in technology advances and competitive pressures from globalization. Blue-collar jobs have been bleeding offshore for decades, going to countries where local hires earn a pittance compared with what U.S. factory workers earn. This leakage continues apace—more than 2 million U.S. manufacturing jobs have been eliminated or moved overseas in the past two years alone. Since the early 1990s, data processing and call centers have also been successfully shifted to English-speaking countries like Ireland and the Philippines.

Now the trend is moving up the worker food chain, as knowledge-based tasks are transferred to lower-cost overseas sites as well. Analyst, research, accounting, and other white-collar office jobs are ticketed to countries like India and China, which feature highly educated and motivated workforces earning fractions of comparable U.S. wages and benefits. “It was one thing to move a back office to the suburbs or send a call center to Sioux Falls—it’s quite another to move an accounting operation to Bangalore.”

Satellites, fiber optics, Web-based systems, and computing advances combine to make “a seamless operation” possible and highly desirable for company bottom lines. “The Indian government rolls out the red carpet: you can pay MBAs less than \$10,000 for work comparable to a U.S. job paying \$50,000. Despite some extra costs for travel, relocation, and equipment, overall expenses can be cut by two-thirds.”

The impacts of global white-collar outsourcing are unsettling at the very least. High-tech has been America’s recent edge, but now industry behemoths Microsoft and IBM plan to move increasing numbers of high-paying software design jobs to Asia and India. Microsoft’s 5,000 planned new hires are welcome news, but 2,000 of them will be located outside the United States. In real estate, mortgage servicers have jumped on the outsourcing-to-India bandwagon. By some estimates, U.S. companies will send upwards of 3 million service jobs overseas by 2015. “Do the math,” says one researcher. At 200 square feet per worker, “that’s 600 million square feet of office worker space we won’t need.” Whatever the number, outsourcing means diminished growth in demand for office in the future.

If U.S. corporate profits improve on the back of more belt-tightening and global outsourcing, it may be good for shareholders and stock prices, but not for U.S. job creation. Not only will office expansions be constrained, but retail sales will

suffer as well. Today, it’s lower-paying service jobs that show the most growth; among corporate middle managers, unemployment is well above average. Little surprise that Wal-Mart is now the country’s top employer instead of GM or IBM.

The potential real estate fallout isn’t all bad. Demand for affordable housing will escalate. And warehouse properties shouldn’t be affected as much—once goods get shipped to the United States they still need to be distributed. “That’s the other side of the global economy,” a researcher comments wryly.

A flare-up in India-Pakistan relations could stanch enthusiasm for relocating operations to the Indian subcontinent. “There is something to be said for stability.” But lower-cost English-speaking alternatives abound worldwide.

What Will Drive the Economy?

It might be extreme to call international outsourcing a “crisis” or “a deflationary nightmare” (our interviewees’ words), but at minimum the trend underscores the country’s growing struggle to find a new economic engine. “We need a saving grace, and can’t assume we have a monopoly on creativity anymore.” The big question: What will be the economy’s new driver?

“It’s hard to anticipate.” In the 1980s, insurance companies and brokerages morphed into financial service giants while Ma Bell’s breakup fueled the telecom industry. High-tech stoked the 1990s “and that turned out to be mostly b.s.” “Nobody seems to know what will turn the trick now—it will be something.”

Interviewees point to biotechnology and nanotechnology. Defense spending and homeland security offer more traditional, less cutting-edge wellsprings. But the tax-cutting wave and looming federal deficits limit government’s role in any jobs recovery. State and local governments, meanwhile, lay workers off or freeze payrolls.

The country’s advantages—wealth, strategic location, labor mobility, huge markets, stability, rule of law, and educated workforce, among many others—outweigh current concerns and doubts about employment generators and global competition. But clearly the solution isn’t more discount store sales-clerks or airport security guards.

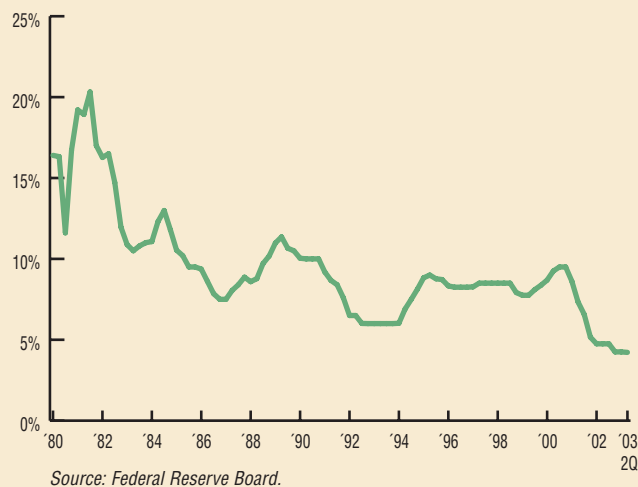
Interest Rates—A Slow Go

Unquestionably, low interest rates have shielded both the economy and real estate markets: “They’re the difference between now and ten years ago,” when property markets were mired in depression. Despite weakened cash flows, borrowers have “been

hanging on,” and delinquency and default rates have remained low. Low-cost debt on well-leased properties has boosted returns. Put another way, “low interest rates have covered up industry flaws and made up for some bad underwriting.”

Most interviewees expect and hope that rates will climb slowly in 2004, coaxed along by the Federal Reserve as the economy strengthens. “It’s an educated bet that the Fed won’t raise rates dramatically in an election year and will try to carefully manage the recovery.”

Exhibit 1-4 “Prime” Lending Rate



Stable or declining rates would mean only trouble at this point in the cycle—the economy isn’t gaining any traction. But if interest rates rise too quickly before supply/demand trends improve, floating-rate borrowers will suffer shortfalls and values could decline. “A 200-basis-point increase in interest rates pushes up cap rates while NOI [net operating income] doesn’t go anywhere,” observes a pension fund adviser. “That’s the biggest risk. The next 18 months are problematic.”

If interest rates ratchet up suddenly from some exogenous shock, “a lot of people could be cooked.” Concern mounts over the federal deficit and increased government borrowing, which normally exert upward pressure on rates. The country’s current-accounts deficit and burgeoning expenses in Iraq cloud the outlook further.

“The smartest people don’t know where rates are headed.”

The Housing Market and Consumer Credit—Keep Your Fingers Crossed

Although *Emerging Trends* doesn’t attempt to forecast single-family residential markets, it’s clear that a decline in house prices would threaten the economy—upending consumer spending and knocking out a key driver in recovery. “It could be the biggest threat.” The American consumer has been overextended for years on credit card and mortgage debt, spending through the recession on the back of inflating home equity. Low interest rates have spurred a tsunami of homeowner refinancing that feeds consumer purchases at malls and car dealerships. Lower mortgage payments mean more cash to burn.

More important, low mortgage rates have enabled many first-time home purchases and trade-ups, strengthening home prices and property values. If housing demand drops because higher interest rates make mortgages less attractive, and home values consequently ebb or fall, retail’s recent run-up could be over. And if consumers stop spending, any rebound in corporate profits would hit the skids. Bad news for everyone. But realistically, if the housing market is not another bubble, it’s at least due for a breather.

Multifamily owners see a silver lining in the prospect of higher mortgage rates: fewer homebuyers will mean more apartment renters. However, an improved business environment and resumption of job formation are more critical to feeding the renter pool.

Ample Dollars: Capital Pulls Back, Not Out

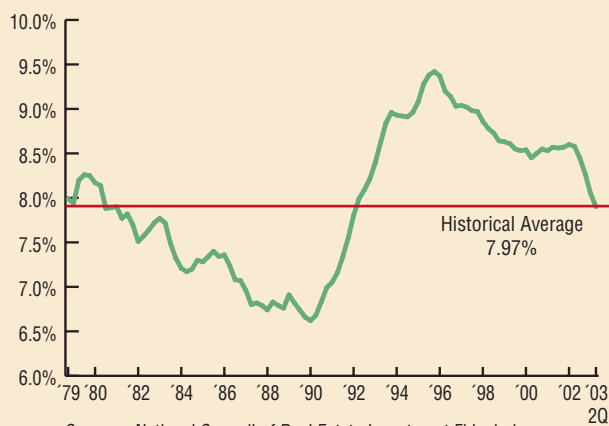
Real estate’s risk profile has improved over the past decade. Heightened regulatory scrutiny, greater transparency, more professional analysis, and public market oversight give investors increased confidence in their ability to assess holdings. Recent solid returns have reinforced perceptions that real estate yields can be sustained through entire cycles, including market troughs.

But interviewees are concerned about whether the recent surge of capital into the property markets and the ensuing cap rate compression reflect a more permanent shift in real estate’s standing or a temporary cyclical phenomenon driven by equity outflows from the 2000–2002 bear market on Wall Street.

“Real estate may turn out to be a **flavor of the month** if the stock market gets hot.”

Coming out of the early-1990s debacle, cap rates shot up as investors factored more risk into the property sectors. During the late 1990s, as property markets returned to equilibrium, “cap rates stayed high when the risk premium should have been shrinking.” With the risk profile declining, investors have been willing to take lower returns in stronger property types (apartments, warehouse, neighborhood shopping centers, well-leased downtown office) with minimal leasing risk. “On balance, cap rates should stay lower for these stronger property types,” says a researcher. In fact, cap rates actually trend near historical averages despite recent compression. (See Exhibit 1-5.)

Exhibit 1-5 NCREIF Cap Rates



Sources: National Council of Real Estate Investment Fiduciaries, PricewaterhouseCoopers.

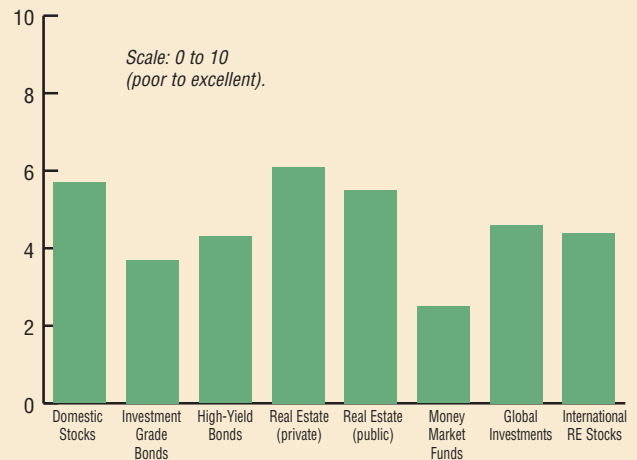
Note: Quarterly moving average.

Private syndication activity and increased pension fund allocations support the view that capital flows are broadening, and the maturing CMBS and REIT sectors have secured real estate’s position in the public markets. “Real estate will never be a rock-star asset class,” says an interviewee, “but investors, particularly baby boomers, want the attractive yields real estate offers, and that will keep money flowing and cap rates down.”

Most respondents believe an improving stock market will siphon capital from new property investments, and 2004 may prove the point. For the first time in four years, a majority of *Emerging Trends* respondents (52 percent) predict that stocks will outperform real estate and that investment potential for both private and public real estate will diminish.

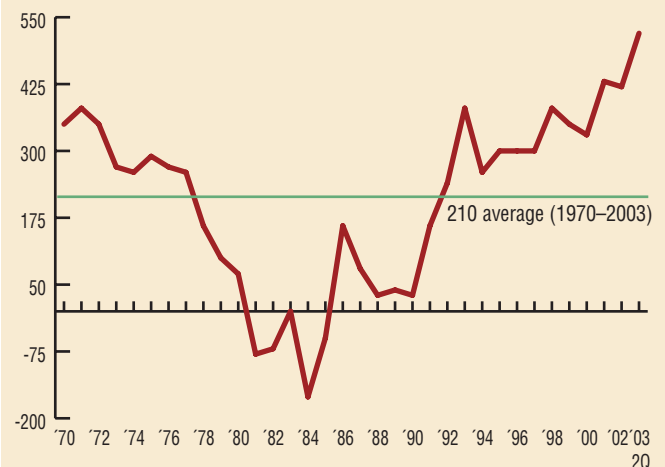
“Real estate may turn out to be a flavor of the month if the stock market gets hot.”

Exhibit 1-6 Asset Class Investment Potential for 2004



Source: Emerging Trends in Real Estate 2004 survey.

Exhibit 1-7 Spreads Between ACLI Cap Rates and Ten-Year Treasuries



Sources: American Council of Life Insurers, Federal Reserve Board, PricewaterhouseCoopers, Economy.com.

Note: 2003 figures as of July 2003.

But more than 95 percent of the interviewees forecast that real estate will beat bond returns, and the persisting cap rate spread of over 400 basis points between real estate yields and ten-year Treasuries continues to offer real estate investors comfort with respect to risk-adjusted performance. (See Exhibit 1-7.)

Still, as a pension fund adviser points out: “Investors are fickle. Real estate isn’t big enough to accept all the money that

has wanted to come in lately. It's an alternative investment category, not an asset class like stocks and bonds. If the stock market looks good, money will move out."

Barring an unlikely rash of bad headlines and red ink, any pullback will be confined to momentum investors. Premium pricing will dissipate, and underwriting will become more discriminating. Office could suffer from weakening operations, and retail has been overheated. Other sectors should hold their own. "Real estate delivered on its promise—it stayed in positive territory and offered diversification. It's done its job. We'll cruise along."

A "Ton" of Vacant Office Space

Despite all the credible evidence of greater transparency and information flow in the real estate markets, most analysts admit a lack of certitude in calculating levels of current office vacancy. They use words like "massive," "unprecedented," "as bad as ten years ago or worse." Brokerage firms put out their leasing reports, but the numbers don't convince anyone. "We're probably identifying 80 to 90 percent" of the vacancy, said one tenant representative. "But it's very hard to pin down."

Getting a handle on the extent of phantom (empty occupied) space, in addition to ample sublease vacancy, has been the primary conundrum. Corporate business units have held onto unused space, anticipating new hiring. Languishing cubes seem omnipresent. "Companies aren't going out of their way to report subvacancy and shadow space." Once they start expanding again, they won't need to lease new space immediately.

Then there's the totally vacant but still-leased space, which creeps off rent rolls. "The pain continues to shift from tenants to landlords" as this space burns off, depressing net operating incomes.

Most observers predict there won't be any significant office leasing upswings until 2005, and rents won't increase until markets show some signs of returning to equilibrium. How long that takes depends on how much vacant space is really out there, and the velocity of job growth. Rental rates in many markets have fallen to mid-1990s levels or lower—well below peaks of the late 1990s and in the range of mid-1980s rents in some markets. "When five- and seven-year leases come due, tenants should be able to sign sweet deals. Many will be able to trade up to higher-quality space for less. That spells big trouble for lower-quality office space, some of which was rescued from obsolescence by the tech-bubble leasing boom.

Perceptions of office-market health typically influence feelings about real estate's overall investment potential. Skylines and towers showcase the property markets' most visible calling cards—too many see-through floors and "For Rent" signs can

chill investor appetites for properties in general. With soft tenant rosters and uncertainty about the depth of vacancies, there's scant reason for near-term comfort.

Intensifying Unease over an Uncertain World

Since the late 1990s, real estate's durability and resistance to a host of shocks and troubling undercurrents have impressed investors, drawing new adherents. Fallout from 9/11 dampened hotels and shook confidence in office towers, but overall impacts have been restrained. The Enron and WorldCom scandals in 2002 raised questions about credit tenancy, but were otherwise nonevents for property investors unless fallen companies were their tenants.

Wavering Confidence

In general, the longer-term nature of mortgages and leases has helped insulate real estate investments from volatile shifts and damaging swings during choppy periods. Eventually, real estate reflects general economic conditions, but it typically lags behind both good and bad phases, smoothing out dips and humps along the way. Today's uncertainty about geopolitical risk, however, is gnawing away at confidence levels and economic underpinnings, raising concerns among interviewees about the strength of any real estate rebound. In addition to the global competitive forces pressuring the U.S. economy, a host of world conflicts test our security and well-being:

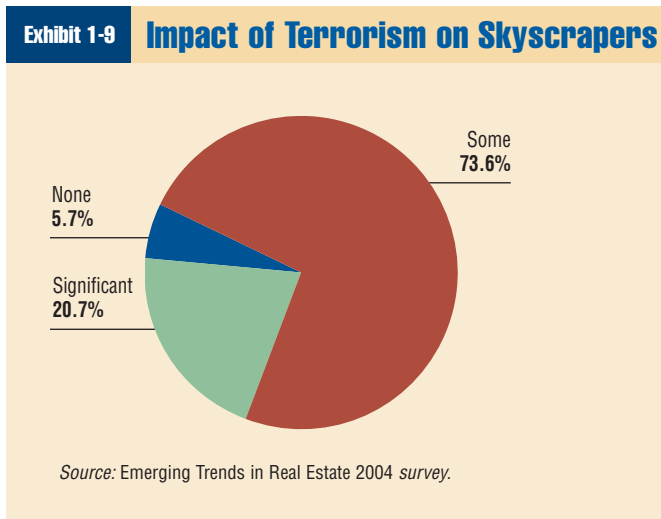
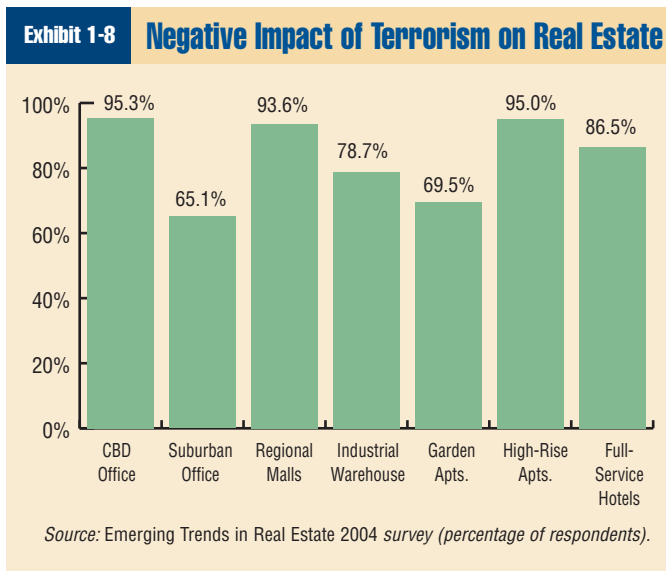
- Israeli/Palestinian turmoil spirals out of control, destabilizing the entire Middle East.
- Iraq looks like a sump for U.S. tax dollars as we attempt to establish social order in the face of terrorist resistance and local distrust. Afghanistan remains a hot spot, and next door, Islamic Pakistan retains nuclear weapons as its shaky government parries threats with nuclear neighbor India.
- North Korea's growing nuclear arsenal menaces Asian security, confounding Pentagon planners.

Countries from Africa through the Asian subcontinent, the Pacific, and South America represent potential breeding grounds for anti-Western terrorists, who seem able to strike anywhere at any time, but probably can't and won't.

"These world events are sidetracking us—creating uncertainty and putting drags on our economy," says an interviewee. "Decisions important to real estate are outside one's control. It's more difficult to assess risks and plan accordingly."

Terror Redux

The domestic terror threat has been pushed toward the background. “Time has helped us come to terms. We’ve bounced back from the first one.” But last year’s overriding interviewee assumption holds firm: another disruptive strike will occur somewhere, sometime, and perhaps with considerable consequences. Only a marginal lowering of concern about terrorism’s negative impact on real estate registers in this year’s survey (see Exhibits 1-8 and 1-9). Here are 9/11’s lasting repercussions:



Skyscraper Anxiety Except for the very tallest buildings in major 24-hour markets like New York and Chicago, fears about occupying skyscrapers appear muted. But tenant skittishness has compromised the value of a handful of icon skyscrapers. “People are still worried about being on the 80th floor.”

Dispersion Major companies continue to disperse operations, both within major metropolitan areas and to geographically diverse locations. “All the big New York–based financial companies are moving operations outside the city. They’ll keep a headquarters presence and certain functions, but not everything in one central location. It’s too risky.” Memories of 9/11 only reinforce companies’ inclinations to seek lower-cost space outside premium office markets wherever possible, whether domestically or internationally.

Insurance As expected, the market has resolved most insurance cost–related issues stemming from the World Trade Center attack. Owners absorb added, but not dramatically higher, costs for most properties. But the federal government backstop sunsets at the end of 2005, which could revive the issue.

Security and Safety Expenses Wherever possible, building owners have shied away from shelling out for top-of-the-line security systems, though installation of additional guards and cameras has increased costs modestly at some properties. More prominent buildings with Fortune 500 tenants in major markets typically maintain greater vigilance, employing not only typical rent-a-guard ID screening, but also expensive optical badge-reading turnstiles and/or metal detectors. Most tenants in most places are considerably more concerned about petty theft than a terrorist assault. They don’t want to go through the hassle of checkpoint screenings, let alone pay additional pass-through charges. Outside major markets or in more commodity-type buildings “it’s walk right in and get in the elevator, just like it’s always been.”

Mall Vulnerability Throughout the world, terrorists have historically targeted shopping districts, where they can wreak havoc anonymously and escape detection. Although the Oklahoma City and 9/11 attacks struck office buildings, interviewees continue to be more concerned about malls or other shopping centers. These properties are largely defenseless and the lasting damage to consumer psyches could be severe.

Travel Woes Terror alerts fray nerves. International flare-ups keep people closer to home. And tighter U.S. visa restrictions reduce foreign visitations. All spell less business for many hotel operators. First, the World Trade Center tragedy devastated occupancies and revenues; then foreboding over the war in Iraq delayed any recovery. Who knows what's next? That's the problem.

Technology Bites

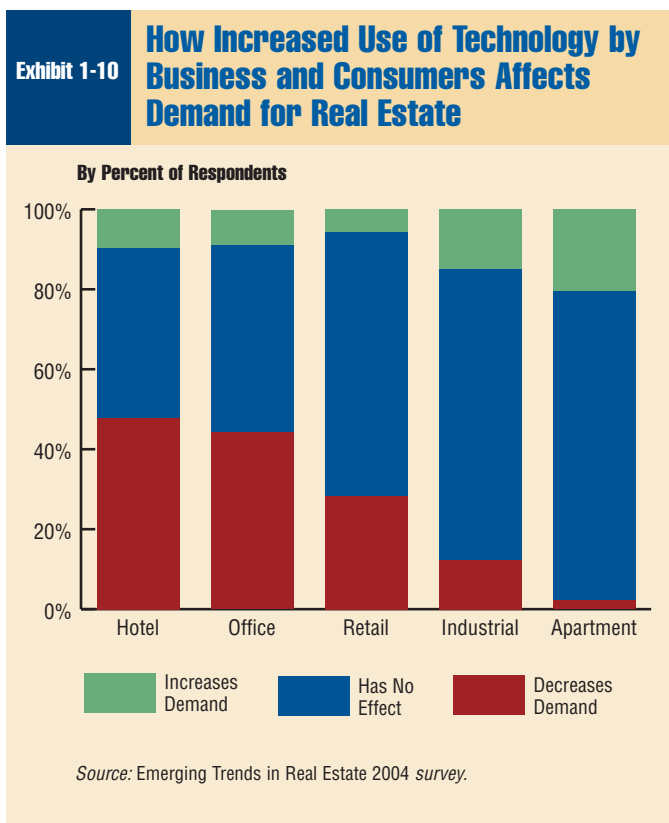
For all the talk of tech wreck, one would think we'd returned to the Dark Ages. To the contrary, technology's impact on real estate continues to evolve—reducing the need for space and cutting demand growth in a number of ways.

Outsourcing Enabler Telecom, Web, and satellite systems are the great enablers of the burgeoning wave of outsourcing. Increased use of hoteling and work-from-home consultants nibbles at office space requirements—they just beam in their work. WiFi makes office layouts more flexible and slims down space per capita at the margins.

Web Merchants Gain Footholds In steady increments, more people are shopping on the Internet. Web sales surged 50 percent in 2002 and could amount to more than 4 percent of total 2003 retail sales if some estimates hold up. A majority of Webtailors have turned profitable. Still in its infancy, e-tailing will steadily bite into the market share of brick-and-mortar retailing. Eventually, online and offline merchandizing will become more integrated, reducing the need for store space. It's just a matter of time.

Warehouse Scanning Nowadays shippers are attaching radio frequency ID chips to pallets, tracking them to their destinations with global positioning satellites and more closely matching delivery needs to inventory requirements. It's the latest wrinkle for just-in-time distribution systems, which have steadily reduced the need for warehouse storage over the past 15 years.

Hotel Woes Internet pricing power slashes at hotel earnings. Surfers have learned to shop for last-minute bargains and get them as operators compete to fill empty rooms. Information is power, and the Web gives travelers an advantage in searching out deals.



A close-up photograph of a hand holding a coin over a piggy bank. The hand is positioned at the top, with the thumb and index finger holding a coin. Below the hand is a white piggy bank. The background is a soft, out-of-focus light blue and white. The text 'Investment Trends' is overlaid on the right side of the image in a green, serif font.

Investment Trends

*“Most Emerging Trends**interviewees envision 2004**as a **transition** year.”*

2004

Real estate markets stabilize, then slowly strengthen behind a reviving economy. There’s no sudden rebound—rents are flat in most sectors, down further for office. Income returns carry the day. Appreciation is negligible, and many office markets experience value dips or worse. Retail returns moderate off recent highs. Warehouses, apartments, and hotels improve slightly. Capital flows remain plentiful, but diminish as an improving stock market draws attention. Defaults and delinquencies increase modestly—again office markets suffer most.

As investors grow more discerning, market bifurcation increases. Demand stays focused on trophy office and fortress mall properties (the few available) and on the “cash-flow kings”—warehouses, apartments, and grocery-anchored retail. But “a huge gulf opens between the very best and everything else.” Buildings with vacancy issues go begging unless owners capitulate on pricing (which some may do if interest rates track up) and finally register their large value writedowns.

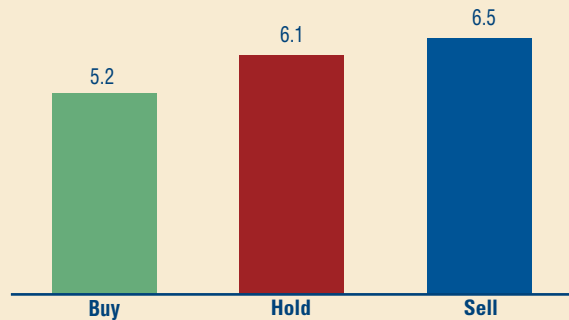
Time for a Reality Check

The market needs to better scrutinize the “in-betweeners”—B-quality buildings in lesser locations where zealous buyers have been overlooking leasing risk and factoring excessively optimistic recovery scenarios into their buy assumptions. “Cap rates have been distorted by leverage, and people are overpaying.” These investments have been unrealistically “priced for perfection.” Expect ardor to wane without downward pricing adjustments for these properties.

In general, 2004 will be a better year to sell than to buy. (See Exhibit 2-1.) Yields have been acceptable, but frothy pricing levels limit any upside potential for acquirers. “It’s treacherous; you’re basically buying bonds.” Another interviewee deadpans: “It’s tough to make an acquisition without feeling it might be your next writedown.” Quality deals have been “few and far between.”

Exhibit 2-1 **Emerging Trends Barometer: 2004**

Buy/sell/hold rating prospects on a 0-to-10 (poor-to-excellent) scale.



Source: Emerging Trends in Real Estate 2004 survey.

Until capital pulls back, sell into the wave, save your profits, and look for better opportunities when distress increases. During the year, sellers will adjust their expectations downward and purchasers will become more realistic—paying attention to the shaky supply/demand fundamentals. Until then, “it’s easier to stay away from things.” Holders of well-leased properties “with credit and term” have the right idea: “Where else can [they] get better returns?” Leveraging strategies are no-brainers—but avoid floating-rate debt. Brokers will lament the overall slowdown in transaction activity.

Core Dominates Opportunistic

Buyers have been willing to pay premiums for anything that is stable and leased. “It’s the era of surety of income and aversion to volatility: everyone’s moving to apartments, industrial, fortress malls, and neighborhood centers.” Compromised properties exist, but owners have not been pushed to sell. Most can meet their mortgage costs, thanks to low interest rates—and buyers want vulture pricing or nothing. A deluge of core

money, meanwhile, pushes down overall yields. Without market volatility and dislocation, the environment is radically different from the last cyclical bottom in 1993–1994, when owners were bailing out in a liquidity crisis. “Back then it was elephant hunting,” says the portfolio manager of an opportunity fund. “Now you’re shooting squirrels and chipmunks.”

Opportunity funds have been scrounging for “needles in the haystack,” venturing outside the major property sector groups to look at land, apartment condominium conversions, even golf courses. Other opportunity funds have masqueraded into core-plus plays, using spread investing (positive leverage) techniques. Return-rate expectations have realistically declined from the 20-to-30-plus range into the mid to high teens, still using those large dollops of leverage. “Our returns look good against T-bills,” says a fund manager. But then, leveraged core investing certainly looks like the better risk-adjusted gambit.

Considerable capital sits on the sidelines—waiting, wishing, and hoping for owners to throw in the towel before a recovery takes hold to bail them out. If surrender occurs, large dollar flows could dampen opportunistic yields. “That’s what’s happened with B malls, where sellers have been achieving decent pricing.”

Some of the opportunity funds that invested through the late 1990s and into the market trough may be suffering. Once-juicy development deals in high-tech markets are floundering. Empty buildings or half-built projects devour investor equity. Market-peak rental assumptions have gone sideways or worse, and re-leasing strategies have been stymied. Some assets are illiquid and overleveraged. Ironically, opportunity fund investments are turning into opportunities for others.

The investment banks continue to shift their attention to raising money for core vehicles. Does that tell you anything?

“Consolidation is coming for opportunity funds.”

Best Bets 2004

Sell into “hordes of cash.”

Sell now, before overzealous capital figures out that it has been too generous. The window is closing. In particular, unload core office with near-term rollovers—it has more downside risk than upside potential. Rent growth will be tempered during the next up-cycle unless job formation gears up unexpectedly. Anything with near- to medium-term tenant turnover will face prospects for declining revenues as late-1990s leases begin to burn off. Expenses are up and concessions are back. Time to exit.

Buy credit and term office.

Avoid rollovers (in the next five years or longer) and load up on low-cost fixed-term debt. “Even if you overpay today in Washington, D.C., or New York, it’ll look like a good investment in ten years.” Returns can easily ratchet up into the low teens, with little risk, on these “credit and term” gems. “You’re buying enough time to let the markets recover.” These properties are worth the premiums, but there aren’t many on the block. Holding on makes sense, too: current owners would have trouble bettering returns on their proceeds.

“Dare to be boring.”

Buy industrials. Warehouse properties react more quickly to economic upswings. Don’t expect any steals, but cash flows are attractive—“rents haven’t been clobbered” despite high vacancies. Concentrate on the leading distribution hubs.

Borrow now.

Use leverage (up to 65 percent) to enhance yields on core apartments, warehouse, and retail. “It’s today’s best opportunistic-oriented return.” Be sure to lock in mortgage rates (ten-year terms). They’re expected to increase unless the economy double-dips—which is an unexpected scenario.

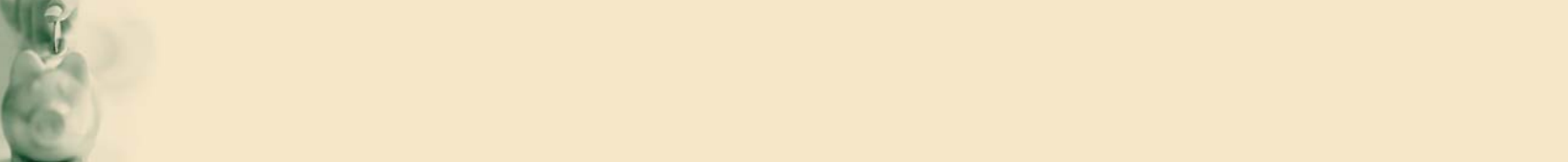
Be patient and husband resources.

“Distress will unfold during the year.” Weak industry fundamentals will lead to some chances for opportunistic buying. As owners are forced to say uncle and submit to bargain hunters, more hotels, suburban office—even some apartments and industrials—will hit the sales block. Focus on hard-hit tech-wreck office markets like San Jose, Boston suburbs, and Austin. Price assets at current rents, not contract rents, and avoid paying for structural vacancy. Underwrite for three- to five-year recovery scenarios. Move quickly: the window is narrow and the vultures are lined up to pounce. Cheap deals may get bid up fast.

Identify vanguard markets that will lead the recovery.

Most interviewees choose diversified markets with defense industry components. Nation-building efforts and terrorist episodes will fire up military and homeland security-related businesses. San Diego and Orange County should benefit, and D.C. suburbs are also prime candidates. California’s deficit crisis could spell opportunity for Portland, Seattle, Las Vegas, and Phoenix. A California exodus could also benefit Colorado markets, as businesses and individuals (especially from northern California) flee higher taxes and costs of living.





Bide your time on apartments.

Buy only when mortgage rates start to increase with conviction, and focus on markets with barriers to entry, typically coastal metropolitan areas. Voracious demand from institutions and private investors provides an attractive exit for sellers at seemingly low-as-you-can-go cap rates.

Expect REITs to trade in a narrow range.

Earnings could be flat or down. But good yields will remain attractive. There's more chance for downside than upside. Most vulnerable are office (rents are declining) and retail (due for a selloff).

Prune grocery-anchored retail.

Centers with less than top-tier supermarkets are threatened by expanding discounter superstores. Pricing has been out of control. "The sector is overrated" after a great run. Sell into the demand curve, but retain prime infill locations.

Sell malls and power centers.

"Retail values are too high and returns don't make sense after calculating capex [capital expenditures]." Fortress malls and the better power centers are keepers.

Consider buying full-service hotels.

The worst is over. After 9/11, SARS, Iraq, what else can happen? Come to think of it, don't ask! Despite all the heartaches, owners have been hanging tough—bottom-fishers have been disappointed in the dearth of deals. But it may be a compelling play if business travel starts to accelerate.

Examine second-tier markets.

Institutions have avoided most backwaters. Competition for deals is less frenzied and pricing is more realistic. But markets are extremely shallow. Focus on the very best properties in the best locations.

Look at affordable housing—both development and redevelopment.

Undersupply continues and demand rises, especially in major cities and affluent suburbs where the divide between rich and poor is widening and service jobs are abundant.

Develop/redevelop warm-weather, waterfront condominiums and mountain resort hideaways.

"Incredible" demand surges from affluent baby boomers preparing for retirement and looking for dream second homes. Florida boasts some prime opportunities: aging, low-rise, first-generation beachside apartments can be converted into high rises. Rocky Mountain states offer different but no less attractive lifestyles.

Focus on infill redevelopment.

Traffic congestion and sprawl encourage "the move back in." Underutilized, inner-suburban-ring retail is ripe for mixed-use makeovers, including large residential components. Main Street concepts based on new urbanist planning can resurrect dead malls and provide a shot in the arm to struggling communities.



Photo Courtesy of Development Design Group, Inc.

Office tenants, upgrade!

If lease renewals are imminent, take advantage of soft office markets and relocate to better buildings and locations at lower cost, nailing down rates for as long as possible. Concessions are ample. Landlords will cut deals to secure income. Strike while you can.



Caution!

Take greater care in evaluating below-investment-grade CMBS offerings.

Issuers sell bonds into market demand, “but relative value is not there.” Underwriting has slipped as markets weaken—not a good combination. “Worry about deals with suburban office.”

Steer clear of syndications.

The 15 percent front-end loads put investors in an immediate hole, and fee-driven asset purchases are forced in markets with flimsy fundamentals. If sponsors are leveraging up returns on mediocre properties, watch out for additional trouble down the road. Investors may not lose money, but returns could fall short of expectations. “Why invest in syndications when you can buy real estate mutual funds with higher yields, diversification, and a much lower-cost fee structure—there’s no rationale.”

Avoid!

Shun almost all development (it’s too early); commodity properties—especially plain vanilla suburban office (the real pain is only beginning); and seniors’ housing (a concerted demand wave is still ten years away).



Real

“Liquidity*won't go away—it will**just be reduced.”*

Estate Capital **Flows**

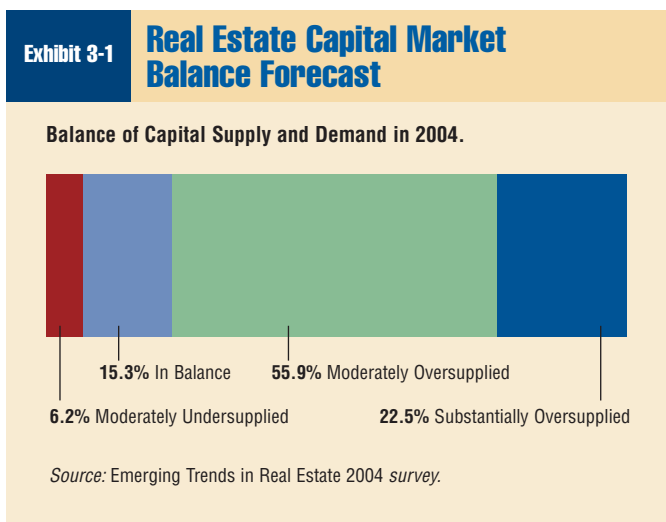
When real estate tanked in the early 1990s, capital gridlock strangled the markets, forcing widespread foreclosures, bankruptcies, and workouts. Today, apartment markets are more overbuilt than they were back then, warehouse vacancies have never been higher, and office occupancies tumble toward decade-old lows. Yet monies flow freely into real estate and mortgage investments. Despite obvious property weaknesses, a profusion of capital has buttressed values and returns.

The reason: a decade of excellent performance—spanning an entire real estate cycle—has restored investor confidence in the property markets. More recently, interest-rate manna in the form of healthy spreads between real estate yields and T-bill returns and an unprecedented Wall Street bear have kept dollars cascading, even in the market trough. Income from favorable lease structures and seductive risk-adjusted returns buoy

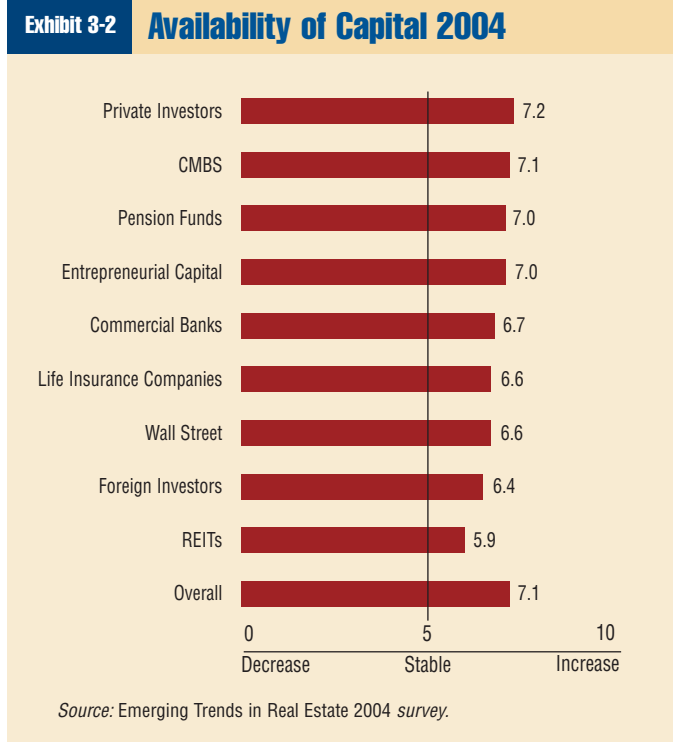
investor fervor, while low mortgage rates help boost payouts and “offset high pricing.” But at some point, supply/demand realities and sagging revenues will catch up with performance and capital flows will readjust accordingly. “Real estate has been overachieving its fundamentals.”

The recent absence of buyer interest in battered suburban office and R&D, except at bargain basement pricing, suggests that capital is still able to find its bearings. “Capital hasn’t been dumb—development has been kept under control. But investors have been paying up for secure income streams.” It would be unrealistic for spigots to stay wide open unless there’s a sudden, unexpected economic leap. And, if you haven’t noticed, the stock market has revived—not enough to convince a tide of Main Street investors to return en masse to Wall Street, but enough to take the edge off real estate’s safe-haven, “place to be” aura.

In 2004, investors will turn more cautious and selective about property deal making, especially if job growth falls short and rental rates decline further. Make no mistake: the flows will be plentiful enough, particularly for sought-after sectors—warehouses, apartments, “credit and term” office, and top-tier retail. And if a recovery takes root, “a bundle of money looks for an entry point.” *Emerging Trends* respondents appear confident about an abundance of capital from all sources. (See Exhibits 3-1 and 3-2.)



The interviewees have good reason to believe that flows will hold at sufficient levels to ensure reasonable liquidity. Whether markets are good, bad, or mediocre, there is more capital available for real estate than ever before. Since the early-1990s depression and ensuing cash-crunch debacle, the industry has developed vast new sources. Most significant, substantial new public debt (CMBS) and equity (REIT) markets now link commercial real estate to huge global capital pools. More recently, the private syndication market has been resurrected as a significant force in U.S. equity markets. Pension funds’ confidence in equity investments has been restored and their interest in CMBS is growing. Fund allocation targets have been raised. Foreign investors remain active players and life insurers continue as important lenders in the mortgage markets. Wall Street investment banks step up their presence, and commercial banks are bedrock mortgagees.



Although near-term performance could be humdrum, there is an overwhelming consensus among respondents that real estate returns will remain solidly in the black. Delinquencies and workouts will likely increase, but not to alarming degrees. “It doesn’t look like we’re going to blow it this time.” In short, capital has no reason to be scared off—but it should become more discriminating and realistic.

Capital Trends: Equity

Institutional capital will become even more discerning in 2004, and syndicator activity will abate after a frothy run. Ample dollars from pension funds and opportunity investors are ready to flow, if owners are motivated by balance sheet shortfalls into a disposition mode. Meanwhile, heightened pension allocations undergird REIT capitalizations. Equity sources aren’t backing away from real estate, but buyers are increasingly reluctant to overpay—they’re focusing more on finding relative bargains in struggling markets.

Syndicators

Crowding Out Institutions Like a phoenix, private syndication has emerged as a dominant force in the equity markets, driving office and apartment prices to what many consider “unrealistic” highs. Most interviewees “scratch their heads” and wonder whether syndicators can sustain capital raising that depends on “country club money” looking for stock market alternatives. Or is this epic spending spree just another round of Sisyphian overreaching, doomed to come crashing down when investors eventually count their “disappointing” returns?

“Syndicators are the chink in the real estate story,” wails an institutional investor, recalling the debacle following the tax syndication wave in the early 1980s. “Between the financial planners and the sponsors, they take a 15 percent promote off the top. Then they bid up prices in auctions, putting their investors deeper in the hole. Grandma and Grandpa don’t know better. If the sponsor uses leverage, it gets worse. How does the math make sense?”

Adds a Wall Street pro who knows the drill: “It could be a recipe for disaster—raising so much money with pressures to get dollars out in weak markets and earn acquisition fees.”

Disappointing Returns? Syndicators counter that some of the criticism is sour grapes over lost deals; they insist that properties have been underwritten off reasonable cash flow models. Office properties with long-term leases have been purchased, and apartment acquisitions should benefit from future demographics. Income streams are relatively secure, returning 6 or 7 percent dividends annually, and investors own hard assets so they won’t get wiped out. These investments are countercyclical to stocks and bonds, provide a “safe” return, and “look good compared with the alternatives.” But no one claims much upside potential from appreciation.

Individual investors provide a cheaper cost of capital: “They’re not like pension funds, benchmarking returns off the NCREIF index,” says an interviewee. The consensus view suggests that most syndicator investments “won’t blow up,” but returns will be “average to below average.” Reversion risk exists and investors may have trouble getting their money out when they want it.

“Syndicator clones are coming out of the woodwork,” and the big investment banks ramp up new core investment vehicles to tap into the retail real estate demand while they can. Syndicator scorecards may take years to evaluate, so near-term investor results should not affect investment flows, although

potential bad press about declining office markets may spook the moms and pops. In any case, momentum investors are likely to back off “when the next best thing comes along” or the stock market sustains advances.

REITs

Dependence on Dividends While syndicators have driven the acquisition markets, real estate investment trusts have been net sellers, opportunistically pruning portfolios “and cleaning things up.” “REITs have been playing it smart,” says a stock manager. “They’re focused on making money for shareholders, not making fees on the front end like the syndicators or accumulating assets like pension advisers.”

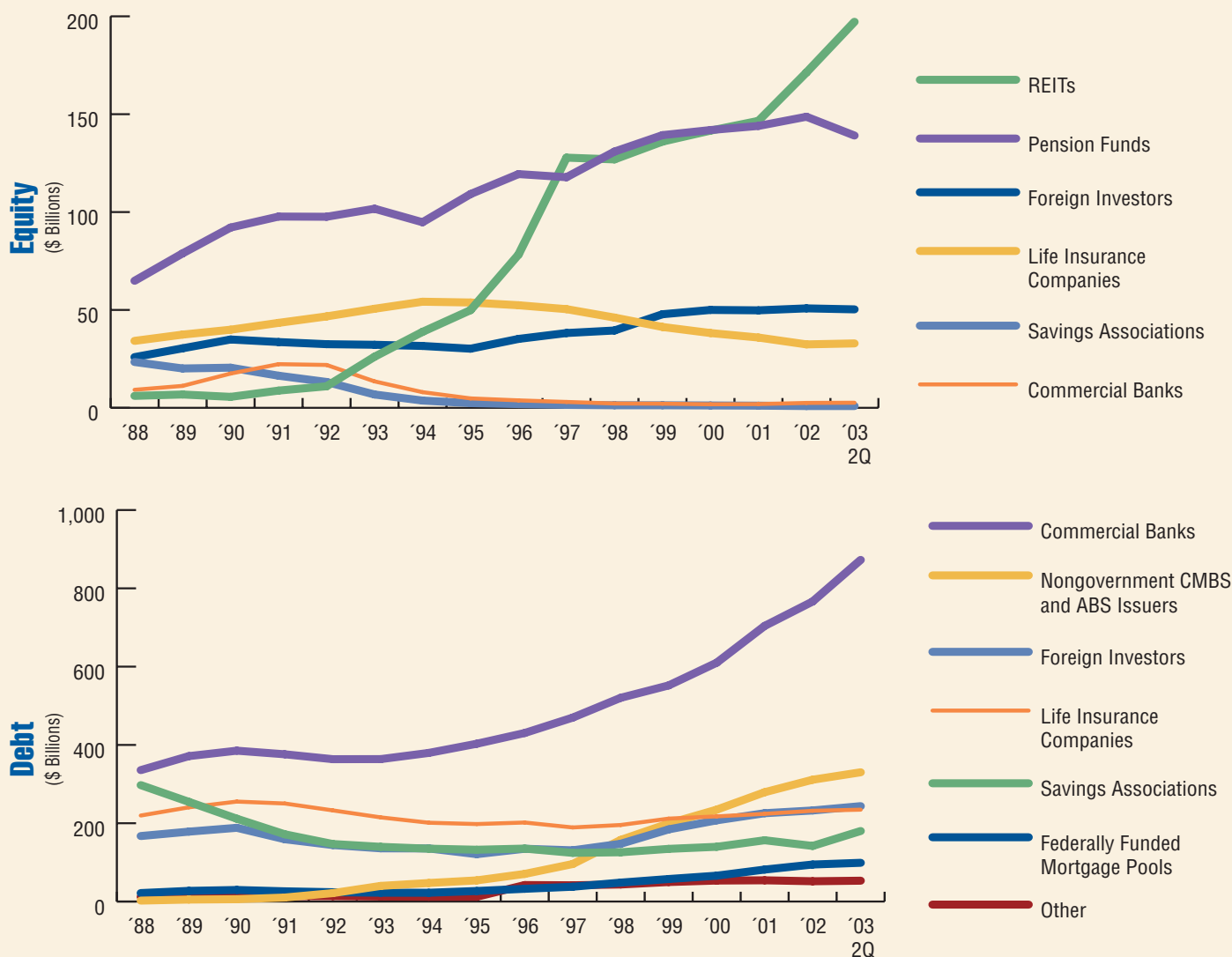
REIT prices already anticipate a “very good real estate recovery,” but dividends “appear safe” and most companies are well capitalized. “Earnings could be mediocre in 2004 and 2005.” This prediction by an office REIT executive is echoed by an apartment company CEO: “Earnings will stabilize” and REITs will trade “in a narrow range.” Regional mall and strip center REITs have enjoyed an extraordinary run, but observers anticipate “sector rotation” out of retail. “A technical recovery ahead of fundamentals has already been figured into those stocks—it doesn’t take a genius to know that grocery-anchored retail is overvalued.” A capital markets expert agrees: “Apartments and industrial REITs are a better value than overpriced retail, but office appears in for tough sledding.”



Tim Hursley photographer. Courtesy of Kohn Pedersen Fox and Gannett/USA Today.

Capital Sources and Flows

Exhibit 3-3 Real Estate Capital Flows

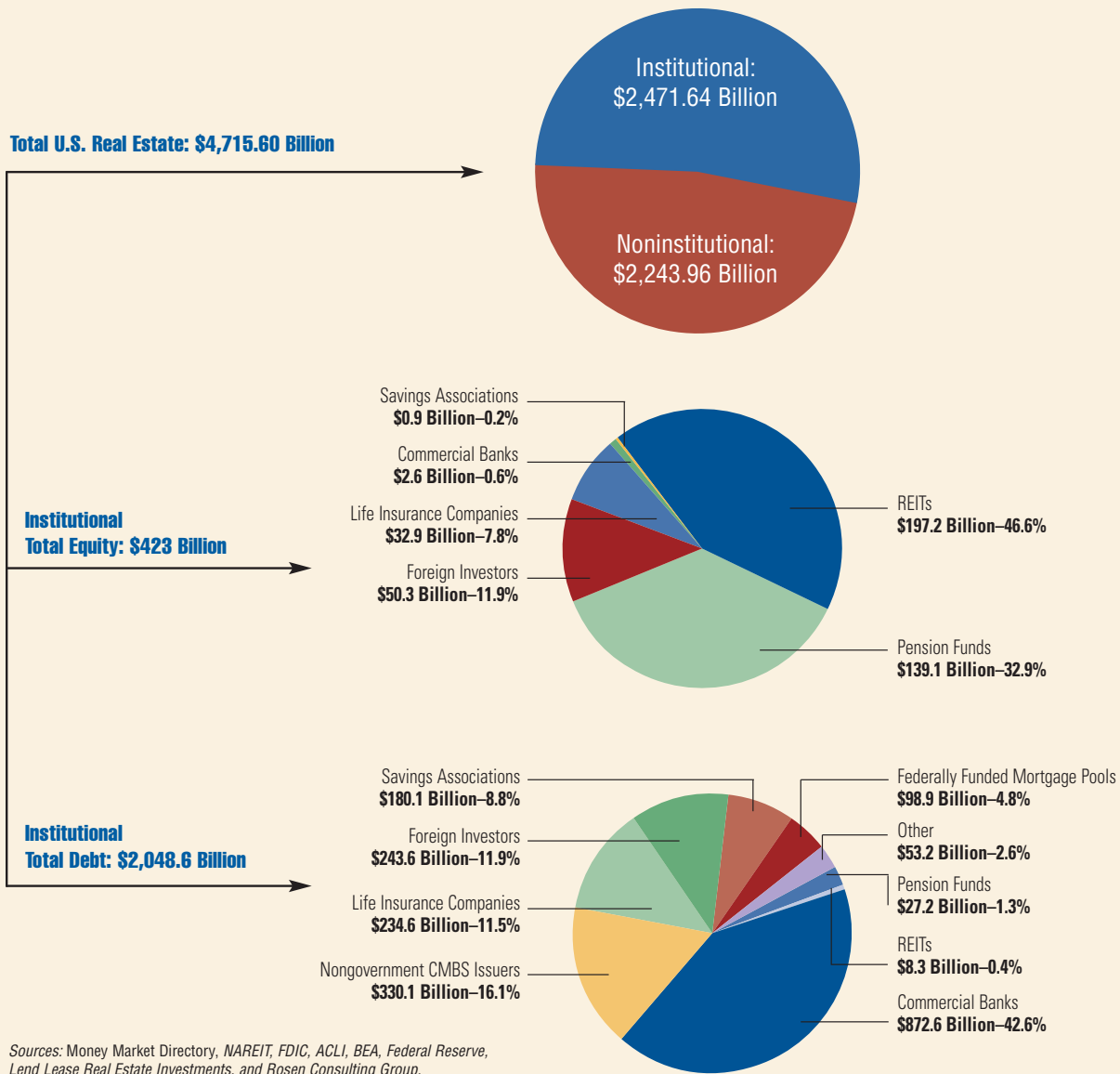


An investor surge into real estate securities and a related sharp increase in stock prices during the second quarter of 2003 propel REITs to uncontested dominance among institutional capital sources for equity real estate. REITs now control a record 46.6 percent of total equity investments, up from 42.5 percent in *Emerging Trends in Real Estate 2003*. The other equity kingpin, pension funds, lost further ground from 37 percent to 33 percent despite talk of raising allocation targets. Most plan sponsors were unwilling to go head to head with private syndicators in bidding up acquisition prices, and some funds preferred instead to invest directly in REITs, pushing up the securities' share of the capital pie. Back in the pack, foreign investors' (11.9 percent) and insur-

ance companies' (7.8 percent) shares held relatively steady. Private syndicator shares are difficult to track and show up in the noninstitutional category.

Institutional debt vaults over the \$2 trillion mark for the first time, representing nearly five times the total equity invested by institutions in the property markets. All major lending sources, led by commercial banks, increased their debt origination volumes as low interest rates inspired a financing and refinancing boom among property owners. CMBS issuers' share leveled off during the year after more than tripling since 1997. Foreign banks and insurers continue to be major players, but their activity pales in comparison to that of commercial banks and CMBS.

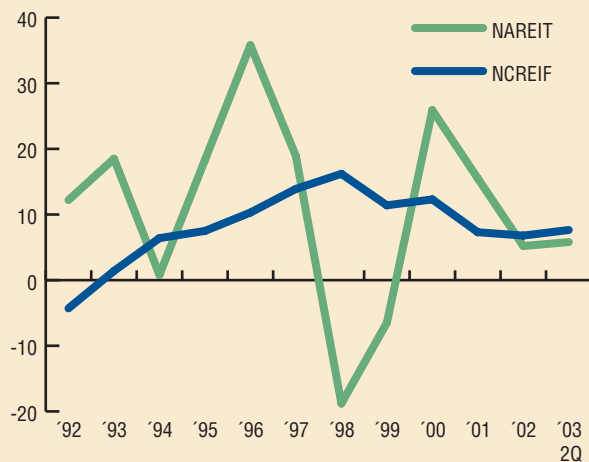
Exhibit 3-4 Institutional Capital Sources



Sources: Money Market Directory, NAREIT, FDIC, ACLI, BEA, Federal Reserve, Lend Lease Real Estate Investments, and Rosen Consulting Group.

Exhibit 3-5

Equity Real Estate Performance vs. REITs



Sources: National Council of Real Estate Investment Fiduciaries (NCREIF) and National Association of Real Estate Investment Trusts (NAREIT).

Note: NCREIF 2003 data are annualized from first two quarters. NAREIT 2003 figure is annual return from second-quarter 2002 through second-quarter 2003.

A strong minority view warns that REITs' "exceptionally good" four-year run (versus the S&P 500) and prices "ahead of fundamentals" signal vulnerability and an overall REIT market correction. "They can no longer be touted as growth stocks to attract interest, and the change in the tax laws takes away some of their dividend advantage."

For 2004, expect REITs to deliver their strong suit—6 to 7 percent dividends—but not much price growth. If office companies surprise investors with downward earnings revisions, bad press generates property-market jitters, and the overall stock market continues to advance, then property stocks could take a short-term hit as momentum investors split. Only improving earnings will lift REIT prices, and that is a challenging short-term prospect given the space markets.

Consolidation and Slow Growth Belying their roots in freewheeling development companies and private family businesses, REITs increasingly look "more institutional" and "corporate." During the past ten years, they have introduced the industry to "cycle-tested management approaches" and "sophisticated business practices," which many private investors have adopted in turn. Inclusion of companies in the S&P 500, Mid

Cap 400, Small Cap 600, and Russell indexes has earned additional credibility for the property markets.

But governance headaches and the high costs of running public companies may deter new REIT entrants. "There's enough liquidity in the capital markets, where you don't need to go public." Developers and entrepreneurial players find themselves hamstrung by quarterly reporting. "It's too capital-intensive a business—it's hard to post consistent enough returns to sustain shareholder support, and in a down cycle you get murdered." Requirements to pay out earnings in dividends can handcuff company growth strategies. Some REIT executives complain that they want to move into less passive structures like c-corps, where they can be more opportunistic. In addition: "Expect continuing consolidation as some smaller firms determine the public markets just aren't for them and merge into larger competitors." The big will get bigger.

REITs' overall market share will expand slowly over the next decade, but the high-octane growth spurt of the mid-1990s "won't return." Private markets will orient to greater risk-taking and entrepreneurial endeavors, while public companies concentrate ownership stakes in office, neighborhood retail, apartments, and warehouses—the income flow and dividend drivers. Large REITs will absorb the holdings of some real estate families and private-market patriarchs who have succession and inheritance issues. "There's a lot of dialoguing going on."

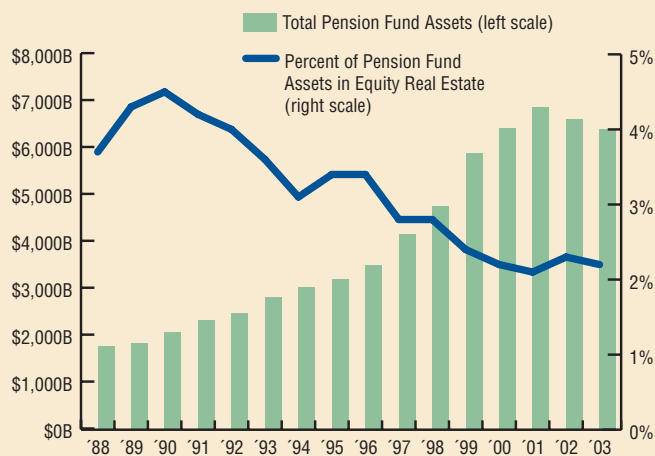
Increasingly, REITs also will look to leveraging capital by partnering with pension funds in side-by-side investments, including in operating companies, while retaining property management and other associated revenue streams. "REITs' place is to venture with other capital," says a developer. "They're big, stable, nonentrepreneurial owners. They remind me of insurance companies in the eighties."

What a difference a decade makes.

Pension Funds

Ongoing Struggle to Boost Allocations More and more, institutional investors will be motivated by a need to produce greater income in order to meet payout obligations for escalating numbers of baby boomer retirees. Pension funds realize that real estate yields fit their revised benefits models, and the stage has been set for increased investments—both equity and debt. But plan sponsors have been battered by recent stock market losses and underfunding predicaments. "Increasing real estate allocations won't solve pension fund problems," says a pension executive. "Much bigger issues are facing funds in the immediate term."

Exhibit 3-6 Pension Fund Assets in Equity Real Estate



Sources: Money Market Directory, Rosen Consulting Group.

Under any circumstances, plan sponsors move with dedicated inertia. Fund executives are paid to be cautious and even more cautious. Allocation studies “have been accelerated” and influential consultants who were reluctant to recommend real estate in the past “are now gaining religion.” At board meetings, “everyone loves us as long as we continue to provide positive returns,” says a real estate pension adviser.

“But no CEO will go above 20 percent real estate allocations [of total investment portfolios] and it’s tough enough to get 10 percent,” says an interviewee. Overall, it’s even a struggle to achieve pension allocations above 5 percent. (See Exhibit 3-6.) “Don’t expect a drastic change; increases will inch along.” Adds a major public fund executive: “Everybody says we have bigger allocations, but I haven’t seen the cash to prove it.” Ultimately, a rising stock market could boost pension flows into real estate as part of a reverse denominator effect.

Discipline and Leverage. In fact, most pension funds have been relatively disciplined players in the current property markets. “They realize that buying steady income is a risky bet right now when other sources of capital are driving higher prices and lowering cap rates,” says a leading adviser. “Many funds are standing on the sidelines,” waiting for markets to improve. “They have long institutional memories of grim losses in the early-nineties downturn.”

Uncharacteristically, funds are now using leverage in their deals in order to elevate returns and stay competitive with aggressive syndicators and offshore bidders. “The cost of debt is

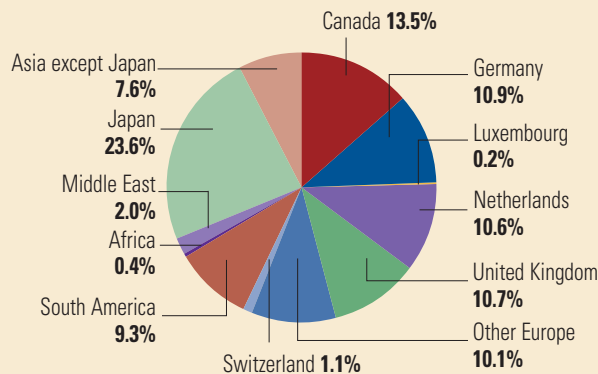
so low, it makes sense,” says an interviewee. Where allocation targets have been reached, “it’s either use leverage or stop investing.” But if rates go up, it will be much harder for boards to rationalize leverage. “It’s been like giving money away.”

Until recently, funds also have sidestepped mortgage and CMBS investments, but now they increasingly examine debt strategies in their search for yields. “They finally realize that mortgage investing can help them manage liabilities and, best of all, improve income on a risk-adjusted basis,” says a debt manager. “Consultants are starting to get on board.”

If syndicator activity decelerates, pension funds are positioned to pick up some of the slack.

Exhibit 3-7 Foreign Investment in U.S. Real Estate

as of December 31, 2002



Sources: Survey of Current Business, Department of Commerce, Bureau of Economic Analysis, Rosen Consulting Group.

Foreign Investors

German syndicators stay active in the 24-hour office markets and in southern California—their lower cost of capital and lower yield expectations give them formidable purchasing power. A weaker U.S. dollar combines with relative economic stability and market transparency to make investing here particularly enticing. Middle East and Israeli investors become more active—they park money in America as heightened conflict upends their backyards. Asian investors “are missing in action,” preferring to focus on the home front. Japanese banks and insurers continue to divest from an ill-timed 1980s buying binge and show no inclination to return.

“The real estate debt markets will move from substantially **overcapitalized** to just

Wall Street

Investment banks and money management firms expand their real estate capabilities to take advantage of the industry’s revived reputation. Following the money trail like sharks to blood, they want to appropriate a larger share of syndicator action in the retail markets, tap further into high-net-worth investors, and expand relationships with pension funds. Since prospects for their opportunity funds have waned, bankers realize they need core products and funds—both public REIT and private real estate accounts—to provide sought-after income-oriented returns. Real estate-related 401K options broaden through mutual fund and defined-contribution offerings. Although banker opportunity funds languish, they have cash to burn if distressed selling ever begins.

Life Insurers

Same old story—their equity real estate portfolios continue to wind down.

Capital Trends: Debt

Debt should remain plentiful during 2004, but increasing defaults and delinquencies will force lenders to become more prudent and tighten underwriting, requiring more equity from borrowers. Mortgage rates will stay low but trend upward during the year. “Higher delinquencies will mean that loan-to-value ratios head down and debt service coverage goes up.” Increasing cost of capital could put modest upward pressure on cap rates. “The real estate debt markets will move from substantially overcapitalized to just amply capitalized,” and borrowers’ best opportunities will come earlier in the year.

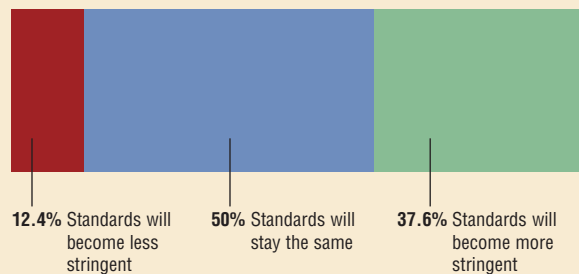
Bankers and Insurers

Kudos for Lenders Interviewees lavish praise on bankers and insurers for providing discipline over the recent investment cycle. “They’ve done a great job.” Whether praise is deserved or not should play out in any borrower shakeout during 2004 and 2005. Most lenders—scorched by prior lax practices—did relatively conservative underwriting in the 1990s. In particular, “construction lenders concentrated on preleased, presold, or solid asset classes” like multifamily. Stricter loan policies cer-

tainly have captured builders’ attention. “If we were to go for a spec loan today, we would lose all credibility with the lender,” says a developer. “We now know to discipline ourselves in the borrowing process.”

Exhibit 3-8 Underwriting Standards Forecast

Predicted Change in Stringency of Underwriting Standards for Commercial/Multifamily Mortgages in 2004.



Source: Emerging Trends in Real Estate 2004 survey.

Banks register good earnings and show ample reserves—their first-loan positions seem secure. “Nobody is getting beat up by real estate this time around.” Life insurer portfolios also appear sound. Both banks and insurers are spreading risk by securitizing portfolios into the CMBS markets, and commercial construction lenders insulate themselves by routinely syndicating larger loans. Some regional bankers may have shown a lack of discipline, financing the rash of multifamily development in many markets. Fannie Mae and Freddie Mac also raise eyebrows in the apartment-lending arena.

Brimming Watch Lists For all the talk, 2004 should determine just how healthy private-lender portfolios really are. “It will be a critical year.” Delinquency and defaults have edged up, though they still trend near historic lows for the bottom of a real estate cycle. “Nobody has even blinked,” says an interviewee.

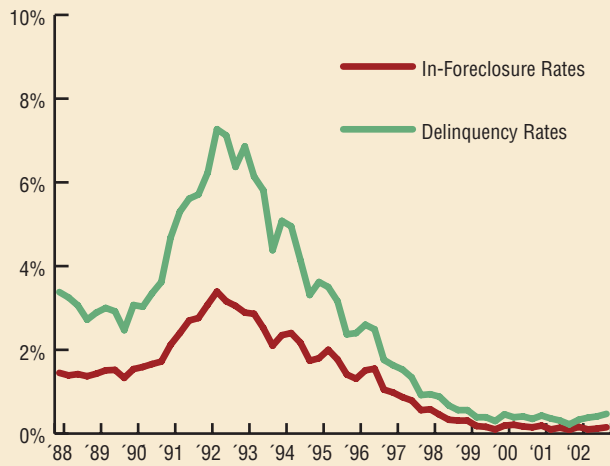
But watch lists are brimming, and most observers expect problem loans to increase as markets bottom out and struggle to recover. “It really shouldn’t be this good,” says a lender, considering vacancy numbers and rent declines. “Any delinquency/default increases should be manageable [even if they double to 3 percent], given the low numbers up until now.”

Wizened lenders point out: “There’s a whole generation of investment officers who have never been through a default.” Even more telling, a whole new capital sector has yet to experi-

ence the exigencies of an extended market downturn. How CMBS markets handle increasing turbulence will be a clue to the future of the debt markets.

Exhibit 3-9

Life Insurance Company Delinquency and In-Foreclosure Rates



Source: American Council of Life Insurers.

Basel II Some bankers red-flag the potential impact of capital regulations proposed under the Basel II Accord. These international regulations would impose higher capital reserve requirements for lenders on real estate transactions, based on credit risk. In particular, construction and development financing could become more expensive and restricted, requiring more equity and increasing the need for mezzanine debt. The reserve requirements also would extend to securitized loans. While the regulations would not take effect until 2007, banks will need to start bringing their portfolios into compliance before then. Real estate could look a lot less inviting for banks and their balance sheets. These changes bear careful watching.

CMBS

Mild Concerns “The stress test is just beginning in the CMBS markets,” says an interviewee. “Performance has nowhere to go but down.” Respondents are generally confident that most investors in commercial mortgage-backed securities will weather downdrafts from rising problem-loan rates. “I’m losing a little sleep—not a lot.”

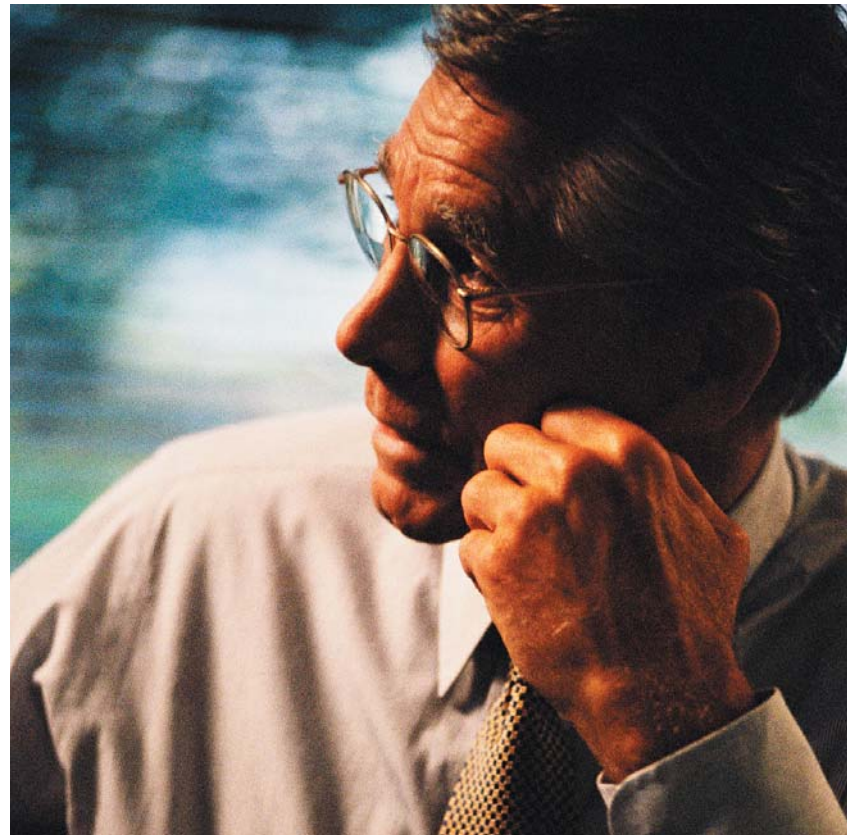
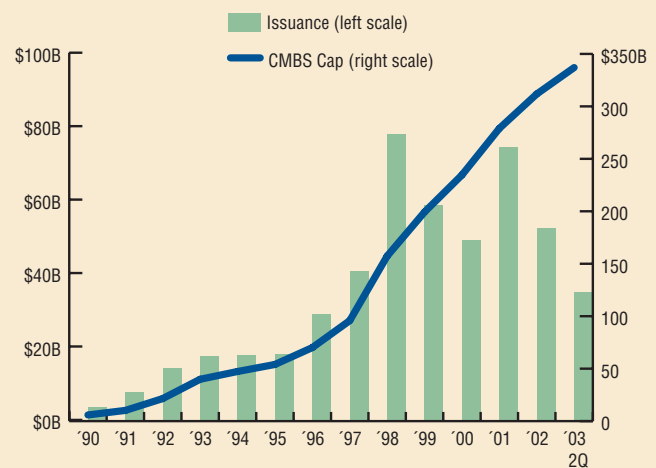


Exhibit 3-10

CMBS Market



Sources: Federal Reserve, Commercial Mortgage Alert.

“If the markets pick up, CMBS will be fine. If markets bounce along at bottom for a while, they’ll still be OK.” This is especially true for loan pools concentrating in apartments, where an active sales market gives owners exits, and in retail, which has avoided any marked distress. But there is concern about bonds with office loans. Capital needs—for concessions, tenant improvements, and retenanting costs—could create problems for some borrowers. “Debt guys are understating the potential trouble.” Loan pools heavily weighted in suburban office bear particular scrutiny. “Lots of leases are rolling over into very soft markets.”

A reasonable uptick in delinquencies and foreclosures to anticipated 3 percent levels “shouldn’t worry investment-grade or BB bondholders,” says a portfolio manager. “That’s less than people had calculated in their underwriting.” For unrated bondholders, underwriting also “has been holding up.” Some issues will experience “de minimis problems”; others “could get whacked.” But these investors have earned extremely high cash returns to date on their unrated bonds. “In the context of their overall portfolios, they will have earned good returns no matter what happens.” In fact, over the last ten-year cycle, CMBS have “materially” outperformed most alternative fixed-income vehicles.

Ignominy in the Spotlight Any CMBS defaults will be public events, befitting public securities. “Everyone will know.” Borrowers will be tested on their willingness to put more dollars into properties or face outing. Private lenders offer more cover and greater pliancy. “If you want the cheapest cost of debt, then you go CMBS, but if you want flexibility when times get tough, it’s not a good choice,” says a developer. Some borrowers may be in for a lesson or two.

“CMBS foreclosures could be a disaster,” warns an interviewee. Workouts are difficult, and servicers have little flexibility within documents to reduce principal. But owners may try to stall foreclosures through lawsuits and bankruptcies—a costly and time-consuming process. “If 3 percent of loans are involved, that’s a lot of workouts. It could get ugly.” Most interviewees expect a latent recovery to puncture such Cassandra prophecies, but defaulting borrowers will be discomfited and there will be a learning curve for investors and servicers, too.

Returns Slacken Investors’ hunger for CMBS grows, and Wall Street issuers “keep blowing issues out the door” at a pace exceeding \$1 billion a week. Lending discipline has slipped on some senior debt, fueled by investor appetites and low interest rates. “Investment bankers are acting the part of clearinghouses. For most of 2003, loan-to-values have been going up and debt service coverages have been heading down” in a weakening environment. Most observers stress that B-piece underwriting has held up. “Investors have been savvy enough to force B issuers to have some skin in the game.” Rating agency oversight provides additional discipline.

Returns, meanwhile, have been declining, and spreads narrowing. “Real estate has been a safe haven, but good credit-quality deals translate into lousy yields. In particular, relative value is gone from investment-grade CMBS, compared to other high-yield bonds.”

Expect bond buyers to “become more wary” as delinquencies and foreclosures increase during 2004. Spreads will widen again. But absent unforeseen disaster, the newly earned “mainstream” status that CMBS have achieved in the fixed-income markets should be cemented further. Whole-loan lenders—insurers and commercial banks—will continue to use CMBS markets as an



outlet to securitize portfolios, manage balance sheet exposure, lay off risk, and provide liquidity. Pension funds' investing should build—they're always late to the game anyway.

Over the next decade, the CMBS share of the debt markets could increase north of 25 percent, but private lenders will continue to dominate mortgage volumes. The less distress and the fewer workouts markets endure in coming months, the faster the influence of CMBS will rise.

Mezzanine Debt

Tough to Invest Like CMBS in the public markets, mezzanine debt in the private mortgage markets has "tranching out risk," protecting senior lenders from first-loss exposure. "It's become an accepted mode of financing." But like opportunity funds in the equity markets, mezzanine investors hunt desperately for good investments that meet their higher yield requirements. "Deals will be less lucrative than advertised," admits a portfolio manager. "Liquidity and low rates have limited the opportunities to put money out." Most interviewees agree: "Too much mezz money has been available."

Return Expectations Down Return expectations have been working down from high teens to mid teens, and now low teens, but arguably they are still attractive. "The medium tier in the capital structure can achieve great yields on a risk-adjusted basis, almost as good as equity. And you have the equity cushion." But lenders need to focus on stable cash-flowing assets and avoid development risk. With concerns about rising interest rates, current borrowers are looking for longer fixed terms—seven instead of five years.

"You don't hear much about mezz workouts—they're negotiated privately." But interviewees suggest that owners who loaded up on mezzanine debt four and five years ago at market highs could be suffering in the wake of declining operating revenues. These borrowers may have trouble refinancing, if and when mortgage rates increase and mezzanine debt matures. It's odds-on that borrower surrenders will increase in 2004.

A vintage surveying instrument, a telescope, and a pocket compass are arranged on an old, yellowed map. The surveying instrument is a large, black metal device with a circular scale and a telescope-like structure. The telescope is a long, brass instrument with a black barrel. The pocket compass is a small, round, brass instrument with a compass rose and a ring. The map is a detailed, aged document with various lines and text. The word "Markets" is written in a white, serif font across the center of the image.

Markets

*“Realistically, only
Washington, D.C.,
earns unwavering
endorsement.”*

to Watch

A lengthening real estate downturn saps the lineup of choice real estate markets. Realistically, only Washington, D.C., earns unwavering endorsement. Southern California retains a strong following, though the state’s fiscal crisis raises some concerns, and New York hangs tough—it is too big and powerful to be knocked off its feet. After that, “Ugh!” Except for Miami, which continues to strengthen modestly, real estate markets from coast to coast slide along bottom, and interviewees anticipate little improvement during 2004.

Perennial 24-hour heavyweights—Boston, Chicago, and San Francisco—reel from a lack of tenant demand. But everyone assumes they will climb back eventually. Not so for the once-hot growth markets—Atlanta and Dallas. Even though these “sprawldoms” might ramp up their expansion engines someday, confidence in their ability to sustain returns has dissipated. That is bad news now that real estate investors have been sold on yields and increasingly gravitate to core properties with predictable cash flows.

Other metropolitan areas sink into a gray morass. Normally, interviewees gush with opinions on regional markets—both favorites and flops. Not so this year, when interest rates, capital flows, and financial engineering have distracted them from the impact of market vacancy rates and local demand drivers. The fundamentals temporarily—and we stress temporarily—do not seem to matter as much. If the property has the right kind of tenants, the lease term is long enough, and low leverage can be smacked onto the deal, where that sucker happens to be located is not as important. Or is it that D.C. and New York are the only places providing term and credit?

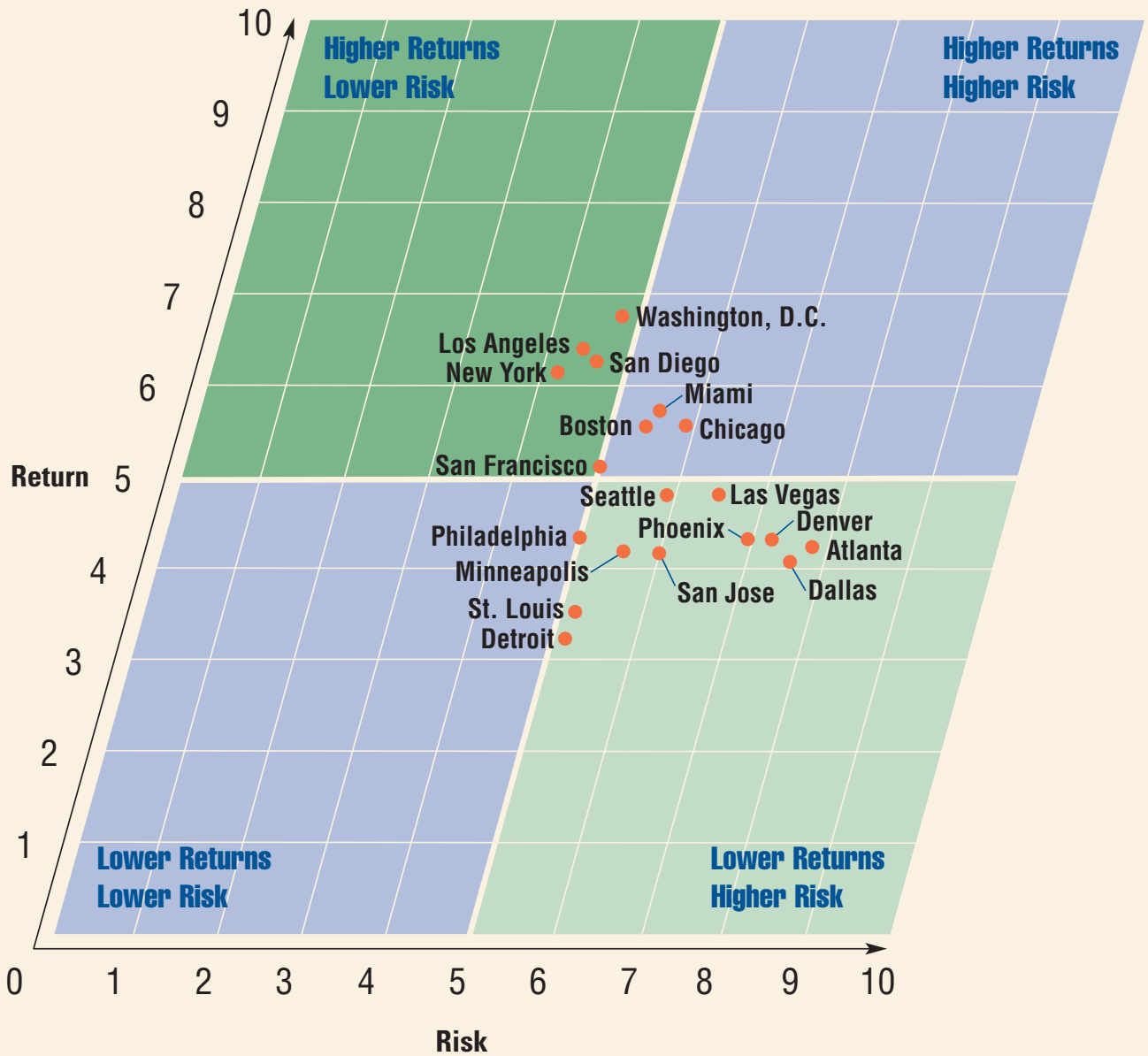
In fact, Washington, New York, and the southern California duo—Los Angeles and San Diego—are the only markets that solidify favorable positions in the *Emerging Trends* risk/return diagram. (See Exhibit 4-1.) Most other markets slip marginally deeper into lower-return/higher-risk territory.

“Mainstream” development needs to take a hiatus. For 2004, “you have a choice if you’re a developer—head to the beach or play some golf.” Only D.C. and southern California rate even mediocre development prospects in our survey.

First-tier cities remain **vibrant** and dynamic, but much of the remainder of urban

Exhibit 4-1

Metro Areas—Return and Risk: 2004



Source for all exhibits in Chapter 4: Emerging Trends in Real Estate 2004 survey.

Investors Gravitate to the Coasts

Coastal population magnets—the West Coast from southern California up to Seattle, the prime Eastern Seaboard cities, and south Florida—increasingly draw the bulk of investor attention. The Pacific Coast faces the growing Asian economies, while the Northeast is the most economically diverse and stable region, featuring barriers to entry and extensive mass transportation networks. Florida’s attractive climate and Latin America gateway status grow more enticing.

Some medium-sized southeastern cities are emerging—Jacksonville, Nashville, Charlotte, and Raleigh-Durham. “They have enough critical mass and infrastructure, and still project soul and character.” But to prosper and “have a chance, they need to take the emphasis off the car” and avoid getting strangled in traffic congestion. These places “shouldn’t try to be another Atlanta,” which is “on the cusp of being too big to fix.”

In the Mountain West and Southwest, open space and sprawl remain the obstacles to achieving more reliable and sturdy real estate markets. In the short term, attractive lifestyles, a favorable climate, and a lower cost of living in these areas will draw some companies and workers away from troubled California. Down the road, legions of aging baby boomers will resettle in mountain and desert resort areas. Denver and Houston take encouraging steps to refashion their downtowns into more multifaceted 24-hour cores—both featuring growing, though small, residential components. In fact, efforts to revive once-moribund nine-to-five downtowns like these—redeveloping empty office space into loft

apartments, turning parking lots into parks, and transforming gloomy side streets into neighborhood shopping districts—will become a major driver of development activity in the next decade. Dallas and Phoenix will need to follow the example.

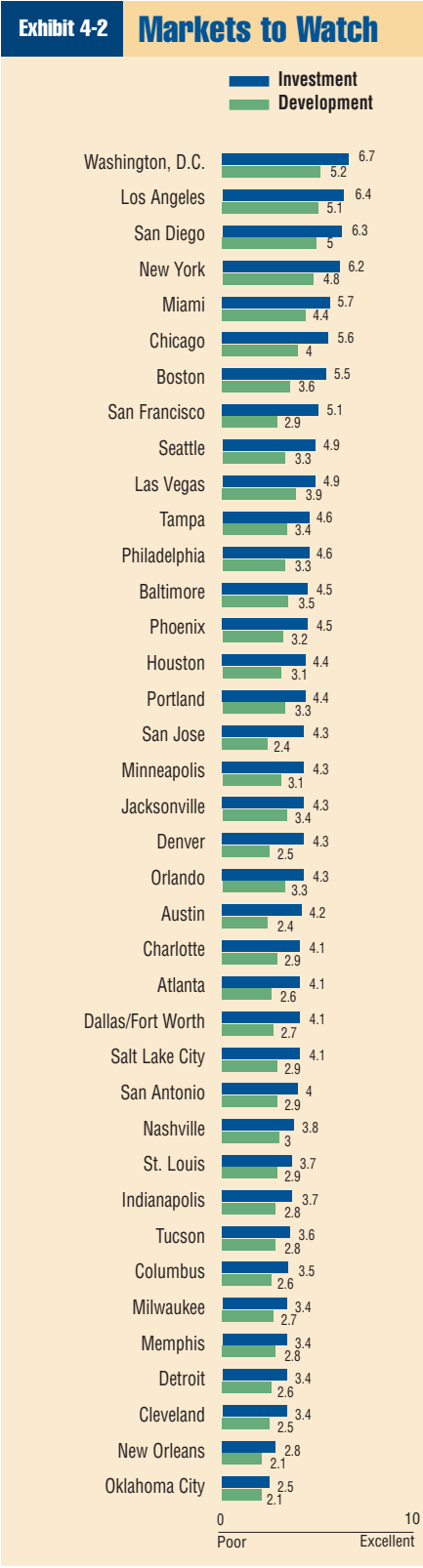
In Midwest breadbasket markets—except for Chicago—prospects decline. Their agricultural and manufacturing underpinnings have withered slowly and steadily. Young people see fewer opportunities and move away. “The middle of the country seems to be emptying out.”

The number of truly prospering urban centers continues to decline. “For every New York or Chicago, there are ten Tulsas or Buffalos.” First-tier cities remain vibrant and dynamic, but much of the remainder of urban America—especially the older Rustbelt towns—is ignored. To investors, they have become irrelevant. “It’s a handful of elites and a huge group of dogs.”

Hanging On Despite Budget Stress

Notwithstanding budget shortfalls, revenue declines, service cutbacks, tax hikes, and reduced federal aid, the big 24-hour cities have managed to keep up appearances while waiting out the economic doldrums. Most important, crime remains tamped down. But infrastructure maintenance gets back-burnered, and troubled school systems fester. “These cities require massive capital investment” to remain viable.

Extended belt-tightening could begin to undermine quality of life. Potholes, uncollected trash, increased homelessness, and more street crime are possible byproducts. But interviewees maintain confidence



in the staying power of these cities and expect them to withstand economic hardships. What a difference ten years makes! At the depth of the last recession, major East and West Coast cities (except for Washington, D.C.) plunged to the bottom of the *Emerging Trends* rankings.

Power, Water, and Oil

2003 brought us droughts, water shortages, a summer blackout, and \$2-plus gas prices—all serious concerns for real estate investors and developers. Reliable power is critical for businesses dependent on telecommunications and computer systems. Bang away on a portable typewriter and you are liable to be committed. Everything runs off of electricity, including cell phone transmitters and laptop batteries. Places with reputations for erratic power service could be big losers as tenants become ever more motivated to disperse operations and reduce the risk of costly shutdowns.

Water availability will shape future development trends and short-circuit the ability of some states and cities to grow. Not only arid western regions, but also areas from the Northeast through the Carolinas into Florida must face up to inconstant or, worse yet, diminishing water supplies. Can Arizona cities keep on building golf courses? Will southern California balance agricultural demands with population needs? Will looming water shortages in the Apalachicola-Chattoohochee-Flint watershed halt metropolitan Atlanta expansion? The questions multiply.

Phoenix was almost brought to its knees recently when a gasoline pipeline

ruptured, cutting off supplies to many service stations and leaving people without transportation in a car-dependent expanse. What happens to suburban America if an oil crisis strikes, curtailing imports and supplies? Since 1979 and the last Arab oil embargo, U.S. reliance on the car has mushroomed exponentially—spurred by population shifts out of urban and rural locations into the auto-addicted suburbs. It is true that strategic oil reserves and new oil sources from Russia and other former Soviet republics might help mitigate shortfalls. But given the precarious situation in the Middle East, is it farfetched to believe that another oil shortage is possible—that pump prices could rise to the point where the economy and consumers would take a broadside? The threat is greater now than it has been in a generation, and the impact on where people will choose to live could be dramatic.

Is Suburban Expansion Approaching Its Limits?

Population growth continues to flow into densifying suburbs—whether around the built-out 24-hour cities or into the Sunbelt suburban agglomerations. “If you’re investing in housing or retail, that’s where you want to be.” But less desirable aspects of sprawl—car dependence, congestion, and infrastructure stress—are starting to push people away from the suburban edge and closer to more convenient subcity nodes.

Increasingly, state and local governments are enacting growth restrictions to protect dwindling open space and reduce strains on the costly sewer, water, and road

systems that have subsidized horizontal growth. “The market’s heightened sensitivity to the environment has led to a higher degree of government regulation and more controls—out of necessity for preserving quality of life.” Suburbs also get a bad rap from public health experts. “Drive everywhere” lifestyles encourage weight gain and related medical problems—suburban dwellers average six pounds heavier than their urban counterparts.

Developers must recognize, if grudgingly, the shifts in demand and the reduced availability of open space. “The gun-toting days of the suburban developer just throwing up a project are over in most places.” Increasingly, greenfield subdivision construction is “heading into the tank.”

Demographics Push the Move Back in

Baby boomers continue to influence market trends as they shy away from suburban perimeters and look back toward the urban cores. In the 1970s and 1980s, boomers extended the suburban envelope, raising families en masse in single-family expanses close to good schools and far from big-city problems. Now, some “front-end” empty nester boomers (in their late 50s) are trading those roomy split-levels for more manageable urban condominiums. Not coincidentally, urban life has become more attractive—cities are cleaner and safer, and “there’s a lot more to do than in your sleepy backyard.” That means more high-rise apartments in prime subcities like Atlanta’s Buckhead and Midtown or townhouses in D.C.’s Alexandria, Virginia. Baby boomer offspring, the generation X crowd, seek jobs and action closer to city centers, too, pushing demand for rental apartments near urban nodes.

Smart Growth Gains Force

Increasingly, buyers are more discriminating and focus on better-planned suburbs. “Areas that stand the test of time are generally the older towns with street grids and retail centers.” Convenience counts: walkable communities near mass-transit hubs “have caught on,” and smart-growth projects—which emulate traditional town centers—enjoy increasing success. “If people like it, the market will push its growth,” says an interviewee. “Smart growth is better than dumb growth, and it’s about to become more predominant.” It responds to what people are most concerned about—“quality of life and the environment.”

Meanwhile, suburban degeneration assaults older, cookie-cutter housing stock, especially in first-generation inner-ring suburbs. Some of these areas face deteriorating property values, akin to urban declines in the 1960s and 1970s. Over the next decade, more communities will be at risk.

Developers Focus on Infill

The confluence of the “move back in” trend, growth controls that limit new construction, and suburban degeneration have refocused developer and investor attention squarely on infill opportunities. While *Emerging Trends* interviewees give overall development prospects an anemic 3.5 on a rating scale of 0 (terrible) to 10 (excellent), they award a healthy 5.9 to infill redevelopment.

Major hurdles need to be overcome in order to fuel the regeneration of infill land:

- Profitability requirements: Rehabbing costs more than greenfield construction, and most developers would rather make a buck than go broke building “a suburban Paris.”

- Zoning restrictions: “Old-model” single-use zoning separations continue to be favored by many local governments, which compete against each other for projects and tax base generators (office parks, retail strips, and subdivisions). Developers “flock to the remaining growth-friendly places where less regulation usually translates into greater profits.”

- NIMBYism: “Not-in-my-backyard” attitudes and an enduring bias against density—suburbs are not supposed to look like cities.

- An aversion to centralized planning and regional control.

“Intelligent upfront planning is key,” says a CEO of a major development firm that has undertaken smart growth initiatives. “It takes a combination of planners, government leaders, developers, and the community. You need wise governance with a regional, not a parochial, view—and developers who want to create something that will last.”

The best infill results occur when large properties—forgone greyfield malls or abandoned industrial sites, for example—can be developed into pedestrian-friendly, mixed-use residential neighborhoods that include town center retail, parks, and even schools. These tracts can be leveled and builders can start from scratch without trampling on existing neighborhoods. “Local government needs to mitigate the risk for investors and developers and provide greater tax incentives.” The future payback in restored tax base can be immense. “But developers will need to work more cooperatively with local governments” to take advantage of these opportunities.

“We’re only in the first chapter of the changeover from growth and sprawl to infill and mixed use,” says an interviewee. “The new model will be more

expensive. Many developers will be on the sidelines until they see what works in the new environment.”

Urban Infill Gears Up Fitfully

Rehabbing underused nine-to-five downtowns and other urban infill will also move to center stage for developers. So far, most initial attempts have been “too boutiquey” or “undercapitalized” or have suffered from a lack of experience. Risk and uncertainty have deterred investors. “What you need is a big guy with the capital and expertise to join forces with a city and make it work.” REITs are not the answer—“analysts would eat them up and principals have too much stock at stake.”

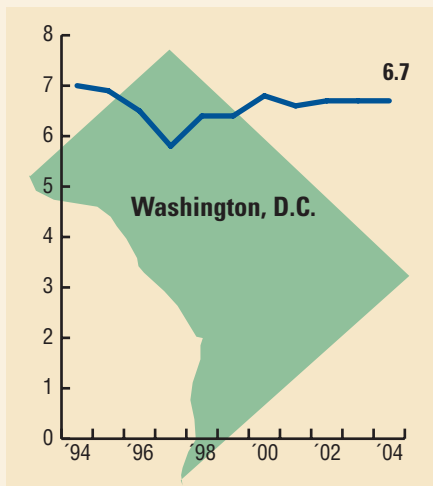
Institutional investors—focused increasingly on surety of income and immediate returns—dodge large-scale urban revitalization. Mutual insurers that benevolently financed urban renewals in the 1950s and 1960s are now public companies facing quarterly bottom-line scrutiny. Banks that were once hometown or regional institutions are now more likely parts of national or international financial giants. Their community dedication is not what it used to be. Large public pension funds eagerly give lip service to supporting local initiatives, but remain exceedingly risk averse.

“Risk hasn’t been reduced enough for the big developers and investors to come in,” says an interviewee. “That’s why you’ll see small to mid-sized projects to begin with. A workable model will be 100 to 200 residential units—sales and rentals, some office, maybe a small boutique hotel, and service retail, near other amenities like parks or an entertainment complex.”

The Best and the Rest

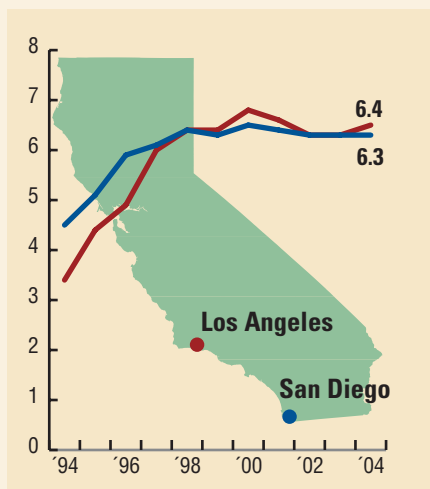
Washington, D.C.

Always the first choice when real estate markets hit bottom, the District has not disappointed. It is the only major city to keep office vacancy comfortably under 10 percent. Although downtown may be “the ultimate yield buyer’s” market, “pricing above replacement cost has been frightening,” and speculative office projects are underway. “If you overpay for something, Washington is the place to make a mistake.” While the government cushions downside with a prodigious leasing appetite, few tenants show signs of expansion. “At least the associations, lobbyists, unions, and lawyers never got whacked like the corporates.” A surfeit of East End residential construction gentrifies the area around the new MCI Center sports arena, but leads to a temporary apartment glut. Another concern: crime has been increasing—the District reclaims “murder capital” status. Suburbs suffer—no post-9/11 boom occurred in northern Virginia as expected. “Any activity is inside the Beltway”—the farther out you go, the weaker markets get. Improvement will be slow, absent major defense department outlays.”



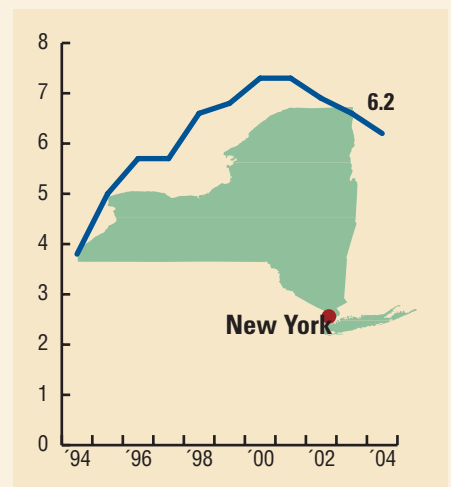
Southern California

Better than the rest but not vibrant, the diverse southern California basin has been an investor magnet, especially for apartment and industrial buyers. Supply constraints, NIMBY backlash, and environmental regulations limit multifamily construction, and enormous renter demand outstrips supply. “Unbelievable” warehouse markets boast miniscule vacancy, and development is only starting to ramp up. Asia-facing ports benefit from a shipping influx. Even so, “between us girls, capital needs to slow down. It’s been a feeding frenzy.” The real weak spot is the office markets: “values have been artificially high, ignoring lowered rents.” Optimists again tout downtown L.A.’s future (yawn), but new residential “has been a drop in the bucket.” The west Los Angeles, Pasadena, and Glendale markets feature much more attractive executive housing. Biotech and defense stabilize San Diego’s fortunes—but while climate and lifestyle draw talent, it lacks an airport hub. A higher-tax/more expensive business environment could slow southern California growth trends, as state and local governments struggle with massive red ink. Despite political hot air about “no new taxes,” lower-cost Arizona, Nevada, and Colorado beckon. Somehow, some way, taxpayers foot the bills. “Premium,” built-out coastal areas will weather a downturn better than inland centers around Riverside and San Bernardino, where growth has accelerated recently.



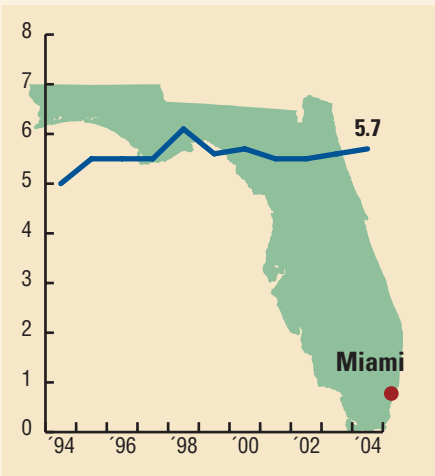
New York

The Big Apple’s long-term challenge is stemming job leakage. “Wall Street is no longer the fatted calf.” Events like 9/11 and the 2003 blackout spur corporations’ job-dispersal strategies. Backbone financial firms “want less dependence on New York.” Despite still-sky-high prices for trophy towers, the city may not rebound quickly or be able to reclaim the heady aura of the late 1990s. Yet Manhattan’s unique dynamic of money, culture, power, sophistication, and glitz “make it the place to be if you want to be a global player.” Midtown is solid for now—“everyone wants to be on Park Avenue”—but major office construction projects move toward completion. Downtown will stay soft. “Rents won’t come back for several years.” In the long term, a planned mass transit hub, more residential buildings, and open space could rival midtown’s amenities. Condominium/coop prices hold up; apartment rents soften marginally. The worst seems over in the city’s budget crunch, and with the Republican Convention coming to town, all stops will be pulled out to improve the outlook further. Worries about crime linger—incidence rates meander near record lows, but can that last?



Miami

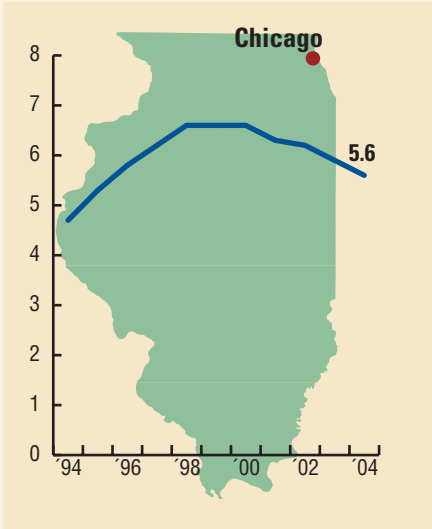
The best in the Southeast, Miami jumps ahead of other faltering markets. Barriers to entry—the ocean and Everglades—keep land costs high. “There’s not much left to build on, and you don’t see crazy development” as in sprawling areas around Tampa and Orlando. Latin Americans park dollars in condominiums and infill retail strengthens. Population growth and immigration, plus supply constraints, push up apartment rents. “South Florida is one of the nation’s best multifamily markets.” Industrial fades, tracking South American economies, but should bounce back in any recovery. Office is “okay.” Infill redevelopment opportunities abound, especially rehabilitating over-the-hill hotels and low-rise apartments along the Intracoastal Waterway and beachfront to create upscale residential space with prized waterfront views. Hotels are overbuilt.



Chicago

A recent ill-timed splurge of downtown office development “looks like a train wreck coming down the track.” “Simply, Dallas on a lake.” As companies downsize or hold the line on space needs, new prime space lures tenants out of older buildings, “creating holes.” Anything with

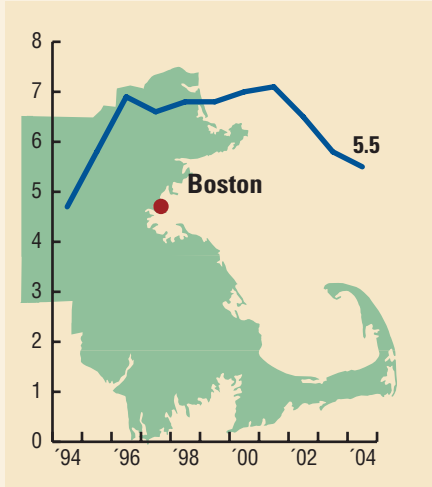
rollover risk faces problems. “Vacancy is heading back to early-1990s levels, and concessions have returned. Free rent may be next.” The suburbs “are waiting for pain to hit.” Major employers that drove growth in the past decade—Lucent, Tel Labs, Sears, Motorola, SBC Ameritech—continue to falter. Owners have been hanging on, but time is running out as leases turn over. Interviewees remain generally positive despite the overbuilding and negative absorption. Diversification, a bevy of Fortune 500 companies, a strong mayor, and excellent mass transit systems provide broad underpinnings for sustained growth once the overall economy perks up. Industrial remains a bright light.



Boston

Office market contraction will stabilize in 2004 after a rocky slump—asking-rents have dropped by more than one-third off 2000 highs and vacancies have zoomed. Nobody anticipates an immediate recovery: “Tough it out for a couple of years; it will come back.” Yield hunters will help prop up prices for leased, Class A properties, but lesser-quality buildings face a challenging environment. The future of two significant employers raises concern—both John Hancock (to be acquired by Canada’s Manulife) and Fleet Bank (another prime acqui-

sition target) could be ripe for consolidation. Any rightsizing could dampen a leasing rebound. Backbone financial-district money management firms need sustained stock market gains and new investor inflows to justify renewed hiring. The suburbs have been hammered in the tech burnout. “It’s been ugly.” Meanwhile, investors circle for deals: “I’d be all over Boston.” Its 24-hour fundamentals and reservoirs of college and university talent make it “an excellent long-term bet.”

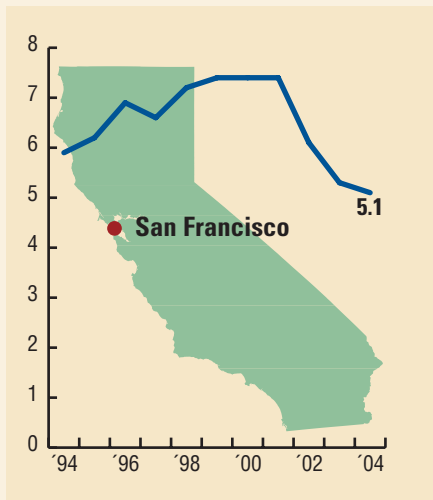


San Francisco

“It’s only a matter of time before distressed trading begins.” Workouts, foreclosures, and sales—they are all coming. But so many vultures are prepared to pounce that pricing could be buttressed. No question, the Bay Area has been through the ringer—and deterioration may extend into 2004, thanks to fallout from California’s fiscal morass. Can Arnold come to the rescue? Expect recovery will take time: three to five years. “At some point, we’ll be wishing we’d bought everything we could have when it was available.” Some estimates suggest 175,000 or more new jobs must be created before rents increase. The ultimate landlord’s market in 2000 (who were the guys who signed \$100-per-

Unremitting growth has caught up with Atlanta.

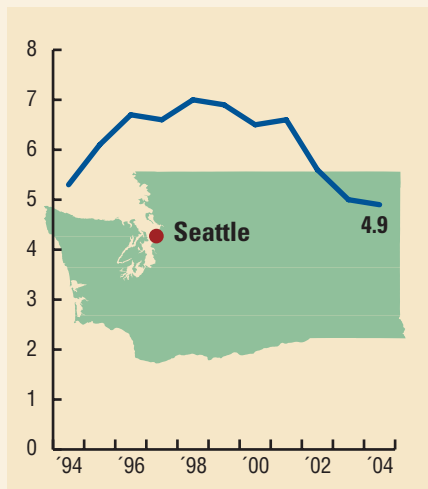
square-foot rents?) has turned into a tenant's paradise (rents are back to pre-spike 1997 levels). Hotels struggle in the impaired business climate. The only good news: office and hotel development has shut down. Conversion of office into residential makes sense, though. The housing market remains tight.



Seattle

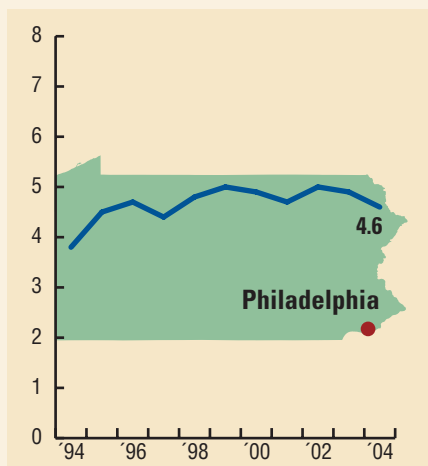
"Well, it's not looking good." Boeing keeps the pink slips coming and Microsoft outsources jobs overseas, taking advantage of its very own technology products and innovations to help manage local space costs. Job growth has dried up (Washington boasts one of the nation's highest unemployment rates), vacancies should top off in the high teens, and rents have more room to fall. Most development activity has stalled, offering a faint note of hope. Some skeletal projects have even been mothballed. No one can figure out the next employment generator. Expect a quicker recovery for industrial, which has been hurt by Boeing contractions. "When Asia comes back, Seattle's port will again be a great alternative to Los Angeles and San Francisco." Not surpris-

ingly, apartments struggle, too. A tech revival cannot happen soon enough. Without it, you're "looking at a three- to five-year turnaround."



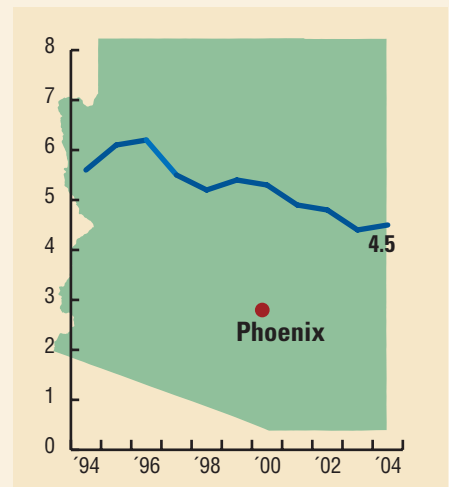
Philadelphia

Philly muddles along at cyclical bottom, starved for action and lost in the shadows between formidable neighbors, D.C. and New York. It is off most interviewees' radar screens. Office leasing goes sideways, investor interest is limited, and construction has halted, thankfully. Prime suburban markets—King of Prussia and Conshohocken—may offer some good buying opportunities if office owners start to capitulate. Suburban vacancy outpaces downtown's. Retail and apartments hold their own. Lethargy will persist through 2004.



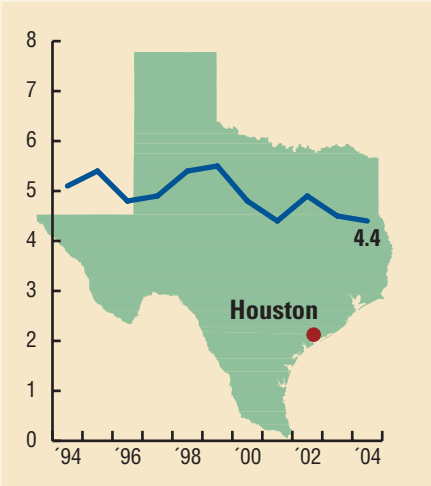
Phoenix

One of the Sunbelt's high-growth, high-risk suburban markets, this desert metropolis improves slightly, if only because capital has shied away. A shallow, "out of whack" office market suffers and apartments are overbuilt. Construction has been "amazing" except in downtown, which "desperately" needs a residential core. Retail does well and the stellar golf resorts draw snowbirds, but most institutional investors just steer clear. "You can't stay ahead of the development curve and make money—they build too quickly." The city could benefit from California's problems. An excellent labor force and affordability "have practically turned it into an L.A. submarket."



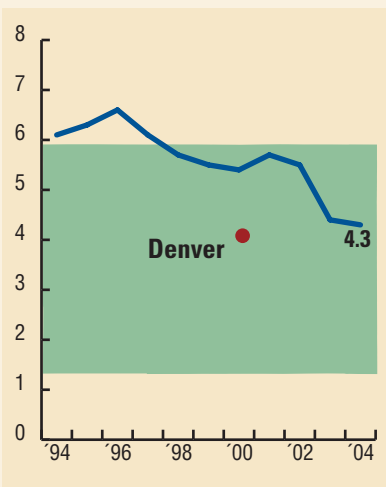
Houston

A reviving central business district—with upscale residential development, restaurants, a sports arena, a convention center, a stadium, and light rail—burnishes Houston's longer-term prospects. But the city's "anything goes" zoning, lack of barriers to entry, and inherent volatility continue to ward off investors. Woeful office markets still depend on lurching energy companies to drive demand, while apartment construction spirals out of control. "Texas real estate people seem only to know how to build."



Denver

A mile-high disaster in the wake of the telecom implosion, Denver bottoms out. Some suburban office market vacancies reach 40 percent and apartment values sink 15 percent below replacement cost or lower. “When there are sellers, it may become a vulture’s paradise.” Like Houston, downtown Denver takes on 24-hour trappings, spurred by new residential projects and the artsy LoDo district. Near-term hopes rest on a tide of California businesses seeking out the lower-cost Rocky Mountain alternative, which features affordable housing, comparable recreation, less smog, and less traffic.



Atlanta

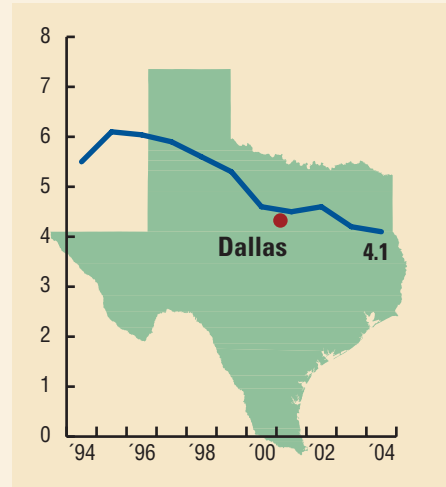
Unremitting growth has caught up with Atlanta. “The infrastructure is a mess and it will be like turning around a supertanker.” Congestion effectively nullifies chamber of commerce babble about desirable lifestyle and reasonable cost of living. The market bottomed in 2003—construction is now curtailed and a once-formidable job-growth machine is showing signs of life. Office vacancies may descend from 25 percent peaks. But apartment construction chugs along despite “negative absorption,” and industrial markets suffer record vacancy—they “won’t be healthy for the foreseeable future.” Real estate pros are pondering when to use the old, reliable buy-and-flip play. “It’s a timing market—you buy low, wait for the growth to kick in, and sell quickly.” But how much growth will there be in this cycle? Live by the sprawl, die by the sprawl?



Dallas/Fort Worth

The industry whipping boy takes more lumps: “The market is just awful.” Metroplex saddle sores include: “phenomenal” overbuilding, employer woes (American Airlines, JCPenney, telecoms), no barriers to entry, and ebbing investor interest. “I just don’t know how to underwrite an office building there.” “You can’t time the boom/bust anymore—it’s mostly bust.” “Properties are just commodities.” Local boosters point to subdued construction levels

and local government initiatives with private developers to bring more residential into the lifeless downtown. A nascent light-rail system helps.



Second Tier Cities

Some interviewees warm to “overlooked” second- and third-tier cities, hoping to avoid the investor crowds who bid up prices to uncomfortable levels in top markets. “You can get better deals when you get away from the herd, but you need to understand the risk.” In fact, the downside can be substantial. With thin tenant bases and little diversification of local industry, the loss of a large tenant or a cyclical business downturn can be devastating. Limited investor interest restricts exit strategies. “Shocks run deeper and you have less liquidity.”

“Focus on cities with little new construction, and buy the best assets—the newest, well leased,” says an interviewee. State capitals and places with universities draw notice—Birmingham, Tallahassee, Columbia, and Greenville (South Carolina), as well as Boise. “But you’ve got to be the first one there.”

Most larger second-tier Sunbelt markets—Orlando, Nashville, Austin, Charlotte—get lumped together in negative sentiment about Atlanta and Dallas. Las Vegas improves—all the glossy hotel/resort development sparks new jobs and attention. Midwest industrial cities are off the radar screens.



Property Types

y. in Perspective

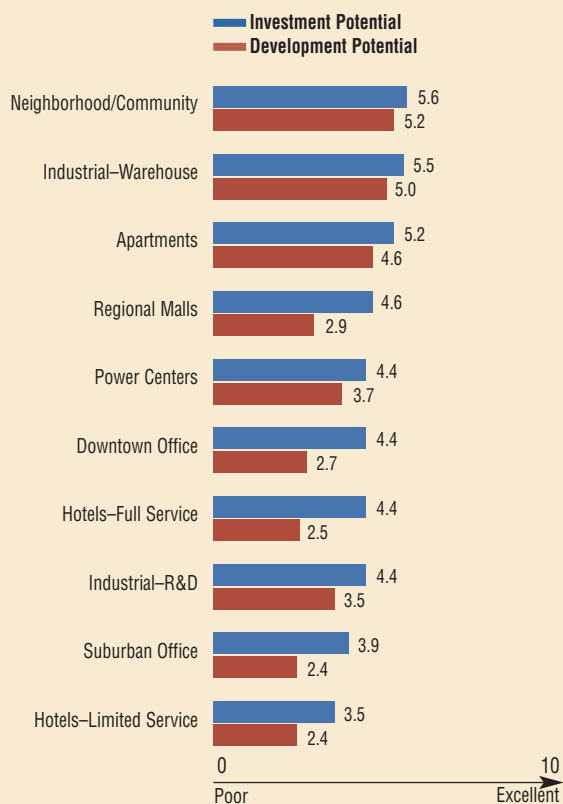
*“For the first time
in this survey’s history,
grocery-anchored retail
gains the **top spot.**”*

Most property sectors will bounce along market bottom in 2004, improving by year-end. Only office appears significantly challenged. Investment prospects are muted, but risk assumptions level off among *Emerging Trends* survey participants. Development activity—already slowed—promises to diminish further, especially in the office and apartment markets where a space overhang limits opportunities.

Favored Sectors

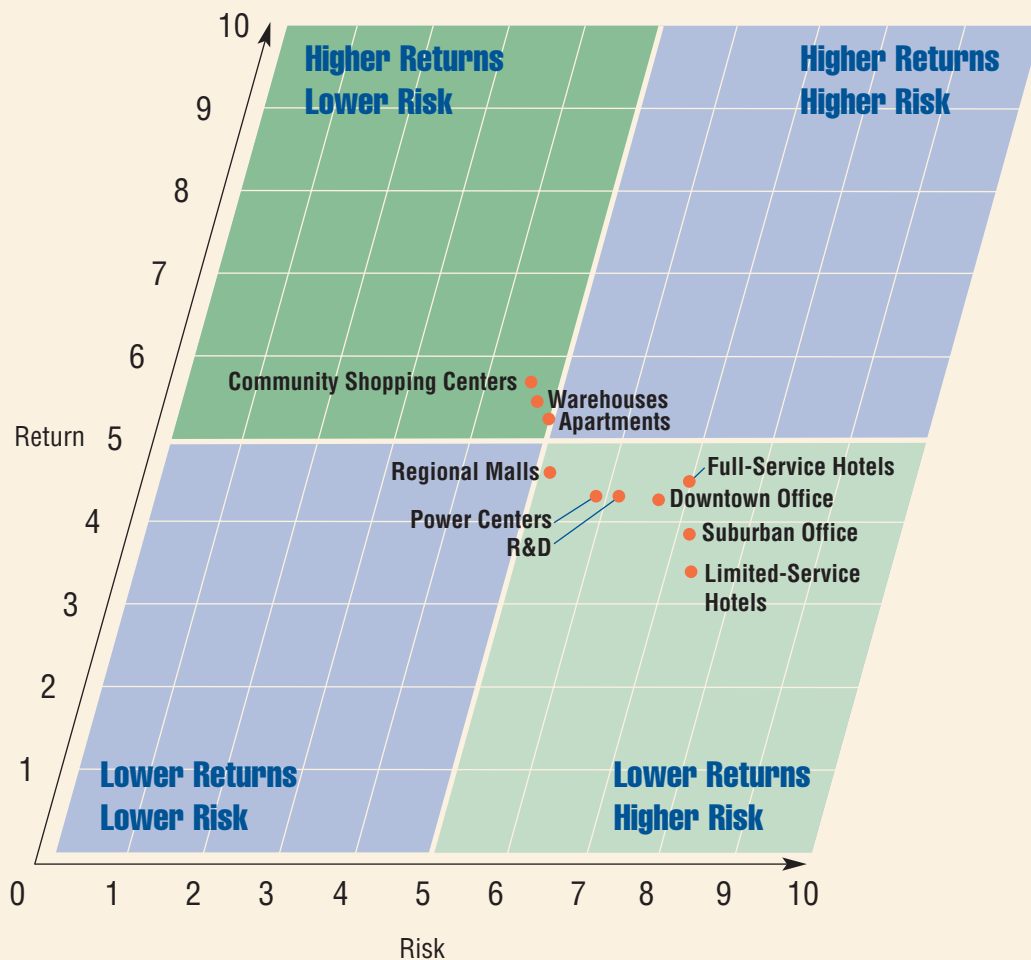
Interviewees continue to favor investments with less volatile, more predictable income streams—the “dull” but cash-generating community shopping center, warehouse, and apartment categories. (See Exhibit 5-1.) In fact, for the first time in survey history, grocery-anchored retail (at a mediocre 5.6) gains the top spot among property types, edging out warehouses’ unchanged 5.5 rating. Last year’s leader, apartments, suffers the biggest decline in survey sentiment, dropping from 5.7 to 5.2 as interviewees reflect moderate concern about overbuilding and unrealistic cap-rate compression.

Exhibit 5-1 Property Markets: 2004 Prospects



Source: Emerging Trends in Real Estate 2004 survey.

Exhibit 5-2 **Property Type—Return and Risk: 2004**



Source: Emerging Trends in Real Estate 2004 survey.

Overall, the retail sectors achieve their strongest survey position since the early 1990s—the heyday of regional malls. Hopes for continued consumer spending elevate both malls and power centers to less tepid rankings than they have earned in recent years. Hotels elicit flickers of interest from investors, advancing slightly, while office outlooks decline sharply, especially for the suburban sector.

On the risk/return spectrum, only community centers, warehouses, and apartments cling to familiar positions in the higher-return/lower-risk quadrant. (See Exhibit 5-2.) Not sur-

prisingly, office appears considerably more risky as its return outlook deteriorates.

In general, prices and yields will stagnate. Office and hotel prices are expected to slip, as some owners in compromised markets finally begin to sell. According to the interviewees, cap rates will stay down, improving the outlook for sellers, despite weak fundamentals. (See Exhibit 5-3.)

Prospects for value growth sag over one-, five-, and ten-year time horizons in line with expectations that future real estate returns will comprise strong income and modest appreciation. (See Exhibit 5-4.) Only malls and power centers show slight

Exhibit 5-3

Capitalization Rate Bid/Ask Characteristics

	BID	ASK	SPREAD (basis points)	DEAL
Apartments	8.0%	7.3%	70	7.6%
Regional Malls	8.2	7.4	80	7.8
Downtown Office	8.7	8.1	60	8.4
Neighborhood/Community	8.8	8.1	70	8.4
Industrial-Warehouse	8.9	8.2	70	8.5
Power Centers	9.5	8.7	80	9.1
Suburban Office	9.8	9.0	80	9.4
Industrial-R&D	9.9	9.1	80	9.5
Hotels-Full Service	11.0	9.9	110	10.4
Hotels-Limited Service	11.9	10.7	120	11.3
Land	16.3	12.5	380	14.4

Source: Emerging Trends in Real Estate 2004 survey.

Exhibit 5-4

Expected Value Changes

Property Type	2004	5-Year	10-Year
Neighborhood/Community	2.6%	11.0%	20.8%
Industrial-Warehouse	2.1	10.4	20.8
Hotels-Full Service	2.0	12.6	23.3
Power Centers	1.5	8.6	16.8
Regional Malls	1.5	9.7	19.8
Land	1.0	13.1	25.9
Apartments	0.7	12.7	26.1
Industrial-R&D	0.7	8.0	17.6
Hotels-Limited Service	0.6	9.8	20.1
Downtown Office	-0.6	9.7	19.9
Suburban Office	-1.7	8.5	17.0

Source: Emerging Trends in Real Estate 2004 survey.

improvement over 2003 surveys. In the long term, apartments are forecast to appreciate more than any other property type, followed by the more volatile full-service hotel category.

Respondents retain healthy appetites for warehouses and anticipate some bottom-fishing opportunities for full-service hotels—the two leading acquisition targets, according to the survey. Retail's improved status makes for disposition opportunities—grocery-anchored centers and Class B malls are “too pricey,” but buyers have not figured that out yet. The interviewees recommend selling apartments into the anything-goes acquisition wave for as long as possible.

Thin Development Prospects Narrow Opportunities

Developers will need to hunker down in 2004. “Why bother about development? We’re back in the early 1990s.” Multifamily construction has been well ahead of demand. Retail needs are spotty—developers keep building new formats despite an abundance of empty storefronts and dead malls. And “the need for new office is four to five years off in most markets.” Only industrial may see near-term activity, although vacancy rates need to come down first. “Speculative building is nowhere in sight—demand has just disappeared.”

Generally, development has been kept in check. “The slam-dunk good news is that banks have been disciplined,” says an investor. Risk money becomes increasingly expensive for developers—they must bring more equity into projects before they can attract either partners or lenders. Many look to alternative businesses, including property management, investment advisory, and deal brokering. Listed below are the best of a thin selection of development opportunities mentioned by interviewees:

- For-sale housing in downtown and infill locations, including condominium conversions, loft rehabs, townhouses, and adaptive use projects.
- Low- and moderate-income apartments as well as tax credit housing in urban areas and inner-ring suburbs. Demand builds as housing shortages persist for low-wage service workers and immigrant families.
- Brownfield restoration: “Litigation issues have been identified, and brownfields can be underwritten with greater confidence. Risk has been reduced and is more quantifiable.” Old infill industrial sites make excellent candidates for town center housing.
- Master-planned community development with town center features and design based on new urbanism and smart-growth principles—pedestrian-friendly neighborhoods, open space, and main street retail.
- Student housing in university areas.

Retail

Strengths

“Popular by default,” retail is the only property sector where rents and occupancies have held up. “Retail never had a recession. People just kept on spending.”

Grocery-anchored retail is the shining light: “It’s last on the retail chain to suffer because everyone needs to eat.” But bond-like returns need to be goosed with leverage. Flight to yield has pushed cap rates down to uncomfortable levels. “You’re not buying any appreciation. What you see is what you’ll get.”



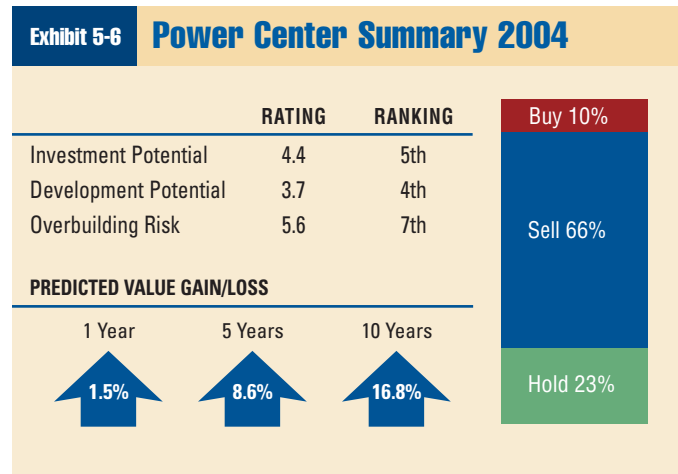
Shoppers fall in love with the drive-up convenience, pricing, and merchandise selection at big-box power centers—now the nation’s most successful retailers. The format is pushing aside weaker regional malls. Investors need to focus on the best centers at the better infill locations.

The top 300 regional malls “can’t be touched—they’re great investments.” These income-powerhouse fortress centers rarely change hands. Most are controlled by mall REITs, which can leverage their market power to cut lease deals with national chain stores.

Weaknesses

Expect major consolidation among retailers over the next five years. “Retail has no staying power—it’s only as good as tenant credit. Some former major-brand stores have no reason to exist.”

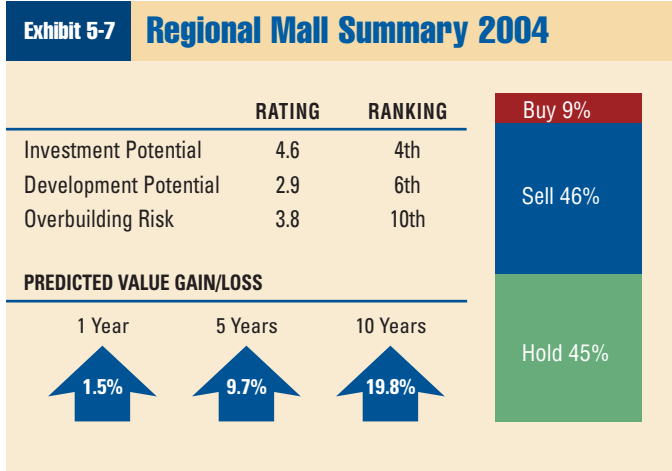
Department stores, in particular, are struggling. Their total market share (percentage of sales) has declined from over 60 percent to 40 percent in less than ten years. Some of these mall anchors stand in the crosshairs—they have lost their merchandizing edge to the superstore discounters and are surviving on low occupancy costs at malls where they pay cents on the square foot. Survivors will gravitate to the fortress malls, accelerating the demise of some B and C regional centers. Retail space per capita continues to climb to uncomfortable levels. Empty (“we’re not



overbuilt, we’re underdemolished”) space in abandoned strip centers and dead malls inflates the numbers, but what does that say about tenant staying power and investment risk?

Anybody who buys retail today “better look over their shoulder at Wal-Mart,” which, with its mostly freestanding stores, cannibalizes everyone. Unless you have the very best location, you’d better be fast on your feet. This is one property sector “where you can’t just buy and hold.” The best locations today “can quickly morph into weak ones,” particularly in suburban areas without barriers to entry. Community centers need to provide flexibility for grocery chains to expand into superstore formats, “or they could be gone.” Further discounter contraction would not be surprising either—Kmart isn’t out of the woods.

In case you haven’t noticed, Internet sales nibble into the market shares of bricks-and-mortar retailers. These Web inroads will continue and become a force—early failures were inevitable and “e-tailers” (including established chain stores) are figuring out how to build sales and profits. “Younger generations have been programmed to buy off the Web. Now my wife is getting the hang of it!”



Best Bets

Hold onto fortress malls, prime neighborhood centers, and the best-located power centers. Sell everything else before investors start distinguishing the wheat from the chaff. Neighborhood centers have been overpriced, given the risk of supermarket chain failures and the threat of Wal-Mart incursions. Consumer loyalty is “extremely suspect—they go after the best pricing.” Only the top one or two grocery chains in each market will survive, “versus five or more grocers ten years ago.” Weaker centers are extremely risky holds.

Sector rotation is likely to strike retail REITs as investors look for more upcycle growth from hotels and apartments.

Expect major mall owners to step up their courting of discounters and big boxes. They need fallbacks if anchors go under. That could set off a turbulent round of retailer musical chairs with power and community centers.

Avoid

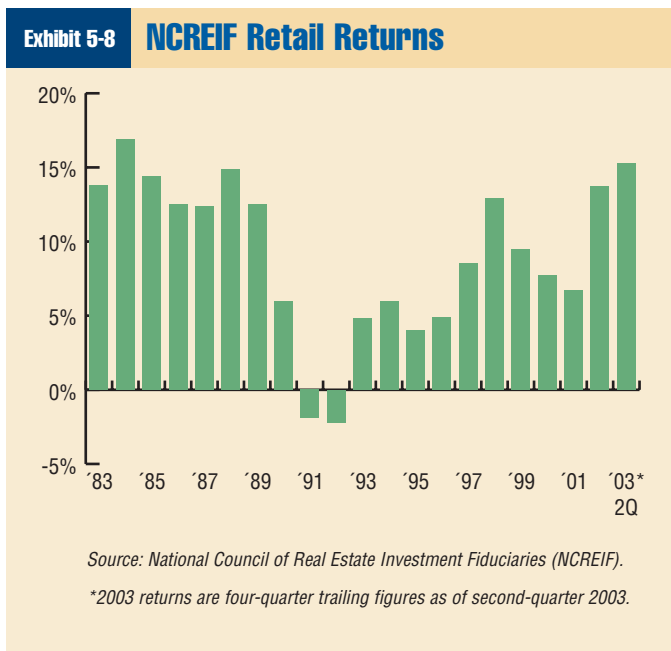
B and C malls are the most vulnerable to retailer consolidation. Repeat after me: “Where’s the exit?” Recent purchasers have bought income streams and leveraged them up on cheap debt, figuring they will cash out a return before the center goes dark and then be able to convert the use. Meanwhile, fashion malls and lifestyle centers steal shoppers at the high end and discounters rob sales from the bottom. Constant mall repositioning to ward off competition requires substantial capital infusions. “You end up buying malls twice—when you purchase and when you need to reposition.” They are risky bets.

Development

Few regional malls will be built in the future. Demand is limited, and the “interminable” entitlement process becomes more daunting as environmental and open-space issues grow more contentious. Recycling potential for failed formats captures more attention. “Main Street” rehabbing of strip centers “transplants urban imagery to safer suburban locations.” Malls were the 1960s and 1970s; Main Street is back-to-the-future in the new century. Lifestyle centers supplant obsolescent space in more affluent infill locations. Ghost malls make prime targets for mixed-use redevelopment—mostly apartment, townhouse, and single-family, with neighborhood retail to serve residents.

Outlook

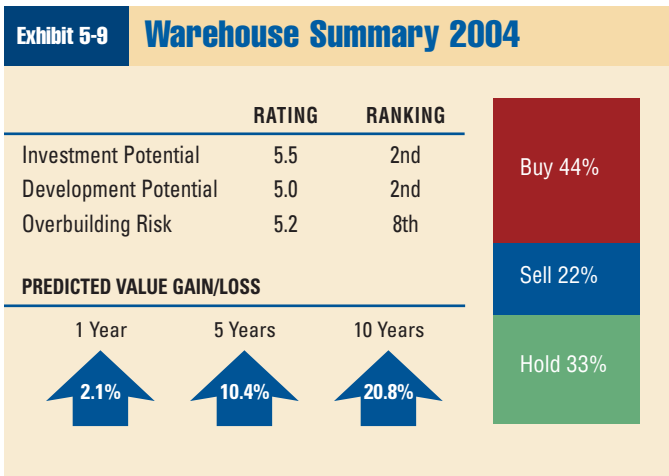
Will shoppers keep spending “like drunken sailors?” It is hard to believe the consumer has strong legs unless substantial personal income growth occurs. Home equity refinancing and tax cuts are running their course. Credit card debt is off the charts. The economy needs to pick up steam fast. “Chickens may be coming home to roost.” For 2004, look for heady returns to head back down. Retail will deliver solid income, but the prodigious run-up in values is over, as capital turns more cautious. Performance will be good, but risk increases.



Industrial

Strengths

“Industrial is always okay.” Unlike office, the warehouse sector typically recovers early in the economic cycle. This time, markets already show signs of stabilizing and improving after weathering vacancy rates exceeding 10 percent nationally—the highest on record. “Rents haven’t eroded much.” Recent leasing tends to be for shorter terms—tenants are hedging their bets on expansion needs until the economic outlook is more certain. Liquidity is never an issue for this sector. Capital won’t let up—institutions can’t buy enough. Despite weakened fundamentals and stressed income flows, cap rates for warehouse properties decline into record territory. “We can’t even compete on acquisitions,” complains a major REIT executive. “The deals have been too aggressive.” Owners turn over portfolios reluctantly—it is not easy to redeploy assets. “Everyone is underallocated in warehouse. They always want more.”



Weaknesses

Enthusiastic buyers in recent deals may eventually end up losers—or at least disappointed. They have no upside, especially if rents temporarily decline further or go sideways in higher-vacancy markets. “Prices upwards of 20 percent above replacement cost for older buildings present a problem when someone can develop space next door with bells and whistles.” Sunbelt hubs—Dallas and Atlanta—suffer from significant vacancies. “Recovery could take a while, but people are paying amazing prices and nobody seems worried.”

Distributors continue to find ways to control inventories, reduce storage requirements, and cut shipping costs. Radio frequency (RFID) chips attached to shipment pallets help to direct deliveries more efficiently. More tenants are using their own truck containers for storage, taking advantage of warehouse site parking. Wal-Mart does this as well, rather than bulk up on warehouse space. “The bigger your parking yard, the more competitive you are.” (But unless parking is figured into rents, tenants get something for nothing.) Strategies like these continue to eat into demand growth for industrials, and focus owners’ attention on providing short-term distribution space rather than storage facilities. Increasingly, industrial parks without adequate parking, turning radii, cross-docking, and access for large trucks are at a disadvantage.

Best Bets

Top markets continue to be the larger regional distribution centers, near airports, rail lines, and ports—Seattle (“Pacific gateway”), San Francisco (ditto), Los Angeles (“on fire—trade with Asia”), Chicago (“rock solid”), Miami (“Latin America will rebound”), northern New Jersey (“the Northeast hub”), Atlanta (“national tenants need to be there”), and Dallas (ditto). In these hubs, focus on the higher-ceiling space that caters to national distributors. Although few tenants stack five pallets high, “you need 24-foot clear at least, and 30-foot is even better.” In more local markets, 24-foot is a safe bet. “You don’t have to be a big box—that’s an institutional myth.”

Avoid

Don’t even look at older, low-ceiling, obsolescent space that lacks sufficient parking and distribution features.

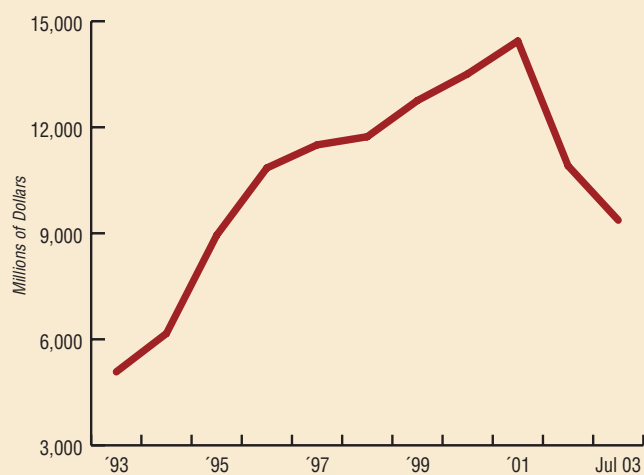
Development

New-construction pipelines are drained, which will expedite overall sector recovery. Expect development to resume by year-end, but record-high vacancies in most markets will curtail the need for new space, so activity will be modest. Short construction lead times keep most markets from getting ahead of themselves.

Airport tarmac distribution offers a new—but admittedly small—development niche. Cargo jets pull up and off-load directly into distribution facilities without intermediary steps. Owners/operators need to negotiate ground leases with the airports. Given RFID technologies and other just-in-time stratagems, direct airport distribution could eventually limit warehouse demand around key air-transport hubs.

territory rents will not start increasing.

Exhibit 5-10 Warehouse Construction Put in Place

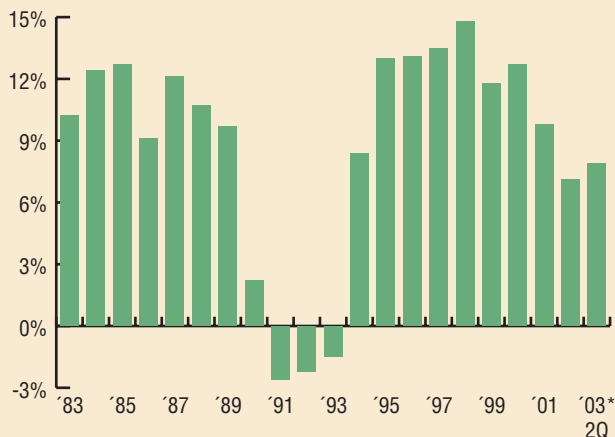


Source: U.S. Census Bureau.

Warehouse Outlook

Warehouse vacancy should fall back to under 10 percent, but until it hits 8 percent territory rents will not start increasing. Anticipate income-only returns in 2004. “Don’t expect much growth in the next few years.” Inventories are tapped out. As the economy improves, manufacturers will need to step up production and distribution to catch up with growing demand. Warehouses can only benefit.

Exhibit 5-11 NCREIF Warehouse Returns



Source: National Council of Real Estate Investment Fiduciaries (NCREIF).

*2003 returns are four-quarter trailing figures as of second-quarter 2003.

Research and Development Outlook

Real estate’s most volatile sector, R&D, labors to emerge from tech-wreck rubble. Interviewees have written off the category, expecting a delayed recovery. But opportunists hover. “The tech-savaged areas are where money can be made.”

In 2004, all high-profile tech markets will languish. San Jose, Austin, suburban Boston, and Bellevue (Seattle) remain “knocked out cold.” Some formerly high-flying corporations plan to disgorge owner-occupied space to help their balance sheets, which could deflate property outlooks even further. The overseas outsourcing issue also clouds prospects.

For owners who can hold on, history suggests that values could spike quickly. Undoubtedly, technology-related industries will drive future economic growth, and R&D facilities will benefit. In 2004, R&D markets could serve as a litmus test for vulture appetites and determine whether a rush of capital cushions pricing levels. Owners have been able to avoid capitulation, but cash-flow shortfalls may finally force sales.

Exhibit 5-12 R&D Summary 2004

	RATING	RANKING	
Investment Potential	4.4	5th (tie)	Buy 20%
Development Potential	3.5	5th	
Overbuilding Risk	5.8	5th	
PREDICTED VALUE GAIN/LOSS			Hold 51%
1 Year	0.7%		
5 Years	8.0%		
10 Years	17.6%		

Apartments

Strengths

“Everyone over two feet tall wants apartments.” Steady income and future space demand motivate acquisitions. The echo-boom surge of young adults (a prime renter cohort) promises to swell occupancies through the next decade. “Demographics will be extremely favorable. We just need to get through this low-interest-rate period and stop building so much.”

“Future scarcity affects the pricing model.” Many markets—around 24-hour cities and in southern California and south Florida—are maturing or are built out. An exit strategy exists for almost any stable property in these areas.”

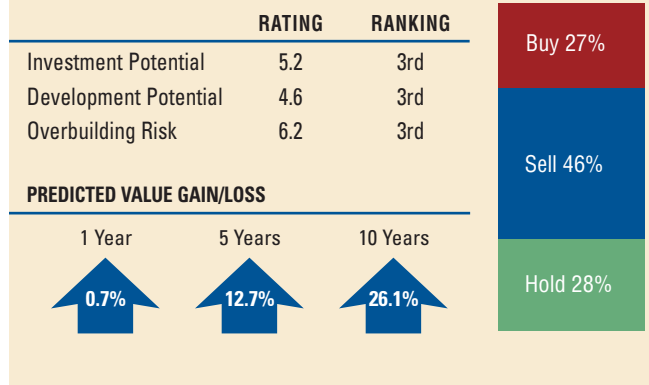
Rising interest rates (“they won’t go any lower!”) will slow down homebuying and increase renter numbers. However, attractive mortgage rates have not mattered much in southern California, where homes remain unaffordable for most renters.

Weaknesses

In most markets, low mortgage rates turn tenants into homebuyers, restraining apartment demand and pushing vacancies to uncomfortable levels. “Luxury rentals are hit hard.” The proportion of rental households has declined steadily since the early 1990s. “People who struggled to pass our minimum income criteria for rentals are now buying homes.” Renter numbers are cut further by a jobless recovery that increases “roommating” and the incidence of young adults moving back in with parents to cut costs. Construction, meanwhile, has not stopped. Developers and local banks have bought into the demographics story, and investors keep buying. “It’s been a perfect storm.” Markets with low barriers to entry are seeing sharp rent declines.

Some of the activity has been “irrational” buying (low cap rates and cheap debt), dominated by private syndicators and high-net-worth investors. “Capital risks have not been factored into pricing.” Recent leveraged acquisitions represent the gamble that an economic recovery will overcome a dangerous brew of falling rents and occupancies coupled with rising concessions and tenant improvement costs. If interest rates rise too quickly, “it’s a bloodbath.” In high-growth suburban agglomerations,

Exhibit 5-13 Apartments Summary 2004



current apartment buying is “almost a reverse arbitrage—purchasing at such premium cap rates when properties normally decline in quality and their cap rates usually increase over time.”

As long as vacancies stay high and rents are challenged, owners of B and C product need to make improvements or lose their better tenants to higher-quality buildings. When financially secure renters leave, credit problems and attendant rent-collection issues are exacerbated.

Questions arise about the impact of post-9/11 policies on immigrants. Tougher entry standards may stanch flows of these significant renter groups and hurt future demand in immigration gateways—typically the 24-hour cities. It is still too early to tell.

Best Bets

Take advantage of the buying frenzy and prune weaker properties in need of capex. “It’s a great time to be a multifamily seller.” Hold core investments in supply-constrained markets: southern California, south Florida, and within the halos of 24-hour metropolitan areas—Washington, D.C.; New York; Boston; Chicago; and San Francisco. “The best markets are those with the highest barriers to entry and least-affordable single-family homes.”

Buy into long-term rental markets that are currently oversupplied, like Seattle, Portland, and Philadelphia—their prices offer bondlike returns and you can “ride them out for eventual upside.” These markets will come back.

Avoid

Bypass overbuilt suburban agglomerations—until the single-family housing boom fades. Then move quickly to buy, lease up, and flip.

Development

Developers need to back off new construction, especially in easy-to-build markets, until rents stop deteriorating and the economic recovery creates jobs. “Apartment construction has been in the range of what will be needed annually in anticipation of a demographic burst,” but the spurt is premature. “Developers don’t try to time. If they like a market, they just keep on building.” Blind capital flows fund the boom.

As long as interest rates stay low, and where strong buyer demand exists, convert rentals into coops and condominiums, tapping into the homebuying crowd. “It’s more profitable.” In high-growth markets like Dallas and Phoenix, condominium conversions may ease some developers through the low-interest-rate period—but buyers beware: “It’s like purchasing a burial plot. You’ll never be able to get rid of it.”

Renovate B and C apartments in anticipation of an economic rebound; you can capture upside when rents advance—and then sell.

New projects increasingly face NIMBY hurdles and zoning restrictions. But infill and urban adaptive uses offer promise, especially near transit nodes.

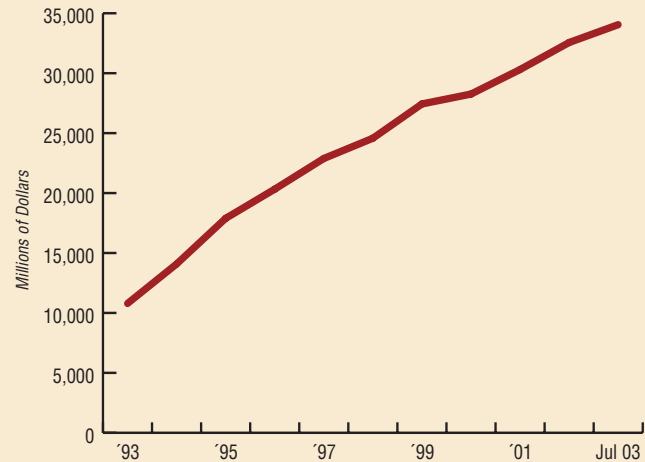
And don’t forget affordable housing. Renter demand will build and build.

Outlook

“The bloom is off the rose.” Expect cap rates to increase modestly and operating incomes to stabilize. Rents will be rolling over to lower rates, at least until midyear. “Real rent growth may not happen until 2005.” Any rebound could be sudden—“concessions should burn off quickly.” Demographics will eventually help demand, “but these impacts are typically slower to materialize than we expect, so temper enthusiasm.” Overpricing means that “no one will make a lot of money for a while,” but over the long haul apartments will deliver.

Exhibit 5-14

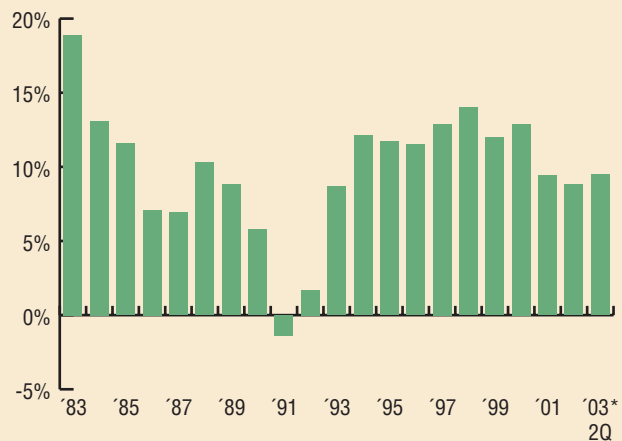
Multifamily Residential Construction Put in Place



Source: U.S. Census Bureau. Data include for-sale condominiums.

Exhibit 5-15

NCREIF Apartment Returns



Source: National Council of Real Estate Investment Fiduciaries (NCREIF).

*2003 returns are four-quarter trailing figures as of second-quarter 2003.

Office

Strengths

Prime, well-leased buildings in the 24-hour cities (primarily New York and Washington, D.C.) attract zealous buyers the way *American Idol* draws caterwauling contestants. These safe harbors—flush with credit tenants and leases signed at late-1990s market highs—have regained ultimate trophy status. “You can’t get into too much trouble in stabilized assets.” With inexpensive financing, prices bid up well above replacement cost are more palatable. Owners are advised to hold—these buildings have become rare commodities. “Where will they get better risk-adjusted return with the proceeds?”

The last time crème de la crème office towers fetched such sky-high pricing was during the late 1980s, and you know what happened next.

Weaknesses

After the trophies, forget office. Supply/demand fundamentals are “as bad or worse” than they were during the early-1990s depression. “It’s ten years ago revisited.” Tenants jump on the lease-renewal bandwagon, hoping to secure low rents and longer terms. “A lot of renewals will be at rates lower than owners want to anticipate.” The crunch will shock some recent investors who thought they were buying more stable income. Sublease space continues to burn off, leaving owners more exposed. Concession packages, work letters, and free rent chomp at net operating incomes. “We haven’t seen the bottom yet.”

Exhibit 5-16 Downtown Office Summary 2004

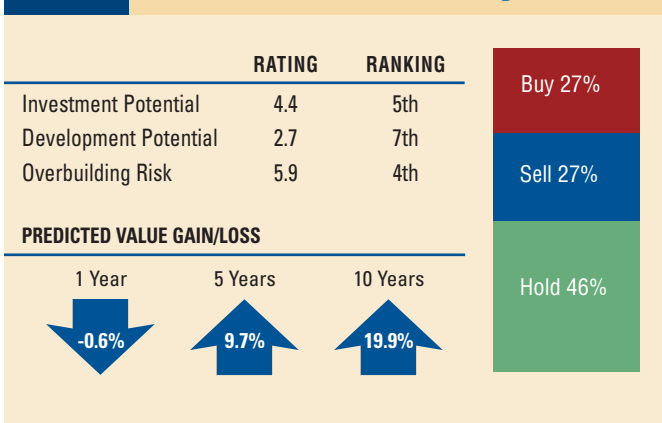
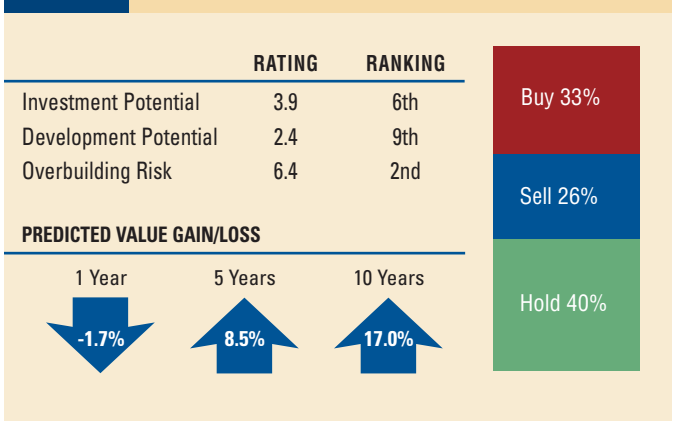


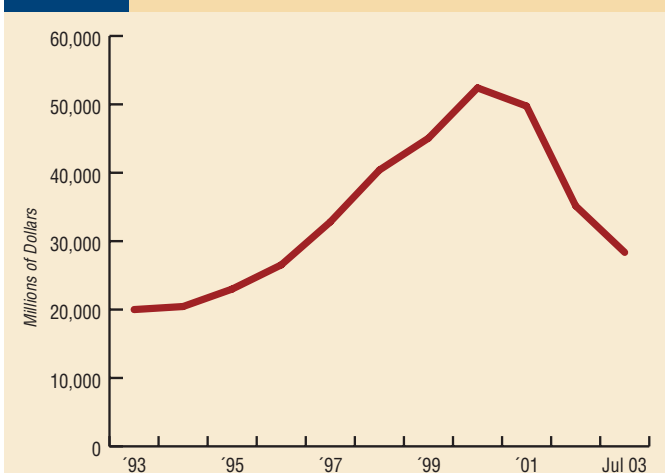
Exhibit 5-17 Suburban Office Summary 2004



Office investments feed off white-collar employment growth, but so far “we’ve had a job-loss recovery.” Any corporate earnings improvements have resulted from efficiencies, layoffs, and outsourcings—all demand deflators. “You can’t create a magic tenant base.” Much of the 1990s job boom turned out to be artificial—“false demand.” Once office tenants decide to hire again, a lot of phantom (empty occupied) space will have to be filled before any expansions occur. “There is no quick fix.” Recent new leasing activity has been “musical chairs—moving tenants around with lower rents and tenant improvements, not expansions.”

Suburban office—especially commodity buildings—should prepare for a free fall. “Rents are going down big time.” Tenants will be able to move around and bargain for lower rates in

Exhibit 5-18 Office Construction Put in Place



Source: U.S. Census Bureau.

higher-quality space. Premium buildings, located in 24-hour suburbia markets, will attract the foraging tenants and withstand the downturn better.

Best Bets

Hold or buy top-tier, 24-hour (“term and credit”) office—that means lease rosters with minimal rollover risk in the next five to seven years. Add 60 to 75 percent fixed-income leverage at current low rates. “You achieve low-teens returns at low risk.” Good luck finding a deal—and get ready to swallow hard.

Exploit potential arbitrage. Patient dollars should find distressed owners eventually, although a ton of money has the same idea. If markets really sink, some capital will get skittish, opening the field. Tech-wrecked markets—the Bay Area, Boston suburbs, Denver, Austin—deserve special attention.

Owners need to stem potential losses by renewing larger tenants at current market rents, while trying to limit new lease terms to five years. “If successful, they can prevent further downside, expensive leasing commissions, and costly tenant work, and be well positioned when rents start to recover.” Landlords will have a tougher time in Chicago, Houston, Dallas, and Atlanta “where tenants have ample relocation choices.”

Avoid

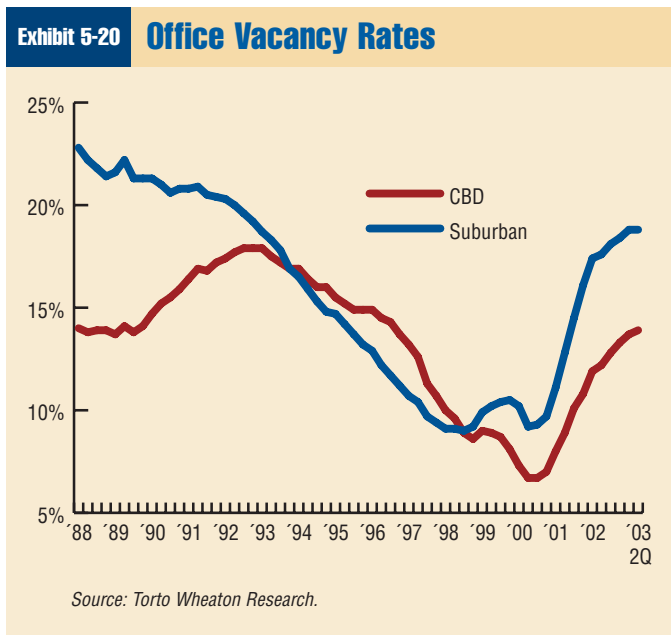
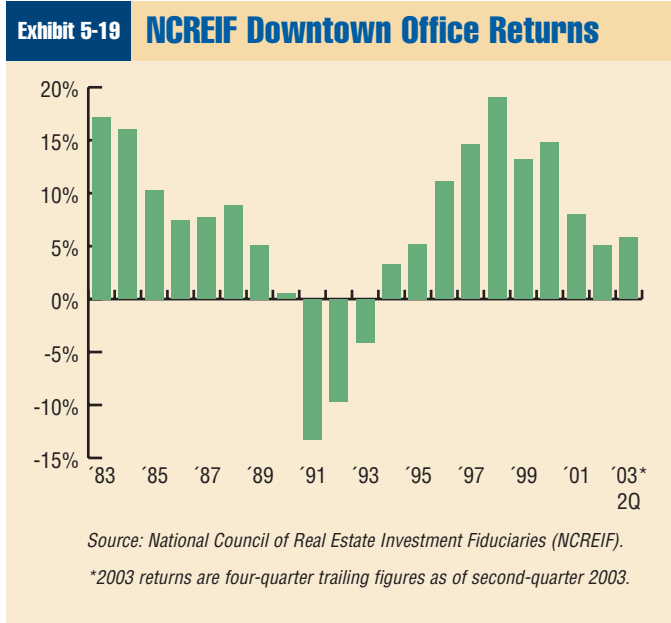
Don’t buy anything with near-term leasing exposure unless you underwrite deteriorating fundamentals into your pricing. And be wary of “tweener” investments. These buildings have currently strong occupancy and cash flows but may face underlying rollover risk—either tenant quality is suspect or lease terms end in the next two to three years. “These aren’t trophies—they could be vulnerable if markets stay down and owners have leveraged them up.”

Development

Projects are getting pulled off the drawing boards. “It will be [four to five] years before new office is needed” in most markets. Discount to replacement cost and falling rents make it impossible to justify anything except build-to-suit construction, and few companies can even think about new headquarters projects in the current rein-in-expenses environment.

Outlook

For 2004, revenues erode and values decline. Concession packages will keep real rents from stabilizing until 2005, and any income growth may be delayed until 2006 or 2007. “Rollover



risk is considerable during the next three years—recovery will be slow going unless the economy sprints. In most markets, supply swamps demand. Warehouses and apartments look better and better.”

Hotels

Strengths

Abundant capital searches for deals, propping up prices and disappointing bottom fishers, who hope for bigger discounts. “Hotels may not be a contrarian pick after all.” Expect minimal distressed selling. In general, owners are well capitalized and can hold investments through any downturn. The industry delever-

aged in the 1990s, and operating efficiencies have steadily lowered break-even industry occupancy rates to under 50 percent. Operators have learned to make money with less, using technology and cutting corners on service. That is especially good news for investors, since occupancies continue to fluctuate uncomfortably below 60 percent. Development remains modest—room starts have plunged from late-1990s highs, offering a window for improving occupancy rates if business travel increases. Revenues may be slower to follow. Leisure travel strengthens—and Americans stay closer to home, giving domestic resort locations an edge over international destinations.

Exhibit 5-21 Full-Service Hotel Summary 2004

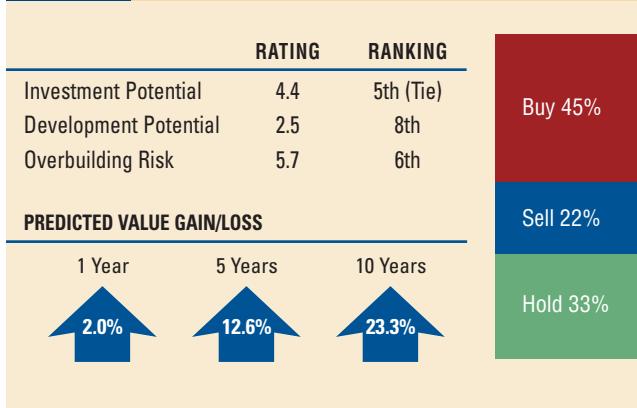
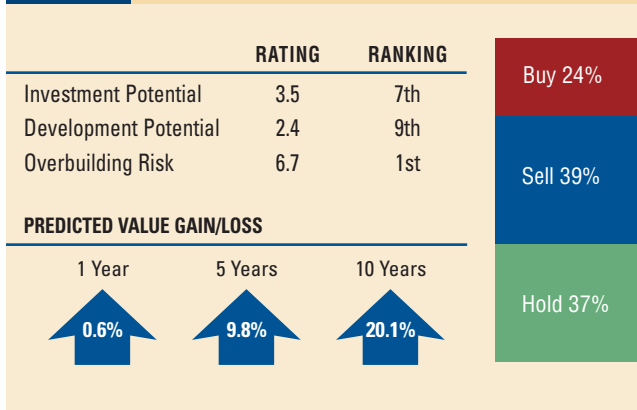


Exhibit 5-22 Limited-Service Hotel Summary 2004



Weaknesses

“Hotels really are at bottom.” Many travelers wait until the last minute and scavenge discounts over the Internet—reducing operator-pricing power. The essential business-travel component lags. Companies tighten the tourniquets on travel and meeting budgets—that is low-hanging fruit for the corporate bean counters. “Greater thrift may be here to stay for a while.” Employee relocations and training conferences have also been slashed.

Ill-fated timing has hurt some hotels built in large metropolitan areas during the late-1990s construction wave. Demand softened in 9/11’s aftermath. Then the war in Iraq and SARS short-circuited a nascent recovery. Now, chronic undercurrents of world turmoil threaten to sap an upswing. Keeping domestic terror at bay is essential for these properties. Visitors from overseas are less plentiful, in spite of favorable exchange rates.

Basically, hotels have been “limping along.” Staffing layoffs help maintain profitability, but guests notice some decline in service.

Best Bets

Hotels are “the best higher-risk play,” but there are “very few steals.” Buyers need to make sure they retain the flexibility to change flags, and deferred maintenance could be an issue—“nobody has been doing much upgrading lately.” It is purely an opportunity investment; “you buy and sell in the cycle.” Focus on full-service in the stronger 24-hour markets and subcities. Sound familiar?

Avoid

Hospitality holdings are not a core play for institutional investors craving income predictability. “All they add to your portfolio is volatility.” Pension funds continue to shy away from direct hotel ownership. “I don’t like the ups and downs or the business—dealing with the management companies.”

Limited-service product in high-growth areas is more vulnerable to new competition and suburban degeneration. “You never see them on institutional investor shopping lists.”

Development

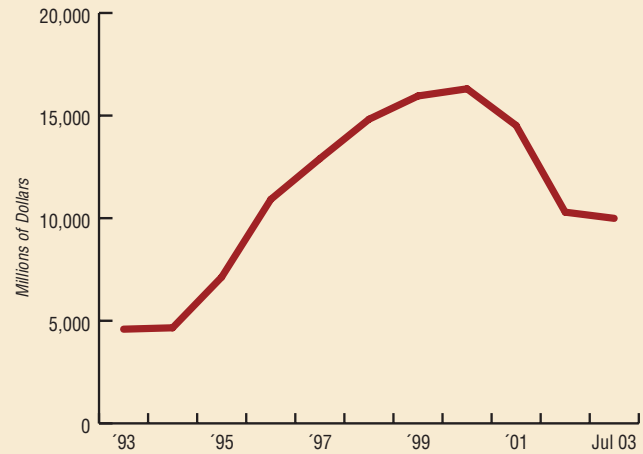
Markets continue to digest overbuilding—“we don’t need new hotels anywhere”—but project activity is forecast to increase in 2004 and 2005. Less would be more.

Outlook

Hope fades for “material improvement in 2004,” although the lodging industry can bounce back quickly if road warriors return to action. Terrorism fallout and global conflict will continue to raise background fears and uncertainties, grounding travel at least on the margins. “Timing a recovery is problematic.” Demand “may be structurally compromised for a while” by business frugality and frayed nerves.

Exhibit 5-23

Hotel Construction Put in Place



Source: U.S. Census Bureau.

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