Emerging Trends *in* Real Estate®

2005

Urban Land Institute

PricewaterhouseCoopers

Emerging Trends in Real Estate® 2005

Contents

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Recommended bibliographic listing:
ULI–the Urban Land Institute and PricewaterhouseCoopers LLP.
Emerging Trends in Real Estate 2005. Washington, D.C.:
ULI–the Urban Land Institute.

ULI Catalog Number: E21
ISSN: 0-87420-934-X

Executive Summary

■ Improvements in supply/demand fundamentals race against rising interest rates. Interviewees are cautiously optimistic that modest economic growth will sustain values and steadily improve revenues. By 2006, higher interest rates could slacken frothy pricing levels, if the economy continues to struggle to create enough new jobs to help advance leasing and increase property cash flows.

■ Over the next cycle, performance expectations continue to ratchet down to high single digits for seasoned core portfolios—still relatively attractive returns compared with volatile stocks and lagging bonds.

■ In 2005, owners should sell nonstrategic assets, taking advantage of strong capital demand, and leverage holdings before interest rates rise any further.

■ Pent-up demand from institutional investors helps sustain capital flows and buttress values as leveraged buyers back off in a rising interest rate environment.

■ Development remains controlled in most commercial sectors. Homebuilders stay in step with buyer demand, not ahead of it.

■ Traffic congestion and changing lifestyles impel more mixed-use town center developments, urban mixed-use projects, and infill residential. Aging baby boomers drive unquenched demand for resort and second homes.

■ Delinquency and default rates will stay under control in 2005. REITs expand their dominance in institutional equity markets, and CMBS conduit lenders continue to gain market share in the debt markets. Private investors back off when leverage strategies become less enticing, and pension funds increase activity to fill the void.

■ Bicoastal investing becomes more ingrained. The herd focuses on four primary markets: Washington, D.C.; southern California; New York City; and south Florida.

■ Sunbelt metropolitan areas face potential growth slowdowns as traffic and sprawl reduce their desirability. Their prospects continue to hinge on developing successful 24-hour infill environments and integrating mass transportation alternatives to the car.

■ Some secondary and tertiary markets could struggle to remain relevant as business and commerce increasingly cluster in major high-profile cities linked to international trade, financial services, and technology.

■ Commercial investors will continue to favor coupon-clipper, income-producing property sectors—warehouses, neighborhood grocery-anchored retail, and moderate-income apartments. Always volatile hotels position to show the sharpest gains during the year. Office promises to lag.

■ Homebuilders face leveling demand—homebuyer appetites could start to flag in the face of higher interest rates and rising construction costs.

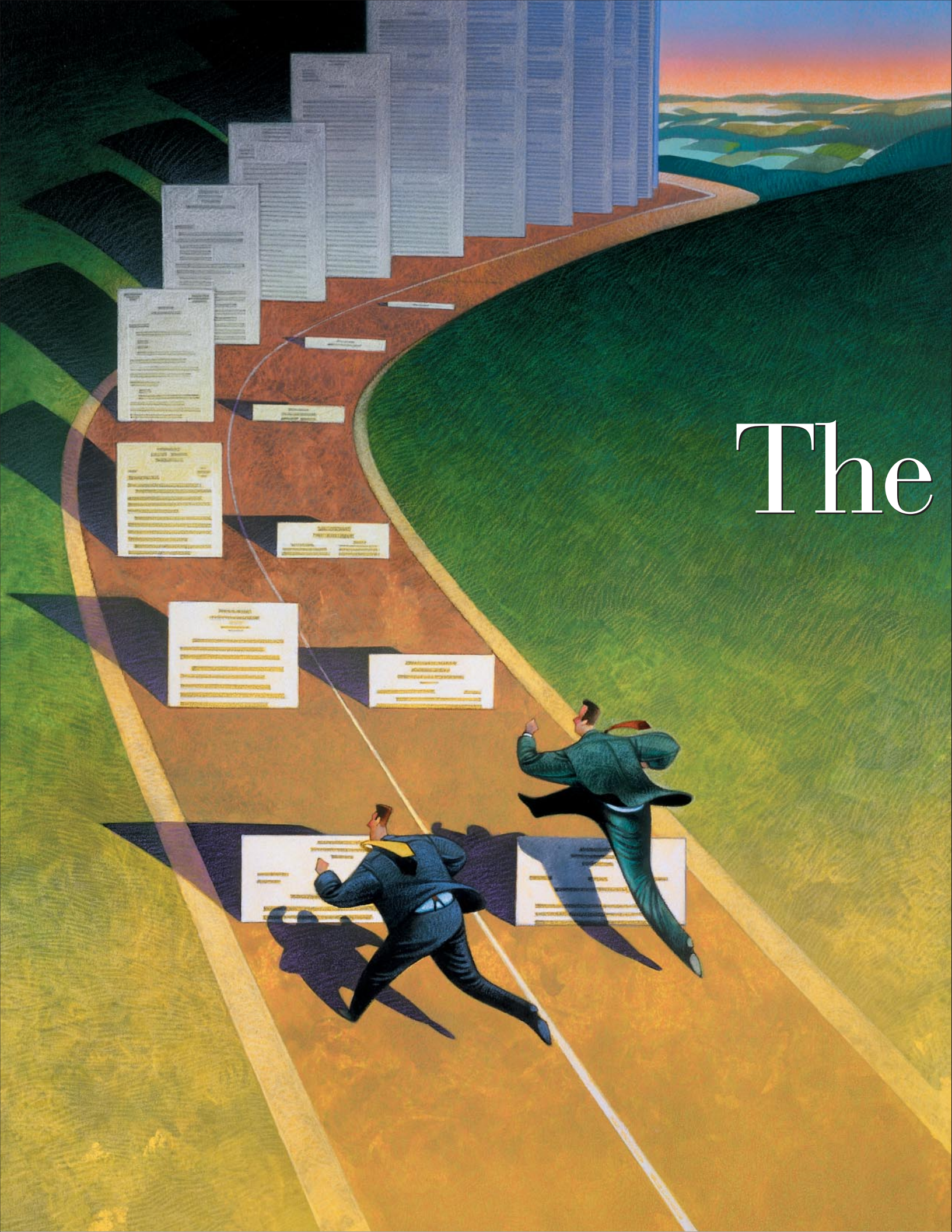
Preface

Emerging Trends in Real Estate® is a trends and forecast publication now in its 26th edition, and is the most highly regarded and widely read forecast report in the real estate industry. *Emerging Trends in Real Estate®* 2005, undertaken jointly by ULI and PricewaterhouseCoopers, provides an outlook on U.S. investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues. This year's report features expanded coverage of the housing industry, a variety of specialty and niche property sectors, and trends in investor site/location preferences.

Emerging Trends in Real Estate® 2005 represents a consensus outlook for the future and reflects the views of more than 500 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. ULI and PricewaterhouseCoopers researchers personally interviewed over 125 individuals (see the end of this report for a list of interviewees and participants) and survey responses were received from 413 individuals, broken down as follows:

37.3%	Private Commercial/Multifamily Property Companies or Developers
19.1%	Institutional/Equity Investors or Advisers
14.0%	Publicly Traded Commercial/Multifamily REITs or Operating Companies
9.7%	Homebuilders or Residential Land Developers
9.4%	Lenders or Mortgage Bankers/Brokers
9.2%	Real Estate Services
1.2%	Other

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



The

"The race is on between improving **fundamentals** *and rising interest rates."*

Race *is on*

Real estate players tout their standing as the "largest runt" in a litter of battered asset alternatives and revel in the wash of unprecedented capital flows searching for relative value in property investments. While volatile stocks struggle and bond markets lose appeal in a rising interest rate environment, uncomfortably high vacancies and compromised cash flows have hardly diminished investor fervor for real estate. A flood of institutional and private buyers, some using gobs of readily available cheap debt, supports values. These investors wager that an inevitable economic rebound will cover their bets. Considerable pension capital, meanwhile, waits on the sidelines for leveraged purchasers to back off, building confidence among many *Emerging Trends* interviewees that capital flows can be sustained: "Real estate is the storehouse of wealth." "It's cycle-tested and now more respected by chief investment officers of the big institutions." "Real estate is not sexy or romantic, but it has the attribute people want most today—income, steady and predictable income."

At the same time, many veteran investors signal now is the time to sell. "Anybody who is not a net seller in this market is nuts," says an investment manager. "Pricing has been nonsensical given the market conditions." Adds a major pension fund consultant: "I've told my clients to dispose of all nonstrategic assets." A leading institutional broker warns that "pretty intelligent pros are not playing in the market." "To make deals at such low cap rates with such poor market fundamentals you are throwing caution to the winds," says a syndicator. "No one knows when markets are coming back." Sums up a veteran investor: "It's certainly a crapshoot."

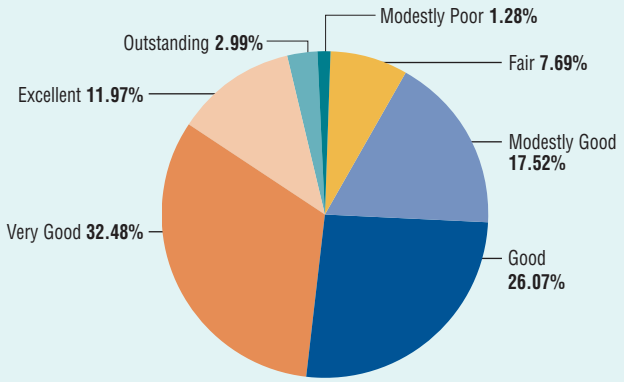
Steady-Eddy Performance

The next two years will probably determine whether restored confidence in the property markets has been well founded or overplayed. Make no mistake, the race is on—can real estate supply/demand fundamentals improve enough in 2005 and 2006 to offset the potential negative impact of rising interest rates on property values and pricing? In turn, will enough job growth and economic improvement occur to help push down vacancies and increase rents in the face of continuing geopolitical distress, uncertainty over terrorism, and related inflationary oil prices, which inevitably crimp consumer and business confidence?

"Increasingly subdued investment expectations across all asset classes should benefit real

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

Prospects for Profitability in 2005 by Percentage of Respondents



Source: Emerging Trends in Real Estate 2005 *survey.*

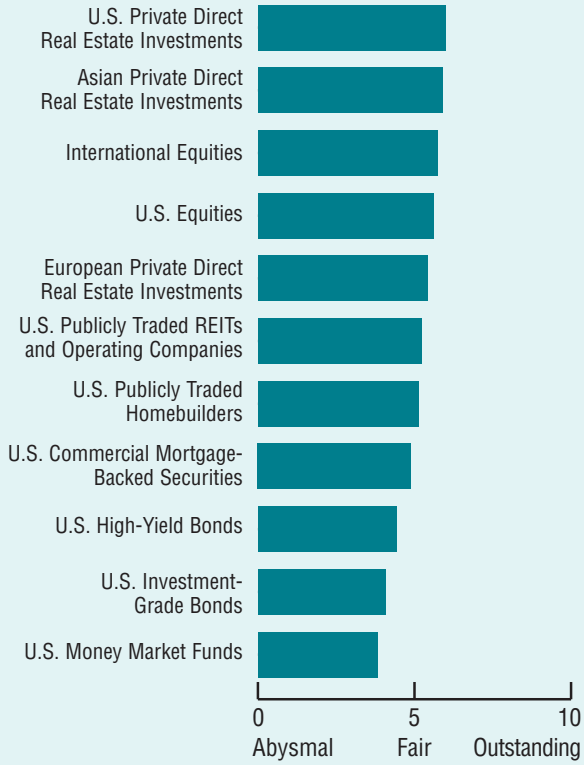
While last year's interviewees cloaked 2004 outlooks in "cautious pessimism," they seem resiliently "less bearish" in forecasting 2005 and anticipate a "soft landing." Many investors count their lucky stars that returns have held up despite poor demand drivers in all sectors, except consumer-fed retail, which has been a stellar performer. "Thank you, Mr. Greenspan." Despite some nervousness over the economy and market imbalances, interviewees almost without exception are confident that U.S. real estate markets can avoid scenarios that would crater property values. "Nothing catastrophic appears on the horizon." But they also forecast little opportunity for any outsized gains. Office, industrial, and apartment markets have stabilized with signs of more animated tenant demand; hotel occupancies rebound finally after the fallout from 9/11, SARS, and the Iraq War; and the economy appears positioned for modest growth. Few respondents, however, anticipate a robust economic upturn.

"We're embedded in a lackluster cycle," says a prominent researcher. Real estate has become a "yield play, not a great story." Most observers continue to predict that seasoned core property portfolios can record 7 to 9 percent total returns over the next five- to seven-year cycle. Judicious dollops of leverage could boost performance into the low teens. But recent investments, purchased at rock-bottom cap rates, may face greater hurdles, given rising interest rates and a mediocre recovery—"buyers should expect more like 5 to 7 percent total returns."

Such "steady-eddy" real estate performance "should be quite acceptable," considering the anemic stock market run and sobering raft of monthly 401K statements. Increasingly subdued investment expectations across all asset classes should benefit real estate, especially on a risk-adjusted basis. "We've entered a lower-return environment where real estate performance will look increasingly positive," says a mutual fund executive. "Real estate will have a lower risk profile, generating moderate returns with lower volatility," nestling comfortably between stocks and bonds on the risk/return spectrum. "It just makes sense to take dividends from well-underwritten real estate when you look at the alternatives."

Indeed, structural changes over the past ten years have arguably reduced risk and "mainstreamed" real estate investing, enhancing its relative value appeal. More information, research,

Exhibit 1-2 **Investment Prospects for Various Asset Classes in 2005**



Source: Emerging Trends in Real Estate 2005 *survey.*

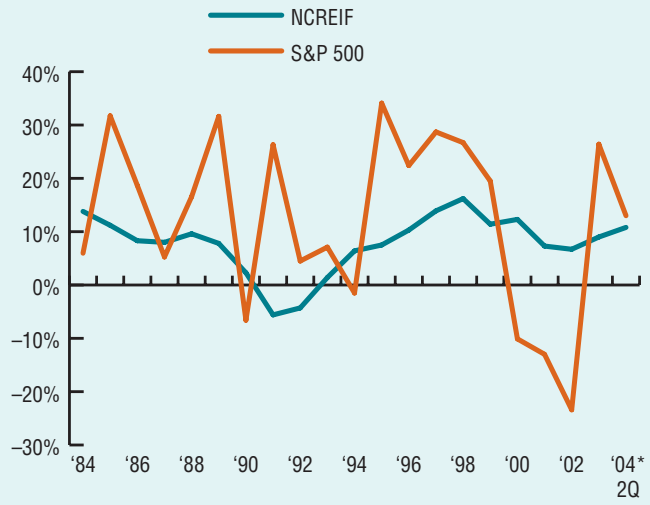
Note: Prospects were rated on a total rate of return basis.

estate, especially on a **risk-adjusted** *basis."*

public market scrutiny, and timely comprehensive data have translated into increased transparency and more informed decision making. "Nothing is sneaking up on investors anymore." Greater confidence has led to increased capital flows, looking for consistent yield, which in turn has propped up values and reduced volatility.

For 2005, survey respondents predict that real estate will outperform stocks (67 percent yes v. 33 percent no) and bonds (96 percent v. 4 percent). They also forecast that private real estate has the best asset class investment potential, ahead of domestic stocks and public real estate. (See Exhibit 1-2.) Worst-case scenario: if the economy tanks from an exogenous geopolitical crisis or terrorist-induced skittishness, *Emerging Trends* interviewees calculate that property markets will suffer no greater decline than stocks or bonds. In fact, long-term leases on hard assets should offer greater downside protection than stock or bond investments, which could immediately lose value in a market downdraft. From a relative value analysis, real estate should hold its edge in a recession scenario, too. "Everyone would be disadvantaged about equally," suggests the consensus *Emerging Trends* wisdom.

Exhibit 1-3 Returns: NCREIF vs. S&P 500



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

**Annualized figure.*

Such misery-loves-company rationalizations aside, some investors who gorged on floating-rate debt to finance acquisitions have become increasingly vulnerable to any market dislocations that would spike interest rates or a tepid economy that would fail to generate enough employment and wage growth. The longer it takes for property market equilibrium to be restored, the greater the investor distress. With interest rates rising, the stakes increase. Borrowers need to lock in fixed-rate debt now before it is too late. Some opportunity players hold their powder in expectation of heightened foreclosure activity. "Then it might get interesting again." While most investors will skate through, some overleveraged players may meet their reckoning during the year.

For 2005, "it all comes back to interest rates, the economy, and job growth." The race is on.

Bye-Bye Low Interest Rates

In recent editions, *Emerging Trends* highlighted how performance would revert to the mean after the anomaly of the bust/boom 1990s, how strong recent performance has been supported by twin crutches of historically low interest rates and prodigious capital flows, and how future returns would be compromised in a "postponement effect," because investors have already anticipated recovery in their generous cap rate assumptions, borrowing from the future.

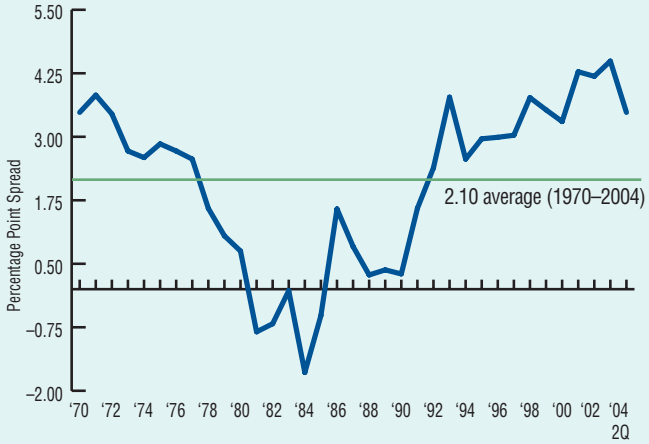
In 2005, the interest rate crutch begins to pull away, diminishing the acquisition appetites of leveraged private investors, who have been bidding up prices and sending cap rates skidding toward all-time lows. In the short term, most interviewees expect pent-up institutional capital to fill any void and sustain markets during the year. "So much money is supporting values, it looks better that improving fundamentals will have a chance to catch up and offset increasing interest rates," says a consultant. Gaping spreads between real estate yields and ten-year Treasury bills offer additional cushion for investors. More pessimistic interviewees suggest that cap rates will back up and erode values. A crunch could come in 2006 and 2007 if interest rates steadily increase and the economy plods along.

"The period of easy credit and low interest rates has always been **unsustainable** *and*

Exhibit 1-4 **"Prime" Lending Rate**

Source: Federal Reserve Board.

Exhibit 1-5 **Spreads Between ACLI Cap Rates and Ten-Year Treasuries**



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

Note: 2004 figures as of June 2004.

No one disputes how low-interest-rate Novocain has deadened the pain of moribund tenant demand in the commercial markets. Thanks to low-cost leverage, private buyers bid up real estate prices and cash-strapped owners refinance mortgages, keeping vulture buyers at bay. In addition, the home refinancing binge—a result of basement-level mortgage rates—helped to boost consumer spending and kept retail "red hot."

The capital surge has affected cap rates paradoxically. "When fundamentals are lousy, cap rates should be going up. This time just the opposite has happened." In fact, capitalization rates have been driven down to historic lows in apartments. Office and industrial cap rates are uncharacteristically low, given discomfiting vacancies and milquetoast tenant demand. Sky-high power center and grocery-anchored retail pricing seemingly leaves little opportunity for more than bond-like returns under the best pro forma scenarios. "Low interest rates have had a huge impact, buttressing the value of our portfolios," gushes an apartment developer/owner. "We've had a great year despite poor fundamentals."

But the period of easy credit and low interest rates has always been "unsustainable" and cannot paper over property-level shortfalls indefinitely. Now, rising interest rates are on "a collision course" with an economic recovery that has failed to create substantial momentum in the leasing markets. If improving supply/demand fundamentals can advance property cash flows ahead of rising cap rates, then prices will hold up and increase. If the reverse happens, prices and values will decline as capital pulls back. Soon, the real estate markets will find out if they can stand on their own.

More Secular Than Cyclical

Emerging Trends interviewees generally expect a modest, measured advance in interest rates, managed judiciously by the Federal Reserve Bank. Many industry players express growing confidence that the real estate risk premium has decreased in a secular shift arising from amplified capital flows, solid cyclical performance, enhanced transparency, and better image. "Cap rates will be lower than in the past when investors paid a premium for our irresponsibility and unreliability," says an interviewee.

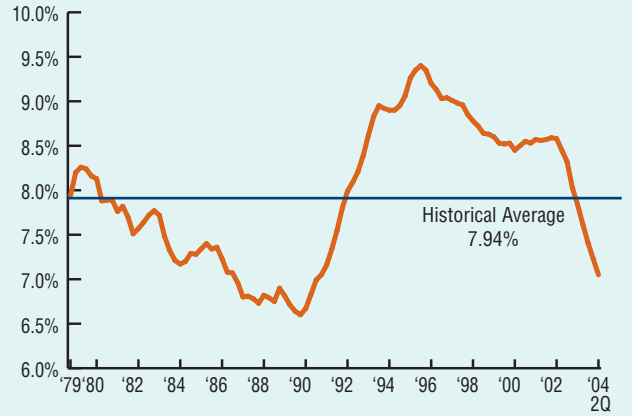
But most respondents struggle over recalibrating the premium. The majority view contends: "Return expectations are coming down for all investment categories and any reduction for real estate will be relative to stocks and bonds." Others suggest that cap rates will increase with interest rates, "but won't be fully correlated on a one-for-one basis."

A vocal interviewee minority argues that cyclical forces will continue to dominate real estate markets and recent pricing levels will deflate with higher rates. In fact, cap rates have not compressed to such low levels since 1990 on the eve of the last market bust. (See Exhibit 1-6.) "The whole relative-value argu-

cannot paper over property-level shortfalls indefinitely."

ment has been in vogue to rationalize the 'disconnect' between fundamentals and prices," says a well-known investment banker. A leading research authority echoes: "Investors have been mistaking easy credit and low interest rates for structural change." Clearly, 5 percent real estate cap rates on some apartments, downtown office buildings, and regional malls cannot be sustained when ten-year T-bills price at competitive yields. "And that day could be approaching soon."

Exhibit 1-6 NCREIF Cap Rates



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

Note: Quarterly moving average.

The Economy: Modest Growth

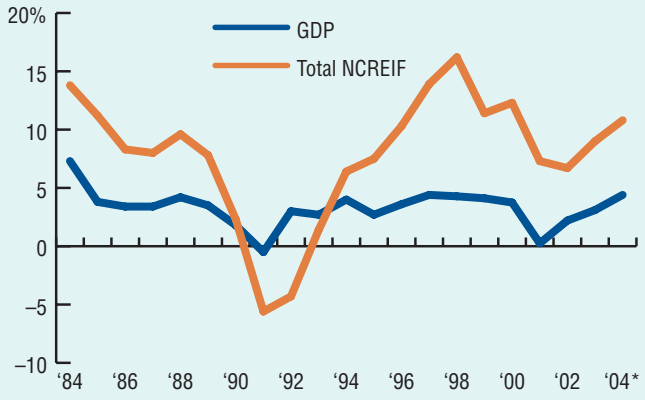
Lest we forget the last recession officially ended during November 2001 (that's right, two months after 9/11), real estate investors would be hard pressed to claim significant benefits from the ensuing recovery. Low interest rates and tax cuts may have accelerated consumer spending and fueled homebuying, but sputtering job growth generates insipid wage gains. At some point, real estate investors need burgeoning employment rolls to fill office buildings, and greater take-home pay levels to encourage apartment renters and keep consumers spending in malls. "The spark has been missing."

A majority of *Emerging Trends* survey respondents anticipate that the economy will gain momentum during 2005. Nearly 60 percent predict medium economic expansion for the year, while 30 percent anticipate at least low growth. Any warnings of a new recession barely register a blip on the surveys—some additional measure of confidence. Still, only 10 percent of respondents suggest that dramatic growth is likely and a host of forces signal "no clear sailing." Interviewees cite rising concerns about federal government budget deficits, balance of trade deficits, the weak dollar, unprecedented levels of consumer debt, inflationary pressures from uncomfortably high oil prices, rising employer health care costs, choppy job growth prospects, queasiness over terrorist threats and the Iraq War, and increasing risks of interest rate spikes triggered by some combination of all of the above. Some interviewees question "understated" inflationary impacts, given rising costs of energy products, health care, and commodities.

This stew of economic ambiguity again boils down to what happens to interest rates and jobs. The large budget deficit and balance of trade gap threaten to force upward pressure on interest rates. Increased government borrowing to close its deficits generally forces up Treasury rates to compete for bond buyer investments. External trade deficits, meanwhile, weaken the dollar and increase demand by foreigners owning Treasuries to compensate them for currency risk—that also translates eventually into higher rates.

Back home, high gasoline pump prices gnaw away at disposable income and boost the cost of air travel. If turmoil in Iraq and other corners of the Middle East continues to roil the energy markets, winter home heating bills could shake consumer appetites. Consumers are already leveraged to the hilt on credit card debt and home mortgages—"consumer debt is terri-

Exhibit 1-7 Real Estate vs. Economy



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

**2004 GDP data are projected; 2004 NCREIF data are annualized for the year ending in the 2nd quarter 2004.*

fying." "People aren't afraid of debt anymore—they've been treating leverage without regard to the downside, encouraged by all the cheap dollars." If adjustable borrowing rates whipsaw or advance more quickly than Americans can digest, consumer spending could be curtailed or even "choked off." Homebuying could stall and the housing industry would be thrown for a loop. At the very least, any reduced consumer spending dampens economic growth prospects.

Interviewees acknowledge the intertwined vulnerabilities, but prefer to believe that the American "supertanker" economy "will grow our way out like we always do." Don't we "inevitably rise to the occasion?"

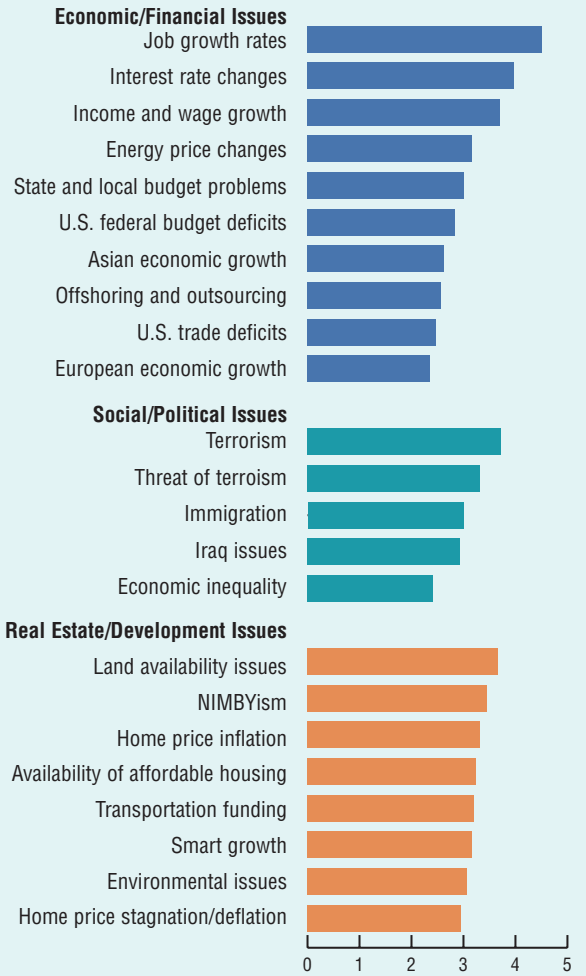
Jobs Quandary

Jobs, jobs, jobs—"Where will they come from, what types, and how will they be housed?" In 2004, the economy finally started producing jobs in fits and starts, but incomes for most workers, adjusted for inflation, have been relatively stagnant and a majority of laid-off workers, working again, took pay cuts at their new jobs. Most hiring concentrates at the lower end of the economic spectrum, which is dominated by restaurants, temp agencies, retail sales, and building services. The number of part-time workers also increased significantly. Discount store clerks, waiters, and "garage-guy consultants" don't fill office buildings or have the earning power to generate growth in other property sectors. "The issue now isn't so much job growth as the right kind of job growth." A consultant/academic anticipates "more zigs and zags in this economy than people would like to see."

Many dominant American businesses—telecommunications, financial services, pharmaceuticals—have matured. Corporate giants in these industries merge and consolidate to squeeze out efficiencies rather than grow new jobs as in the past. An executive suite focus on quarterly profits coupled with federal government belt tightening slows research and development spending. Halfhearted initiatives to send man to Mars or develop the next-generation fuel source so far gain little traction. Defense spending picks up significantly, but fighting Al Qaeda and Iraqi insurgents requires fewer big-ticket weapons systems than those needed during the Cold War. Although corporate profits have improved, cost-cutting efficiencies continue to play a greater role than new initiatives. Interviewees look to health care and biotech to stimulate growth, especially as baby boomers age. Advances in high tech should bring the industry out of its bubble-triggered slump. "Businesses will need to upgrade after their extended round of cost cutting, helping the tech sector," says an interviewee. "But there doesn't appear to be a silver bullet."

Much of the 1990s' high-tech–generated job boom, which filled office buildings and made rents skyrocket, turned out to be more phantom than enduring. But productivity gains from Internet, computer, satellite, and telecom applications have permanently changed business practices in the office and industrial markets. Even with the proliferation of help-desk folks, the technology revolution reduces per-capita office space requirements.

Exhibit 1-8 **Importance of Various Trends/Issues/Problems for Real Estate Investment and Development in 2005**



1=no importance, 2=little importance, 3=moderately important, 4=largely important, 5=very large importance.

Source: Emerging Trends in Real Estate 2005 *survey.*

Many companies no longer boast once-significant support staffs—BlackBerries, laptops, and voice mail reduce the need for administrative assistants and receptionists. Workers spend more time toiling on DSL-connected computers from home or hotels, and don't require as much space when they show up at headquarters. Taken a step further, companies can easily outsource more jobs to "consultants" and part-timers, who work from refitted basement or garage home offices and don't receive costly benefits. Controlling employee health care expenses—escalating on average to upwards of $3,000 per worker annually—appears to be a major factor extending the corporate hiring slump and keeping some cubes empty.

Dare We Mention Offshoring?

Of course, the ultimate technology-enabled productivity efficiency has been offshore outsourcing. Many interviewees continue to dismiss the impact as "overblown media hype," "a bratty issue that shouldn't even be mentioned." "What's the big deal about tax returns prepared in India anyway?" A West Coast developer proclaims "not a single tenant" in his portfolio has been lost to offshoring. Other observers point to the offset from new jobs created by foreign companies operating in the United States. But offshoring is really only an extension of domestic outsourcing and the ongoing transfer of workers to back offices by businesses that seek bottom-line improvements from cheaper labor and cheaper space.

Companies are not picking up and relocating lock, stock, and barrel to India, China, and other offshore locations. That's why landlords can claim they have not lost any tenants to the trend. But corporations steadily transfer some jobs overseas because of available well-educated workforces who get paid a small fraction of American wage and benefit rates. A trickle of analyst jobs and accounting positions get ticketed offshore, and start to multiply. The impacts quietly show up when companies lease less space or don't expand to the degree they might have in a typical economic recovery.

Offshoring will not result in any mass exodus—that's politically and practically untenable. Performance hiccups will occur and the pool of qualified personnel in places like Hyderabad and Bangalore may be more limited than advertised. "But it's hard to deny that it is an issue," says an office REIT executive. "The economy is in transition, and offshoring is a moderator of growth. It is not as dismal as the alarmists predict, but it is part of the current lag and may be stalling some of the near-term acceleration."

Increasingly, interviewees raise concerns about the nation's schools and their ability to educate Americans to compete in a rapidly evolving global economy that places a premium on math and science skills—an area where U.S. students appear to be falling behind. Web-based telecommunications systems have effectively broken down borders for companies seeking the best talent at the lowest cost. "We need to do better if we are to maintain our edge and keep creating high-level, high-paying jobs at home."

Disappointing Demand

Most interviewees express some discouragement over the slow pace of office market recovery. Vacancy rates hover in the high teens for suburban and mid-teens for downtown buildings. Rents have plummeted in many markets and new lease transactions will roll down net operating incomes from late 1990s market highs even as rents recover. Tenant improvement packages, higher local taxes, and inevitable capital costs depress returns further. Smaller businesses take advantage of the tenants' market and lead a budding leasing wave. Tenant reps say large companies finally are poised to follow, now that a surfeit of sublease space on their books has been retenanted and corporate profit outlooks improve. "Although the worst is over," many observers extend the recuperation period into 2007 and even 2008 for commodity office in fringe districts. "2005 is too early to expect much improvement."

Apartment occupancies should start to advance once rising interest rates dissipate the fervor of first-time homebuyers and employment increases allow more echo boomers to leave home or curtail "roommating" out of financial necessity. Demographics point to a swell of young renters over the next decade, which should spur greater demand. Industrial vacancy rates, meanwhile, edge down off record highs in the low teens. Just-in-time technologies continue to make inroads, shifting market demand for industrial space away from storage capacity toward distribution capability. Warehouse construction ramps up as buyer zeal has pushed pricing well above replacement cost in some markets despite tenant softness. Again, recent investors in multifamily and industrial properties count on greater economic thrust to boost operating incomes. Their wagers on paying such low cap rates depend on it.

Hotel occupancies and revenues shoot up as companies feel good enough about profit outlooks to increase executive travel and hold more meetings and conferences. At last, lodging owners start to feel "pricing power," and room rate hikes fall right to their bottom lines. With construction under control, hotel performance—especially in full-service and upscale categories—could accelerate. A caveat: higher fuel costs may restrain car and air travel for both business and pleasure. Hotels also remain particularly vulnerable to any new terrorism repercussions.

Retail has been the prime beneficiary among commercial property sectors of the recent low interest rate–induced mortgage refinancing craze and federal tax cuts. With more money in their pockets, American consumers have headed to malls and power centers in droves. Investors have followed suit. Some moderation in shopping mania seems inevitable. Can consumers just keep spending and adding to record credit card debt? We keep asking that question and at some point the answer may be negative. Of course, a more vibrant economy that creates jobs could extend consumer cravings indefinitely.

Commercial Development Checked

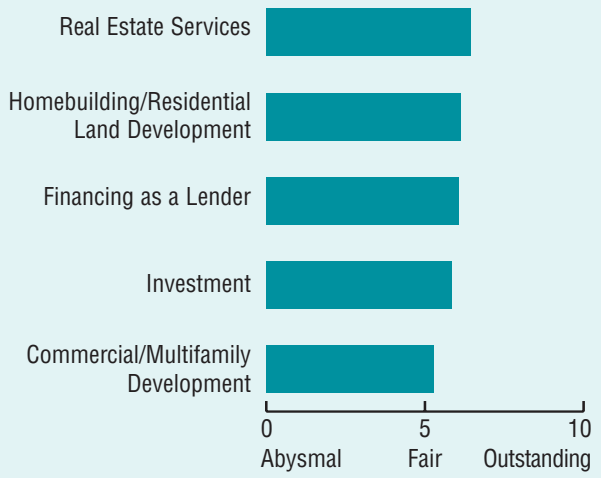
Villains in the early 1990s real estate market debacle, commercial developers feel comfortable taking little responsibility for the current oversupply in the office, apartment, and industrial markets. "This time round the vacancy problem has nothing to do with overbuilding." Investors view the ongoing development restraint with relief: "I'm less concerned about whether fundamentals will improve," says an insurance company lender.

"Banks have tamed the development cycle," says a California developer. "Good institutional memory dating from the problems in the 1980s lingers. Very stringent underwriting focuses on cash flow and debt service coverage, requiring significant equity and preleasing. Their vigilance has cut down on speculative building dramatically in this cycle." In particular, mergers and consolidations among money center banks have reduced the availability of construction loans on major projects. "These big banks are more conservative." Syndicating loans among a smaller number of players has also led to greater discipline as well as checks and balances on construction lending. "Capital is much smarter today and dictates the business," says a veteran Southwest developer.

Material shortages—China competes for steel supplies, lumber is earmarked for reconstruction efforts in Iraq—escalate construction costs. "We see double-digit increases." Some contractors enter lotteries to purchase concrete for projects. Higher construction overheads raise replacement cost barriers and provide justification for higher pricing on existing buildings. "That could help keep upward pressure on values." But commodity shortages and bigger development budgets could also sideline some projects.

Hardening antigrowth sentiment and environmental restrictions also constrain the supply side in some regions. The NIMBY syndrome impinges on developer options and delays new projects in expensive, drawn-out entitlement processes that often lead nowhere. Some interviewees champ in frustration over the restrictions. "It's just a huge problem that must be overcome." Antidensity movements lead to the election of "antigrowth government officials" and "poor or impractical regulations." The "one- and two-acre lot mentality" exacerbates affordable housing shortages and actually encourages sprawl. But others contend that "development regulation controls growth, and favors better projects and better developers."

Exhibit 1-9 **Real Estate Environment Prospects in 2005**



Source: Emerging Trends in Real Estate 2005 *survey.*

downtowns and/or mass transit."

Housing Splurge

Low mortgage rates and federal subsidies, including downpayment grants, have pushed U.S. homeownership close to 70 percent, a record by any measure. Huge buyer demand has spurred homebuilders and multifamily developers into construction overdrive—subdivisions, high-rise condominiums, infill and fringe projects spring out of the ground like weeds wherever builders can muster entitlements. Existing homeowners marvel at how rising property values over the past decade have increased their net wealth beyond any other "investment"—forget about the stock market. During the 2001–2003 period alone, the median price of an existing home in the United States jumped 15 percent and prices are expected to increase nearly another 10 percent in 2004. Many people eagerly have refinanced mortgages or taken out home equity loans on their ballooning equity, using proceeds to fund expansions, acquire new cars, or just buy stuff at the mall. Affluent baby boomers snag resort-area condominiums and second homes in preparation for retirement. Young couples and 20-somethings put little or no money down on starter homes thanks to aggressive lenders—payments on their adjustable-rate mortgages aren't much more than apartment rents, at least for now. Viva home sweet home that I own—well, that is, along with my bank.

Now interest rates are slowly rising—adjustable-rate mortgage payments will start to increase. In addition, property taxes in many communities have shot up as home prices have risen and local governments look to make up shortfalls from reduced state aid and federal government programs. New "homeland security" costs also have been drains. Property reassessments capture recent value hikes and may result in whopper tax bills in some communities. All these payments come on top of car loans, credit card debt, and normal monthly bills that many Americans juggle as a matter of course. Oh yes, gasoline prices have been a bear—those low-gas-mileage SUVs may not be so practical after all—and heating bills this winter could be a backbreaker. Maybe renting that apartment would cost me a lot less!

Rising construction costs, meanwhile, begin to inflate new home prices. Good tracts are more difficult to tie up. Local governments force homebuilders to pick up the tab for roads, schools, and sewers, all of which are becoming more costly to provide. "The gravy train" days—when federal subsidies and government highway grants paved the way for new home construction—have come to an end. "So far we have been able to pass these costs onto buyers, because of demand," says a homebuilder CEO.

But how much steam can be left in the housing markets with homeowner costs in an inflationary mode, led by higher mortgage payments? Many indicators point to a market at cyclical peak—"It just can't get any better." At the very least, rising rates will knock some buyers out of the market. "Prices will have to adjust as interest rates go up," says a researcher. "The market has been overhyped. Some homeowners are overleveraged and defaults are coming. It won't be a bloodbath. But it's another sobering element."

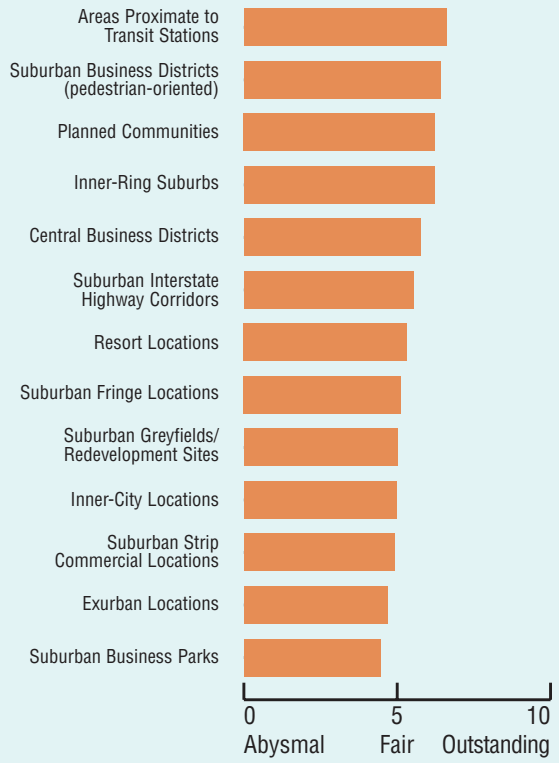
Optimists keep faith that interest rates will not ratchet up too quickly and sustain the market. "Everybody has been spoiled by 4 percent interest rates. Six-and-a-half percent won't bring people to their knees." But will upward rate adjustments stop there and how fast will they move? That's the worry. Any cooling of the housing markets would affect the overall economy. Housing construction has been an important growth engine, generating construction jobs and supporting commodity pricing.

Shifting Lifestyles, Changing Developer Focus

Developer attitudes shift to accommodate emerging market realities. Mounting traffic congestion and a lack of mass transportation in many built-out suburbs focus attention on infill and mixed-use town center projects with pedestrian-friendly designs. "A lot of multifamily development is taking on the urban village concept," says a developer in the Northwest. "With fewer fields to plow down, abominable traffic, and the land density issue, people want to live closer to work or transit. This will lead to more expensive, complex, and dense development" and favors larger-scale developers and homebuilders.

If energy prices stay high, shorter commuting distances and reduced errand time in the car will become more prized by renters and homeowners looking to alleviate gas pump shock as well as frustrating, gas-guzzling bumper-to-bumper delays. "People just want out of traffic." Growing numbers of empty nesters and echo-boom singles, meanwhile, seek housing closer to downtowns and/or mass transit. They want proximity to 24-hour centers and convenience to work, restaurants, cultural institutions, and recreational areas. Choice suburban school districts are not a selling point for either of these expanding demographic cohorts. "Household growth is childless. Lifestyles are changing."

Exhibit 1-10 **Prospects for Investing and Developing in Specific Geographic Locations in 2005**



Source: Emerging Trends in Real Estate 2005 *survey.*

Note: Survey respondents were asked to choose one of four property types and then rate the location based on that property type. Of the 290 respondents who answered this question, 36.6 percent rated the locations for office, 24.8 percent for apartments, 21.3 percent for single-family residential, and 17.2 percent for retail. The overall rating presented here is an unweighted average that combines the ratings for each property type.

Mass market developers gladly appropriate new urbanist concepts—integrating parks, sidewalks, retail centers with apartments, townhouses, and single-family homes in pedestrian-friendly neighborhoods. Quaint retro-village developments of the 1980s and early 1990s have become "a product of choice." Smart growth influences are "no fad," says the CEO of a major homebuilder. "New urbanism has definitely been mainstreamed."

Denser infill, village center developments will force homeowners to trade off size for convenience. Expect these projects to concentrate in obsolescent urban industrial zones or inner-ring suburbs "where people will tolerate greater density" and where failing greyfield malls present opportunities for tear-downs and reuses. Some developers, lenders, investors, and local officials also focus on major urban mixed-use redevelopment, converting forlorn urban sites into residential and retail space with offices and possibly hotels or even stadium/arenas included. "To have any chance of success there must be housing." Projects can be difficult to underwrite—their complexity limits lenders' interest. "One component always turns out to be a dog," says an insurance company executive. Tax breaks and bond issues can help ease feasibility concerns.

Interviewees don't expect Americans to give up on their dreams of suburban "McMansions" and expansive backyards despite traffic snarls and growth restrictions. "There is smart growth and then there is real growth," says a Dallas developer. "You may be able to control growth to certain cores or suburbs, but then places around them are going to do what they want to do—grow and sprawl. Nothing much you can do to stop it. Real growth is suburban sprawl." He may be right, especially in markets without barriers to entry and land to burn to the horizon. But conditions wane for unremitting horizontal development in many areas, while imperatives and market demand intensify for denser, more integrally planned communities and projects. Even at the edge, builders look to develop more master-planned, town center–styled communities that avoid the pitfalls of more one-dimensional, greenfield subdivisions.

Global Uncertainty Shadows the Markets

Through 2004, office buildings in Manhattan and Washington, D.C., traded at 5 percent cap rates and their vacancies were the lowest in the nation. Tourists poured into various attractions including the reopened Statue of Liberty and the museums around the Capitol Mall. Together with southern California, these cities continue to rank as survey respondents' favorite investment markets. Obviously, the risk of terrorism has not influenced pricing or their standing as global centers. Either post–9/11 concerns seem to have dissipated in a wave of complacency or investors are more confident that any future terrorist acts will have fleeting impacts on these world capitals, given how they have bounced back from the 2001 attacks. To some degree, terrorism "has been factored out of the system as everyone goes about their business."

A handful of major market corporate headquarters buildings—particularly housing global financial giants—continue to feature expensive security systems, including airportlike metal detectors, photo identification scanners, elevator bank turnstiles, and even X-ray screenings of packages and carrying cases. Wall Street is permanently blocked off around the New York Stock Exchange like the White House on Pennsylvania Avenue. Most companies now have secure backup technology systems, and some larger corporations have decentralized operations beyond typical back office locations. Leading 24-hour cities have strengthened building and fire safety codes, forcing landlords to upgrade emergency evacuation systems and procedures. But in most markets, frugal corporate honchos and landlords back off spending on building-related security upgrades they might have considered after the 9/11 attacks. Investors, meanwhile, expect the federal government to keep extending backstops to insulate property insurance carriers from potential losses in terrorism coverage.

For all the business as usual, terrorism remains an immutable force and cloud on the real estate markets. "It pervades the entire economy, creating uncertainty," says an interviewee. "You can't quantify it, you hear very little discussion about it, but it's there even if it isn't factored into pricing."

The repercussions from rooting out terrorist threats and the economic costs of the Iraq War cannot be calculated. Deficit issues and rising energy prices must be a drag. If turmoil in Iraq subsides and concerns about oil supplies abate, then odds improve dramatically that the economy can get untracked. Even so, hotel owners worry about incidents that will shut down air travel or discourage tourists. Shopping center executives shudder over what would happen if a mall became a target. On the margins, businesses are just more tentative. Who knows if and when or even whether another jolt could happen? But the uncontrollable risk of a "bolt out of the blue" is considerably higher than it was before 9/11.

Given the state of real estate markets—the slow recovery to equilibrium and many highly leveraged owners—investors probably are more exposed to a dislocating geopolitical shockwave than they would like to acknowledge. The short-lived liquidity crisis of 1998 taught everyone that real estate capital markets are tied into global capital markets directly, and that highly levered owners are susceptible to ugly meltdowns. The past ten years also offers lessons proving that U.S. real estate markets are particularly resilient and can rebound from jarring external surprises. Nobody is ready to venture a guess as to what might happen "next time" as discomfiting insecurity shadows the markets.

2005 offers hope and opportunity, but little room for complacency.

Investment

"No bargains, *but relative value."*

Trends 2005

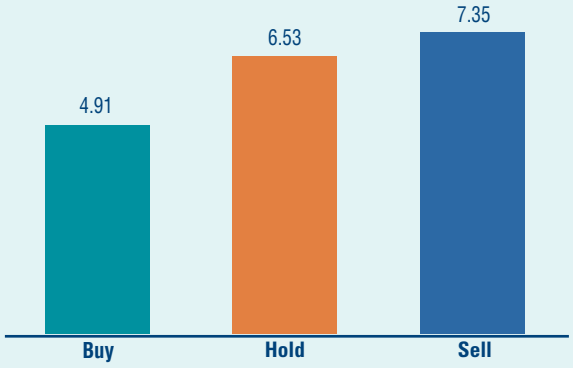
Leverage strategic-hold assets with fixed-rate debt while financing rates stay attractive, and sell everything else for as long as the flood of acquisitive capital flows allows. That's the overwhelming investment advice of *Emerging Trends* interviewees for navigating the commercial real estate markets in 2005.

"Who knows what overpaying is in this market," says an interviewee, who "is selling everything in sight" and getting "ludicrous" prices. But "what looked highly priced three years ago would be a bargain today, and some investors have given up hope that prices will come down." At some point, investors start overpaying and that line may have been crossed. "You can't be sure when it will happen, but buyers will revolt soon at some of these prices, yields, and risk premiums."

In fact, *Emerging Trends* surveys have never showcased a wider spread between low-buy and high-sell sentiment or as low a rating for buy opportunities. (See Exhibit 2-1.) "The smart money is selling," says a national broker. "Our sales pipeline is almost 50 percent above normal."

Exhibit 2-1 ***Emerging Trends* Barometer: 2005**

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



Source: Emerging Trends in Real Estate 2005 *survey.*

Note: 5=fair, 6=modestly good, 7=good.

"For core fund managers, any new **acquisitions** *probably will not enhance future*

Pay Up or Sit on the Sidelines

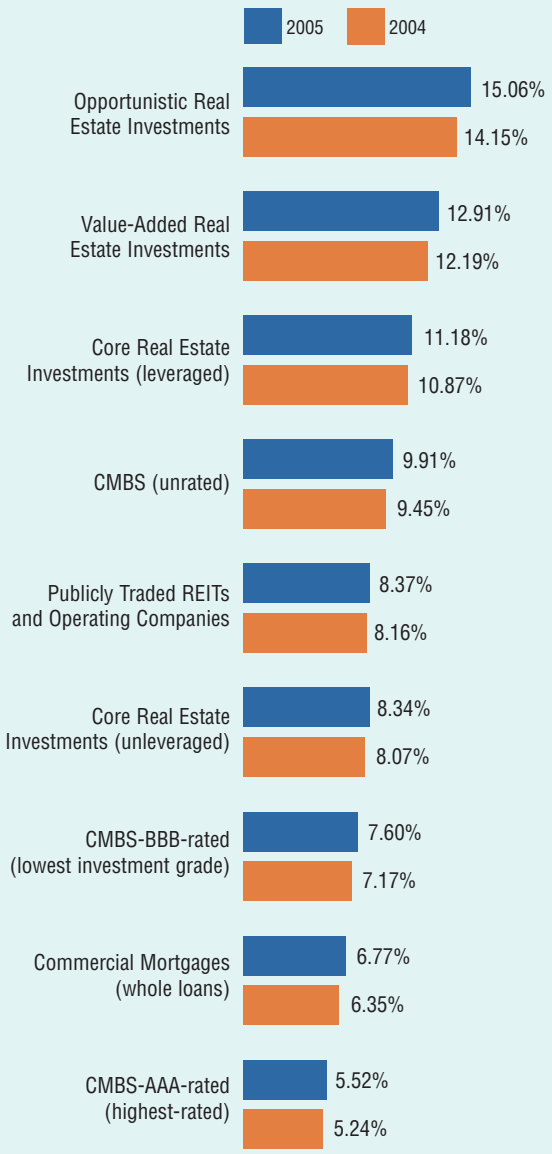
The problem then becomes where to reinvest the money. Some owners "cash in their chips" and wait for pricing risk to ebb despite minimal returns from money market accounts or high-grade fixed-income investments. Real estate's seeming "relative value" versus other investments still compels many players to plow capital back into properties. But some buyers lack conviction. "Prices may be very high, but the real returns for real estate still look better," says an interviewee. An investment banker adds: "You can't be an acquisitions guy without being optimistic and you'll sit on the sidelines if you don't meet the market."

Much of the "frothy" purchasing has been justified by availability of low-cost debt and spread investing. "Buyers lock in long fixed-rate debt, net operating income just has to stay even, and they have a positive spread. In 20 years there can be three real estate cycles. At worst they break even." Buyers also "try to rationalize" that higher construction costs have increased property replacement cost hurdles. "It makes them more comfortable," says a smiling broker, who revels in recent purchasers' frenzied bidding. "Don't put a price on whatever you're selling, or you'll leave something on the table."

At best, pricing offers "no bargains" and ignores the risk in market fundamentals, which just "don't jibe." Some buyers "are visiting Vegas." "What people are paying incorporates recovery and more, leaving you tomorrow with a disappointing, very mediocre return," says an interviewee. "You'll probably get what you paid for and the income you can collect in between." In other words, investors may not court catastrophe with their acquisition strategies, but they can forget about realizing much appreciation.

Interviewees and survey respondents nevertheless forecast sustained capital flows in 2005 thanks to pent-up demand from institutional buyers, who will fill the vacuum left by private investors and syndicators, if and when higher interest rates make their bread-and-butter leveraging strategies less desirable. (See Chapter 3.) That means prices have a good chance to hold up during the year, especially if tenant demand improves further and the Federal Reserve does not act precipitously. "It looks like it will be more of the same—paying up to put money out."

Exhibit 2-2 **Total Expected Returns for U.S. Real Estate Investments in 2004 and 2005**



Source: Emerging Trends in Real Estate 2005 *survey.*

performance."

Tempered Core Expectations

As property brokers enjoyed "a record year" in 2004, institutional portfolio managers faced the quandary of investing impatient capital in markets that offered limited future upside. "Finding deals has been extremely frustrating." Investors seek to avoid broker auction sales, attempting instead to ferret out off-market transactions by tapping relationships with operating partners, local developers, and management companies. In general, *Emerging Trends* survey respondents are expecting core returns in 2005 to be similar to those of 2004 (see Exhibit 2-2), but many interviewees were somewhat less optimistic.

For core fund managers, who have been delivering attractive low-teens returns to investors, any new acquisitions probably will not enhance future performance. Either they make nonaccretive transactions on traditional well-leased core properties or stretch into riskier deals with higher leverage than fits typical fund investment parameters. Any portfolio cash earns miniscule money market rates, if not put to work immediately. As interest rates rise, the likelihood increases that recent strong core fund appreciation from cap rate compression may start to reverse.

Some investors take liberties with core acquisitions. "The definition of core has changed because of all the liquidity in the market," says an interviewee. "Core used to mean 90 to 100 percent leased properties with credit tenants in prime markets. Now it can be 80 to 90 percent leased in more off-market locations."

As a result, caution flags signal concern about near-term core investments, which may "risk more chance for depreciation than appreciation." Plan sponsors can't achieve "a return above actuarial assumptions, especially after fees," warns a pension consultant. As interest rates rise, "core looks less and less compelling."

A major institutional manager admits: "We need to reduce client expectations appropriately about the returns they [clients] will be getting." The relative value argument, nevertheless, suggests existing core portfolios with good diversification among all the property types can continue to deliver solid, competitive yields. What's wrong with fairly predictable mid- to high-single-digit returns when the stock market keeps giving up its gains?

Opportunity Stays Offshore

Opportunity fund managers continue to promise returns that exceed 20 percent, but 80 percent or more of their investments "will be outside the United States." Leveraged office acquisitions in Japan ("where the economy may be taking off") and nonperforming Asian debt top acquisition lists. "Anybody in the United States with a high-return strategy will have a very tough time achieving performance." The only way to have a chance employs "a ton of leverage [85% or more]" and goes "off the charts with risk."

Savvy managers sell out existing portfolios. "It's harder and harder to put out money," says an opportunity fund executive. "My domestic pipeline is scary—few if any office, hotel, or retail possibilities."

Value-added investors, sandwiched somewhere between core and opportunity, shift from office and retail to "all kinds of housing-related investments, tapping the homeownership wave as long as it lasts." The mix includes condominium conversions, ground-up condominium development, entitling land and reselling to homebuilders—just about everything but actual single-family development. Deal sizes get smaller and more esoteric, including student housing, even assisted living and medical offices.

"The only way to be successful is to seek relative value through a robust deal flow," says a value-added investor. "You need to have a network of local operating partners who can give you access to private transactions or you'll go nowhere today." In other words, it is slim pickings.

Smart money waits ambivalently for market turmoil, which nobody really wants to see. "Our outlook might change if the economy just plods along, interest rates more than creep up, or a terrorist attack occurs," says an investment banker. That's why they call them vultures.

"Risk premiums may have lowered and real estate relative value arguments may prove out,

Best Bets 2005

Investment

Sell Nonstrategic Assets into the Capital Wave

Risk premiums may have lowered and real estate relative value arguments may prove out, but prices still appear over the top. Too many pros "are scratching their heads" about the outsized level of buyer zealousness. Take advantage while you can: rising interest rates could end the bidding war frenzy. Maybe not in 2005, but the lights could dim in 2006.

Hold Some Powder

Economic uncertainty is greater than people may want to admit. The employment picture is a mixed bag. The Islamic world from the Palestinian territories to Pakistan is a cauldron, potentially controlling the fate of energy prices. Iraq's open sore may take a long time to heal. Deficits and trade imbalances could speed the pace of rising interest rates. Sudden capital dislocation is not likely, but it is more possible. Taking advantage "will be where real money can be made." Under any circumstances, defaults will increase in 2005, probably within manageable levels. But distressed debt opportunities present themselves. Know those CMBS special servicers.

Refinance at Low Fixed Rates

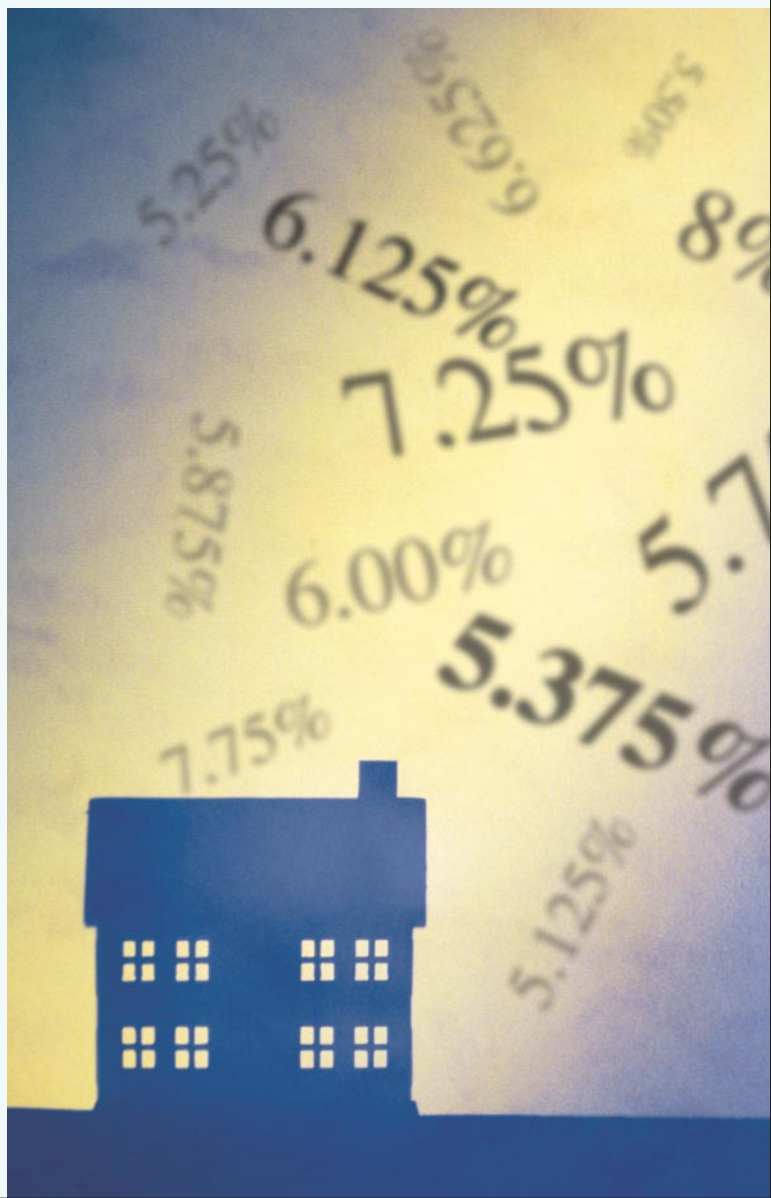
Secure long-term fixed-rate debt on well-leased core assets now, before interest rates rise any higher. Low mortgage rates still offer the chance to make hay out of spread investing "and you will get through the cycle without any problems." Move quickly—it looks like the window is closing. "Lock in rates as soon as possible, period, exclamation point!"

Consider Buying in Former High-Tech Hotbeds

Painful tech industry consolidation appears mostly over, although software companies struggle to reinvigorate and expand, and chip companies disappoint. Economists predict that American business will need to step up tech spending to remain competitive. Everyone waits for announcement of "the newest, new, new thing," but nobody bets on a 1990s-style resurgence. "Tech may make a comeback, but it won't be of Y2K-esque dimensions." Among the obvious market beneficiaries would be Austin, the Boston 128 corridor, Denver, Seattle, and of course Silicon Valley.

Why Not Vulture Lending?

Identify mezzanine lending opportunities to obtain preferred equity positions from potentially overleveraged borrowers. Only the most adept investors should play, but this off-market strategy can certainly avoid brokered bidding wars.



*but **prices** still appear over the top."*

Development

Develop Resort/Second Homes for Baby Boomers

The bulging demographic age cohort looks to retirement options now that children have left the nest. At peak earning years with more disposable income, this graying tide focuses on waterfront condominiums, mountain resort communities, and relaxing getaway hideaways "to enjoy and use." "No better niche" exists "than the moderate/high-end resort vacation home business." Best locations include small college towns in the temperate Southeast and anywhere just outside a two-hour drive in a ring around the major metropolitan areas. "It's dumbfounding what's popping up in the middle of nowhere like Idaho and Montana." Waterfronts along the Great Lakes strike million-dollar homes. Folks from Chicago and Detroit bid up prices. Naturally warm-weather Florida and Arizona are prime retirement targets. State capital/university towns may be "the perfect storm," offering sophisticated academic communities with a wide range of cultural and entertainment activities for spry seniors who don't think of themselves as over the hill.

Develop 24-Hour Market Infill Residential

Empty nesters and later-marrying echo boomers move back into 24-hour market centers. These growing childless demographic cohorts prefer the stimulation and accessibility of city center attractions—restaurants, cultural institutions, nightlife, and workplaces. Traffic tempers the desirability of suburban lifestyles unless you are raising families and covet good school districts. Baby boomers look to trade in big homes and gardens for a pied-à-terre in the city and a second resort home—"the best of both worlds." Infill housing meets growing demand. Anything near mass transit stops almost can't miss—convenience counts. Securing precious sites for development is another safe bet. Buy land, obtain entitlements, and flip to residential developers. Prospects should only gain momentum over the next decade as boomers and their children swell into the demand curve. Caveat: overbuilding tempers some markets—like Chicago, which bolted ahead of growth prospects.

Develop Housing for Active Seniors

Investors salivate over aging baby boomer demographics and figure senior projects can't miss. A premature investment wave in the mid-1990s hit the skids. Active senior communities—age-restricted townhouses/apartment/villa developments—have begun to gain traction. These projects satisfy graying suburbanites who want easier lifestyles but resist move-back-in trends. But don't bury baby boomers yet in higher-care, assisted living facilities. The oldest boomers are barely 60 and their average life expectancy exceeds 80. They focus on golf and fishing, not on rocking chairs and elder care.

Cautiously Pursue Urban Mixed-Use Projects

These developments require strong retail and large residential components to ensure success. Though they are difficult to pull off, revived districts that can offer "a strong sense of place" experience increased market demand. This category ranks highest for investment prospects in the *Emerging Trends* survey among specialty property types. Denver's LoDo, San Diego's Gaslight Historic District, Portland's Pearl District, and Arlington, Virginia's Market Common, Clarendon provide blueprints for creating exciting 24-hour environments that restore urban vibrancy. Developers, lenders, and investors need to work closely with local governments, businesses, and community groups to determine the right local formulas. These visionary projects can change the fortunes of neighborhoods and entire cities. Suburban town centers—Reston (Virginia) Town Center, Southlake Town Square (outside Dallas), Kierland Commons (Phoenix), Birkdale Village (Charlotte)—also win kudos from shoppers, homebuyers, and tenants who appreciate the pedestrian-friendly environment and convenient amenities.

"If you want fortress regional malls, better buy **REIT** *shares."*

Look at Niche Development

The generation Y cohort heads to college in growing numbers, spurring demand for student housing. Some affluent boomer parents invest in nearby campus condominiums to give their kids greater creature comforts. Demand for tax credit affordable housing remains unquenchable.

Yellow-Flag Some Condominiums, Starter Homes

High-end infill condominiums in prime 24-hour markets like New York and Washington, D.C., and in southern California should do fine. The same can be said of many resort area projects. Beware of areas where buying is dominated by speculators, including some Florida markets. Condominium development tailored to first-time homebuyers in low-barrier-to-entry markets could slam into rising interest rates. Commodity single-family home development where houses have been selling with little money down and adjustable-rate debt could suffer the same fate. Defaults will start to increase. Time to cool it!

Property Sectors

Hold Moderate-Income Apartments

Pricing has been rich, probably at replacement cost. But tenant demand should firm up as rising interest rates deter first-time homebuyers. Any anticipated employment growth and wage gains will encourage more people "to look for their own places" and move away from parents or roommates. Increasing demand will push rents. More echo boomers entering the workforce over the next five to ten years will create additional momentum. Urban coastal markets offer excellent prospects. Southern California rates best.

Secure Tracts for Warehouse Development

Vacancies stubbornly lurk near record highs in some markets, but institutional buyers bid up pricing well above replacement cost on existing big-box industrial properties, and developers see opportunity: "It's cheaper to lease up new projects." Just-in-time logistics continue to threaten aging warehouse storage space with obsolescence. An improving economy should lift demand further for newer, more desirable space. Higher-ceiling distribution industrials in hub transportation markets satisfy core investors' appetites for solid income returns.

Buy or Hold Full-Service Hotels

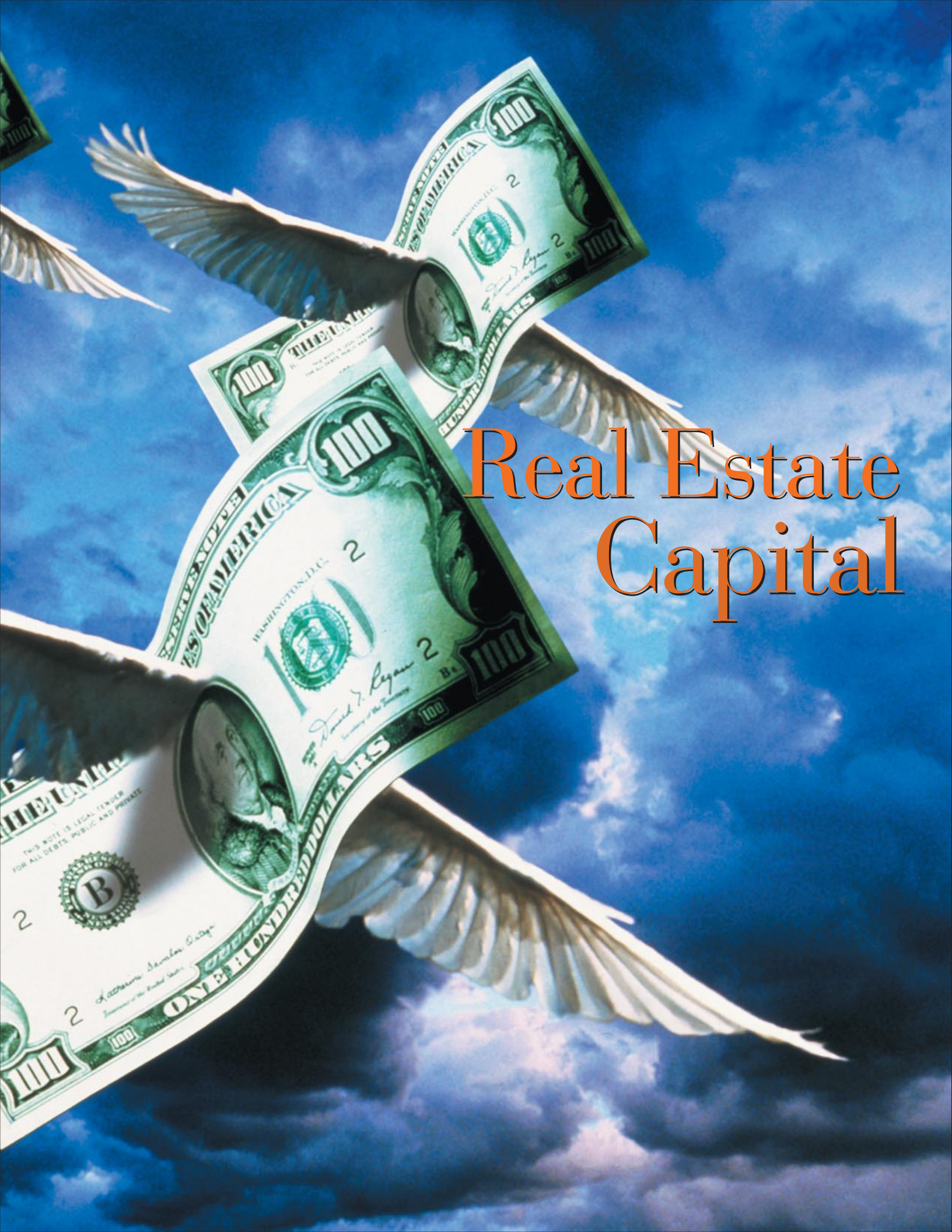
"We're on the cusp of a significant ramp up of average daily room rates." Development has been significantly curtailed and road-warrior travel is increasing. Meeting and conference business has finally returned. Focus on gateway cities and more upscale properties. "It's the right time in the cycle." But buyers will have plenty of company. Forget about steals. In the current seller's market, acquisition opportunities are all relative.

Be Careful about Retail

"Totally overplayed." From a pricing standpoint, "it's the biggest risk." Paying up for neighborhood malls is "playing the slots." Investors buy yield, but the "Wal-Mart effect is a huge risk." If you want fortress regional malls, better buy REIT shares. Despite recent value gains, long-term prospects for B and C malls have not improved—many are threatened by the proliferation of power and lifestyle centers. The competition forces uncomfortably high capex (capital expenditures) risk. Redevelopment of some flagging malls into power centers or other uses will continue.

Steer Clear of Commodity Office

Typically at this point in the cycle it's time to buy B-quality vanilla office and ride economic recovery to strong occupancies and rent spikes. In three to five years you flip. Concerned interviewees claim rollover risk is too great in the current market, and rents will trend down from late-1990s highs before they push back up. "Replacement tenants will be hard to find." "Avoid like the plague" and forget about development opportunities.


Real Estate
Capital

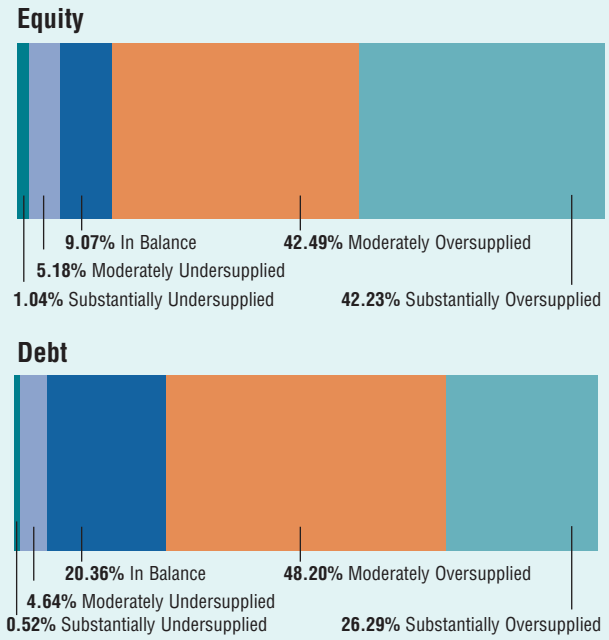
"I don't think there can be more liquidity."

Flows

Typically in past real estate cycles, one outlier group would pump up markets in often overly enthusiastic buying sprees. During the early 1980s, tax-shelter syndicators got into trouble, followed later in the decade by the trophy-office-hunting Japanese. Wall Street opportunity funds led the industry out of the early 1990s depression. Then surging REITs became "accretive buyers" before their high-growth story hit the wall. Germans took over for a short period, bidding up office building prices in gateway markets. "Now it's everyone into the pool," including high-net-worth syndicates, private REIT investors, 1031 exchange buyers, tenants-in-common, pension funds, and even a slew of Australians. Together they have precipitated "an extraordinary period of investor demand," facilitated by low interest rates. Both debt and equity capital markets are moderately to substantially oversupplied with capital, according to survey respondents. (See Exhibit 3-1.)

"The 'big momentum' has been too enticing," says an investment bank portfolio manager. "Don't fight it, join it." Capital has not been totally irrational, given cap rate spreads, relative value comparisons to stocks and bonds, and the opportunity for economic growth to increase tenant demand and rents. Still, borrowers have "gorged on cheap dollars" to buy and refinance properties, "maxing out on leverage." People have

Exhibit 3-1 **Real Estate Capital Market Balance Forecast for 2005**



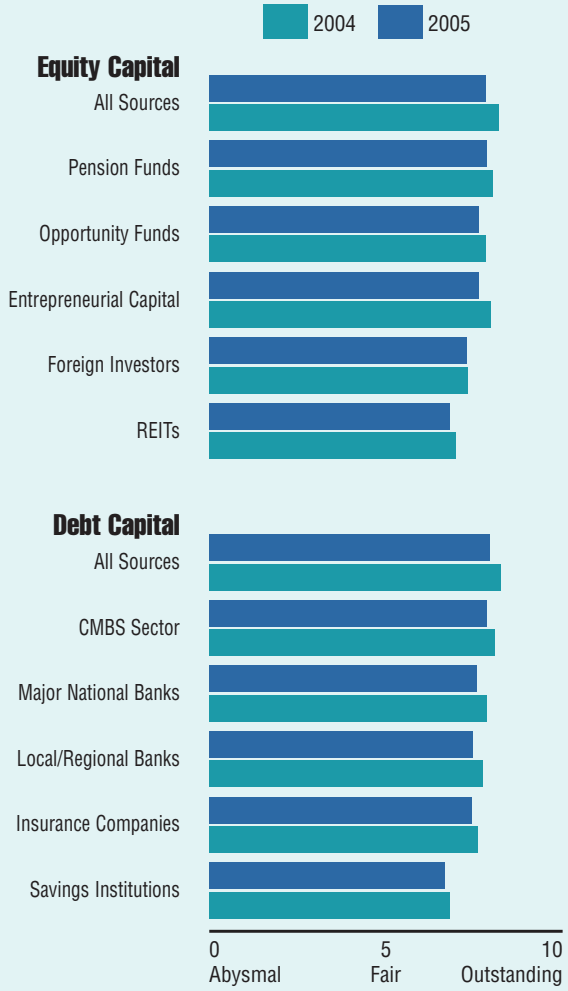
Source: Emerging Trends in Real Estate 2005 *survey.*

*"Even as interest rates head **north**, 'a ton of capital' waits for a home."*

wagered that leasing will improve quickly, "but they are betting with someone else's money."

Even as interest rates head north, "a ton of capital" waits for a home—or, well, an investment property. Syndicators continue to attract buckets of money from individual investors fed up with the stock market. Financial planners, wire houses, broker/dealers, and investment banks, among others, have enticed tens of billions of hungry retail dollars by marketing real estate as a steady, income-generating "safe harbor." Investors have not been deterred by generous front-end loads, which swell broker profits but may compromise eventual returns.

Exhibit 3-2 **Availability of Capital for Real Estate in 2004 and 2005**



Source: Emerging Trends in Real Estate 2005 *survey.*

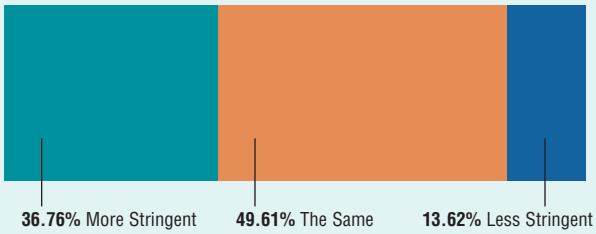
Pension funds, meanwhile, have been raising real estate allocation targets, because of recent solid performance and their growing need for predictable yields to pay the burgeoning numbers of retirees in their plans. After watching prices advance and missing out on the action, many plan sponsors now are convinced that "pricing is not an anomaly" and have reentered the markets at full throttle. Offshore players—Germans and Aussies especially—remain a force to be reckoned with.

In 2005, survey respondents predict that capital availability from both debt and equity sources will fall only slightly from unprecedented 2004 levels. (See Exhibit 3-2.) Pension funds will lead the equity investment charge as interest rate hikes begin to slacken private capital momentum. "Tremendous amounts of institutional capital have been committed in reallocations, but have not been invested," says an investment bank research head. "Major funds have large queues of dollars waiting to be funded and are hungry to see it invested." At the same time, CMBS issuers and banks will remain ready financing sources. Even interviewees with qualms about unrealistic cap rate assumptions expect "the investment pattern to continue through 2005, given the lack of alternatives."

Lending activity should remain robust in 2005, led by the one-two punch of CMBS issuers and banks. About 50 percent of survey respondents anticipate lending underwriting standards will remain the same in 2005, and about 37 percent of respondents believe they will become more stringent. (See Exhibit 3-3.) Opinion is mixed over lending restraint or the lack of it. "The Rosetta Stone for markets has been the discipline of construction lenders," says an interviewee. "Very few markets are out of control." The competitive environment, however, has forced up loan-to-value ratios and pushed down debt service coverage. "Some lenders have been dumb, taking no amortization and no

Exhibit 3-3 **Underwriting Standards Forecast**

Predicted Change in Stringency of Underwriting Standards for Commercial/Multifamily Mortgages in 2005



Source: Emerging Trends in Real Estate 2005 *survey.*

reserves," said an insurance company honcho. A banker counters that lenders have been aggressive on spreads, but not loan amounts, and seem well protected on holdbacks and escrows. "It's hard to get in trouble thanks to low interest rates."

"First mortgage positions appear very safe," says a CMBS investor. "There is no longer a binary relationship between the first lender position and the overall mortgage investment. Securitization spreads risk to investors who have sliced and diced risk into tranches of mezzanine, B-piece, and unrated positions for higher returns." But these finance layers also can distort and dilute transaction risk for the higher-risk positions. "Slicing and dicing clouds protection in the layering," says an insurance executive. "Complexity may add to the risk depending upon where you are in the stacking plan. So far, there hasn't been a real test of what happens if it unravels." Most investors in higher-risk tranches have been well rewarded for their investments. Defaults have been "negligible." Problems in limited-service hotels and assisted living subside, replaced by small pockets of multifamily distress. "Overall, it's under control."

Capital Trends: Equity Players

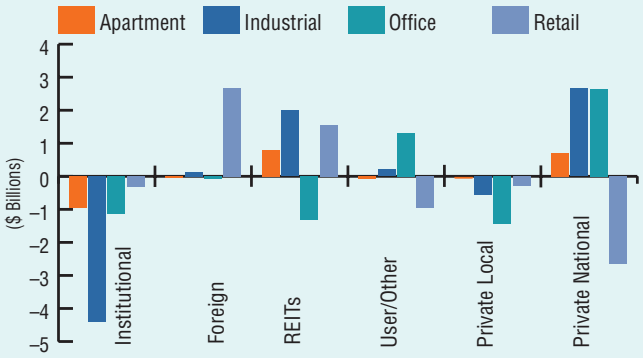
Private Investors and Syndicators

For the past three years, institutional investors have lambasted syndicators and some private high-net-worth investors for inflating the markets and making stupid, highly leveraged deals. In the meantime, they watched flat footed as prices kept rising and private investors started hitting doubles, triples, and even some home runs in roundtrip transactions. "The nontraded sector has performed well," claims a private REIT syndicator. "A rising tide has lifted all boats. This is not the tax-driven syndication business of the 1980s. It's market and economy driven with conservative strategies, looking for mid- to upper-single-digit returns in undervalued, well-leased properties."

But bilious outrage over the hodgepodge of private players continues to pour out of interviewees as money keeps flowing into the markets to buttress everyone's portfolio returns. "1031 exchange investors have driven up prices 5 to 10 percent all by themselves." "It's never good when you see doctor syndications—that's a huge red flag." "It's dumb money." "People are buying anything" and "floating-rate leverage is rampant." Broker dealers chase fees "in a pig fest." Fifteen percent front-end loads "set investors up for failure and sink returns." "It's the classic failed business model." "A lot of people may end up spooked." "It's disgusting."

In fact, private buyer syndicates, who had been targeting smaller acquisitions, mostly apartments, in the $10 million to $20 million range, more recently have been involved in major downtown office purchases at some headshaking prices with heavy financing doses. "They have been driving the markets, no question." Many interviewees continue to predict that private REITs will produce "disappointing" performance—returning principal and income less fees but without much hope of appreciation.

Exhibit 3-4 **Net Capital Flows by Source and Property Sector**



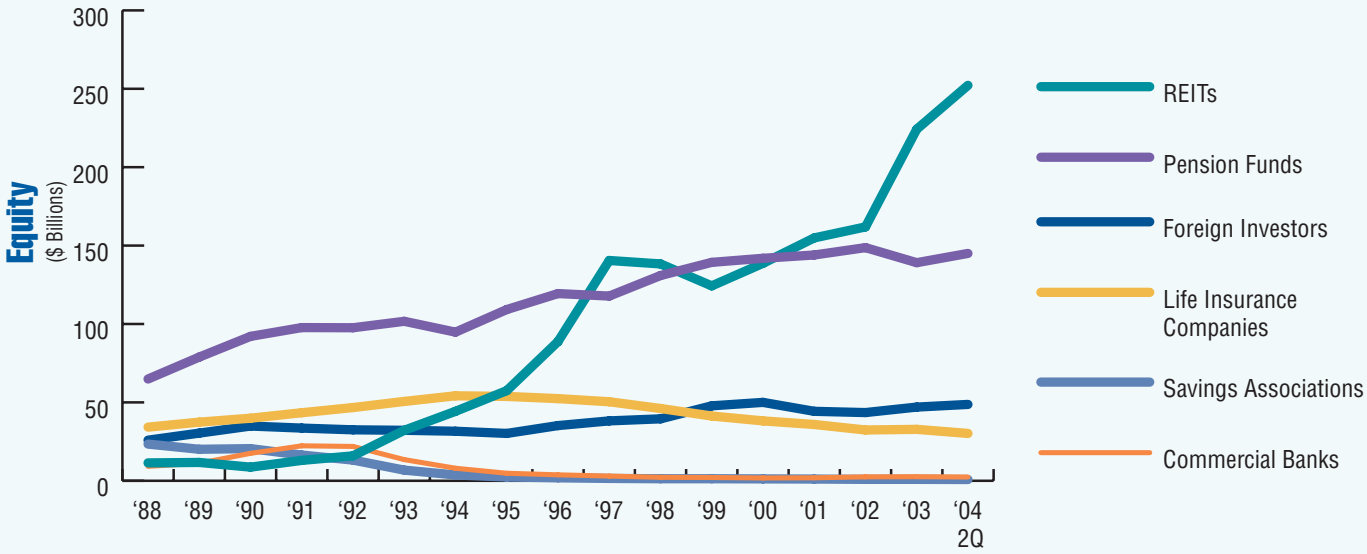
Source: Real Capital Analytics.

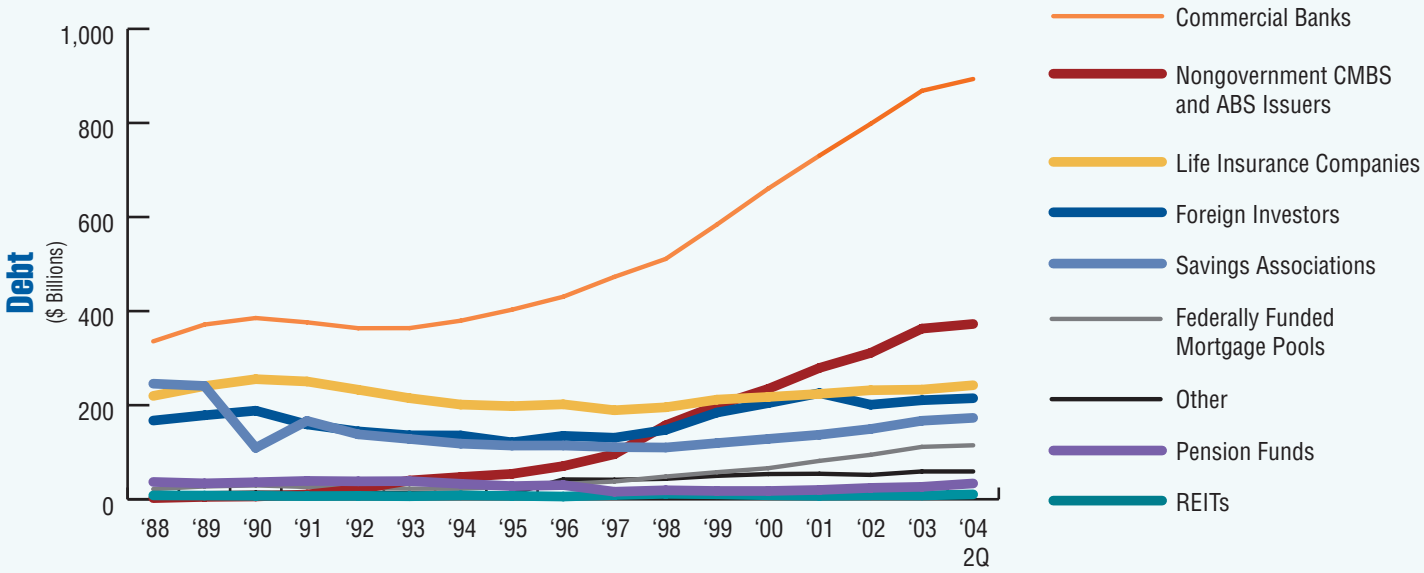
Note: Annual net capital flows for the period mid-2003 through mid-2004.

Over the long term, that might not be good enough to hold these more fickle relative value investors. Consensus reigns that higher interest rates will curtail private sector investments in 2005. But unless the stock market catches sustained fire or real estate returns nosedive suddenly, this noninstitutional capital could have some staying power. Interviewees, who stake their optimism to enduring cap rate compression and ample capital market liquidity, should hope so.

Capital Sources and Flows

Exhibit 3-5 **Real Estate Capital Flows**

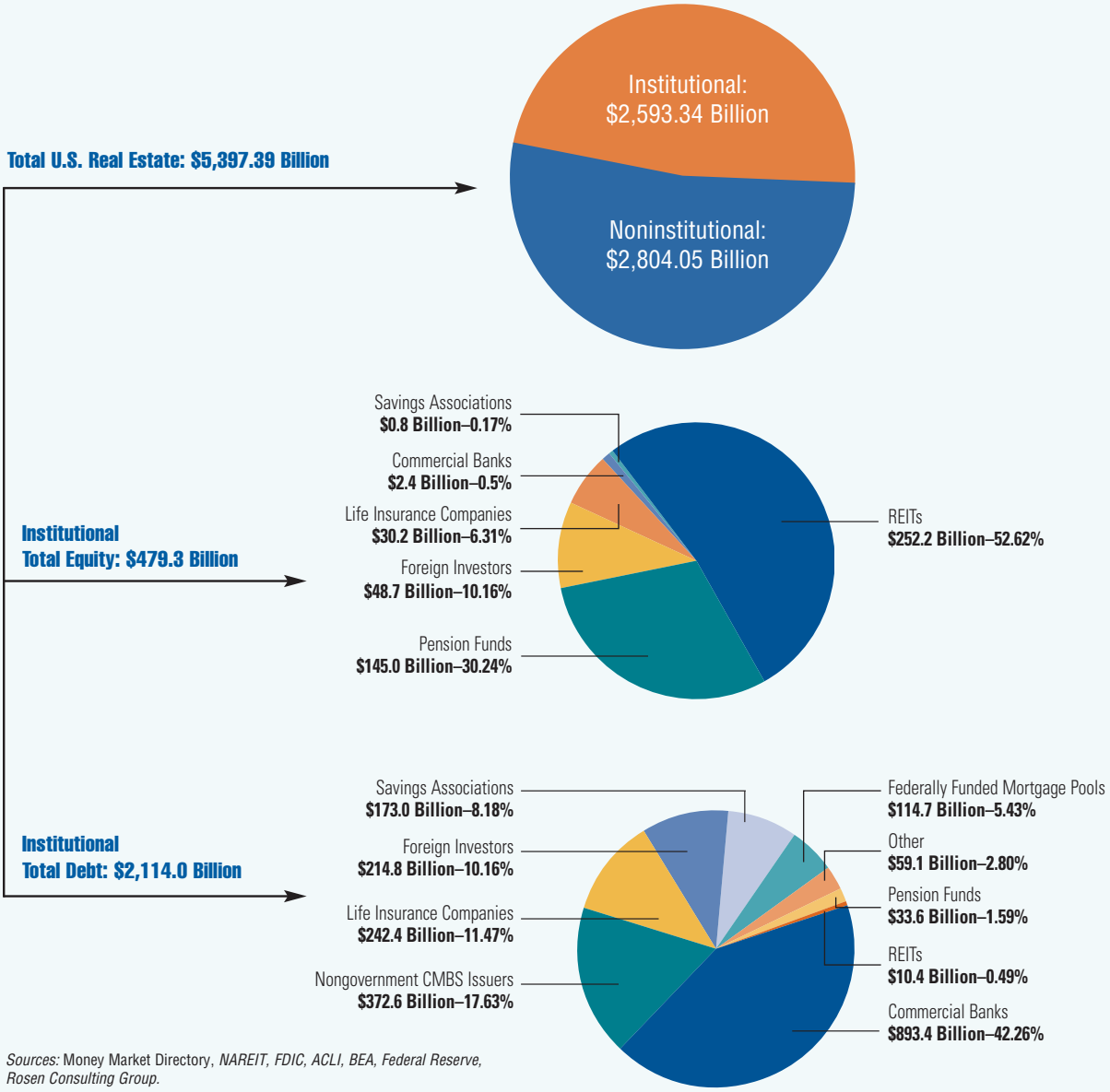




Sources: Money Market Directory, *NAREIT, FDIC, ACLI, BEA, Federal Reserve, Rosen Consulting Group.*

to pick up much of the slack."

Exhibit 3-6 **Institutional Capital Sources**

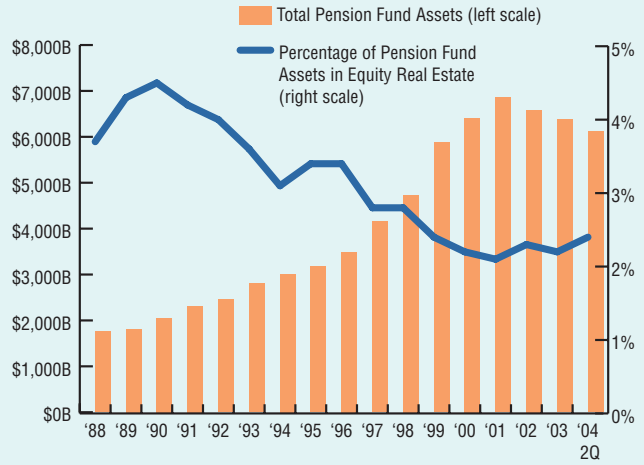


Sources: Money Market Directory, *NAREIT, FDIC, ACLI, BEA, Federal Reserve, Rosen Consulting Group.*

Pension Funds

If and when private investor capital backs off, interviewees expect pension funds to pick up much of the slack. "The private guys have had their run. Institutions will take over in 2005." Pension funds seem always late to the party, and characteristically these more conservative investors have not led the charge during the recent buying splurge. Larger plan sponsors, including state employee funds with established real estate portfolios, have generally played the market strategically, selling assets into the capital wave and avoiding bidding contests on acquisitions. Typically spurning high-leverage investment structures, they cannot compete against many syndicators who use financing with abandon. "We've been bidding, but losing deal after deal," said a public fund executive. Consequently, many pension property portfolios have contracted just as many plan sponsors raised allocation targets to achieve increased yields and meet cash demands from an earnings gap versus their required retiree payouts. "Show me stable returns that offer diversification to other investments and I want it," says a state pension fund administrator. "Pension funds want to diversify away from the equity beta and have less dependence on appreciation. That's why they like real estate."

Exhibit 3-7 **Pension Fund Assets in Equity Real Estate**



Sources: Money Market Directory, *Rosen Consulting Group.*

Smaller plan sponsors, endowments, and foundations have caught the real estate bug, too, after many steered clear in the wake of the early 1990s market debacle. Strong cyclical performance and income-driven returns are too attractive to pass up now. "Pension funds need to diversify portfolios," says a leading consultant. "Market timing is not the issue. The key is to get their allocations out prudently." Consultants recommend that funds step up portfolio target allocations to 5 to 10 percent of total assets. "Anything less is not beneficial." Currently, the total pension universe invests less than 5 percent of assets in real estate. Some plan sponsors invest up to 15 percent, while some smaller plans continue to avoid property investments.

"The pressure is on to make acquisitions" and investment managers are caught in an uncomfortable squeeze. "It's been easy to sell, but hard to recapitalize and improve portfolio risk." The challenge for most advisers is "to withstand the pressure and weigh the client patience level." But managers also have incentives to place money and earn asset management fees, and some pension funds are "forcing capital out."

Certain funds also increase leverage limits, even though it slows investment in equity. At least they take advantage of spreads and can compete to invest some money. Once leverage is no longer accretive, "they are sure to back off." To gain better access to transactions, pension investors joint venture with REITs and other operating partners, who demand leverage on transactions. "They won't do deals otherwise." Other funds, frustrated by the slow pace of real estate equity placements, invest directly in REIT stocks. "It all looks like the wrong time," says an investment manager. "They're buying when pricing is well above historic ranges and net asset values, driven by a need for current income." For those plan sponsors just getting into the game, "they may be disappointed."

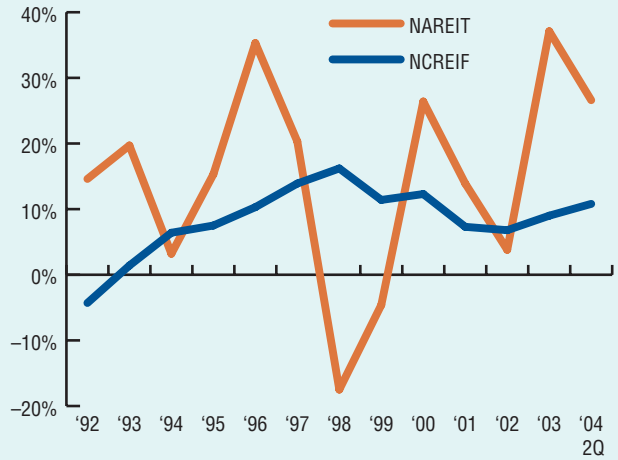
Sponsors, consultants, and investment managers hope that once higher lending rates curb private investor enthusiasm, the acquisition market's exuberance will recede enough to allow for more comfortable pricing. Nobody expects any bargains, but maybe they can make deals that will produce returns above their actuarial assumptions. A public fund executive muses: "Can you imagine the impact on pricing if all funds put out their money at once to meet their new allocation targets?" No wonder interviewees retain confidence that capital flows will hold up in 2005.

Real Estate Investment Trusts

Despite the surge of private investment and newfound pension fund assertiveness, REITs continue to solidify their market leading position and clearly dominate the institutional capital markets with a 53 percent equity share compared with only 30 percent for pension funds. (See Exhibit 3-6.) The REIT growth track has been steady and impressive, building from less than $15 billion in total market capitalization in 1992 to more than $250 billion in 2004. Just five years ago, pensions commanded a 39 percent institutional market share versus 38 percent for REITs. Capital inundates REIT mutual funds and stocks from smaller institutions and individual investors, who cannot access the private markets easily and like the strong dividends.

"REITs have become the gathering place for mature assets, while development and growth strategies will take place more on the private side," says an investment banker. Indeed, many REITs, established in the early 1990s by cash-strapped entrepreneurs as a strategy to escape foreclosures in illiquid capital markets, have become "cycle-tested" institutional-scale enterprises operated by highly skilled corporate-styled management teams without developer zeal or risk-taking fervor. "Founders have given way to professionals." A REIT CEO asserts: "We should not be looked at like a collection of assets, we're a company and we are managed to maximize earnings across all our operations."

Exhibit 3-8 **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 2004 data are annualized from first two quarters. NAREIT 2004 figure is annual return from second-quarter 2003 through second-quarter 2004.

Many companies stand "at a transition point, figuring out a new business model" that ensures they can maintain the solid, steady dividends that shareholders demand and expect. "We're long past the stage when we will be recognized as growth stocks," says a REIT honcho. "We're moving away from just buy and hold to more of a capital allocation model—buy, asset manage, enhance, sell, and reallocate," while trying to retain income-producing management contracts. REITs entertain more partnerships with pension funds and offshore capital, which have lower-cost capital. They can add to holdings and critical mass, while enhancing operating revenues from fees. Companies have also boosted earnings by adding leverage while mortgage rates stay low.

Some executives continue to chafe under REIT requirements to pay out 90 percent of earnings as dividends, short-circuiting capital-intensive, higher-growth strategies like development. But moves to less passive structures like C-corps have been sporadic. Expected consolidation continues slowly as companies seek economy of scale advantages in corporate overheads and from market share gains. Large mall REITs continue to gain significant leverage over national retail chains in negotiating tenant agreements. Apartment and office REITs look to concentrate activities in specific local markets to improve marketing to tenants across regional holdings and centralize operations as much as possible.

Returns will reflect the economy—"slow and steady." Interviewees and survey respondents forecast that the public markets will underperform private real estate in 2005, pointing to stocks' outperformance in recent years and market prices in excess of net asset values. "REIT upside is missing from earnings growth in real estate fundamentals," says an interviewee. "The game of refinancing debt to create better income cash flow is ending. There is more downside potential in prices than upside." Rising interest rates will also pressure companies to maintain or increase dividends and hamper them in the transaction markets, where private investors can still use leverage and accept lower initial yields.

Shareholders and stock analysts tend to lump companies into property sector groups, especially malls, which trade together "in tight bands." "Little differentiation between real estate stocks exists among investors." Interviewees continue to debate whether REITs are a private real estate proxy, a complement, or volatile dividend-producing stocks. Over long-term investment horizons, REITs and private real estate provide simi-

"Very aggressive *German players may take a breather."*

lar returns, but REIT performance is considerably less stable and increasingly tracks the overall stock market. "Volatility is reduced in private markets, because investments are not marked to market. In the end there is not a huge distortion." But a pension executive complains that "REITs are too susceptible to capital flows and the vagaries of the capital markets, which don't bear on real estate attributes. Eventually, REIT holders will be disappointed with volatility."

Investors are learning to tier REITs by sector, geography, and strategy, which is more difficult to accomplish on the private side, says a REIT executive. "Availability and interest in international REIT stocks are also increasing." "It's certainly the best way for the general public and smaller institutions to access real estate markets."

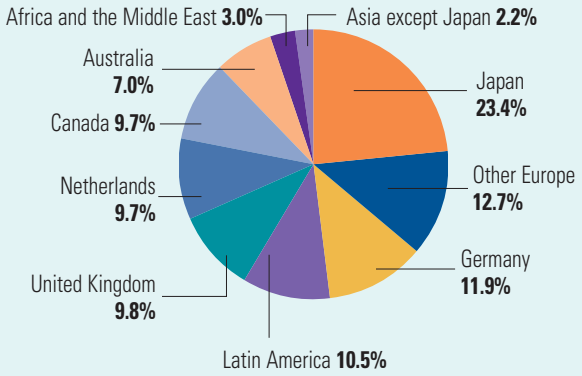
Foreign Investors

Steady flows of offshore money keep "backbone" in the capital markets. Foreign investors "have been consistently in the hunt" for acquisitions, bidding actively alongside the rabble of other private and institutional sources. Everybody gravitates to stable U.S. markets and the weak U.S. dollar can enhance buying power.

"Very aggressive" German players may "take a breather," given record-low cap rates for the core, stabilized assets on their shopping lists. Afraid of cap rates decompressing, Germans "will buy only the safest of the safe to weather the next five years as interest rates go up." Closed-end syndications, similar to U.S. private REITs, "cannot find competitive yields" in office and retail acquisitions given high pricing. They avoid multifamily—"Germans are unfamiliar with garden apartments since they don't exist in Germany." German open-end funds also find tough sledding in familiar overheated top-tier office markets where they concentrate activity. "D.C. has been the favorite," but it is now too expensive.

Exhibit 3-9 Foreign Investment in U.S. Real Estate

as of December 31, 2003



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

Dutch investors continue to invest in U.S. REITs or operating companies, but shy away from direct investments. In general, rising familiarity overseas with REIT structures has made foreign investors more comfortable with investing in U.S. REITs. French and U.K. investors seem to stick to home cooking. "They don't crop up among competitors."

Australians now rank as the most active foreign investors after the Germans. Government pension diversification mandates and a dearth of domestic property options coax Aussie superannuation funds and trusts to American shores. Hungry for yield, Australian funds find "slightly" higher returns in U.S. holdings than in their domestic assets. Higher interest rates and sky-high pricing in Australia make the United States look very competitive.

Asian money from Singapore, Malaysia, and Indonesia remains regionally focused. But Japanese capital may be edging back into U.S. real estate markets after a 15-year hiatus. "The Japanese are looking for stable dividends, a new tax treaty will be advantageous, and their economy is improving after a long decline. The arithmetic is finally working again." Expect "low key" investing rather than the "flashy," price-is-no-object purchases made in the 1980s. Back then, high-profile acquisitions of countless downtown trophy landmarks and even the Pebble Beach golf resort ended in big losses when markets tanked. Some Japanese will dip their toes in 2005, "starting with REITs."

Arabs and Israelis cannot agree about much, but both groups remain active in U.S. property markets, looking for a safe haven from their regional conflict.

Wall Street

Investment bankers' attention shifts overseas as opportunity investing dries up in the United States. They remain vigilant in case domestic market distress develops. Major financial companies move to expand private core fund offerings beyond pension plans to high-net-worth, offshore, and individual investors. Real estate mutual funds and 401K options make further inroads.

Life Insurers

You have heard it before—the trend continues away from direct real estate ownership. There appears to be no turning back.

Capital Trends: Debt Players

Banks and Insurance Companies

The liquidity in the system has made maintaining lending discipline difficult as loan-to-value ratios drift up and debt service coverage ratios edge down. The interviewees' overall view confirms that banks and insurance companies have been generally responsible underwriters, competitive on rates, but generally holding the line on loan amounts and terms with slippage at the margins. "Underwriting has been appropriate and conservative," says an investment manager. No warning lights flash about widespread delinquencies, let alone out-of-control foreclosures. The culture seems intact for avoiding major errors. The low-interest-rate environment has enabled borrowers to keep paying down loans, despite less than vigorous property cash flows. An unexpected interest rate spike would put a whole new complexion on the market.

If banks don't extend enough proceeds, borrowers have additional resources to access: some CMBS issuers will stretch more on loan amounts and extend interest-free terms for a couple of years. Mezzanine lenders will offer additional capital for a higher rate of return.

Construction lending remains checked. All the available market vacancy data chill activity, while bank regulators and stock analysts monitor trends closely. Any jump in development lending by major bank companies would draw unwelcome attention from shareholders. Institutional memories run deep—no one wants a repeat of the early 1990s, when some banks were brought to their knees by problem loans and the savings and loan industry almost went belly up.

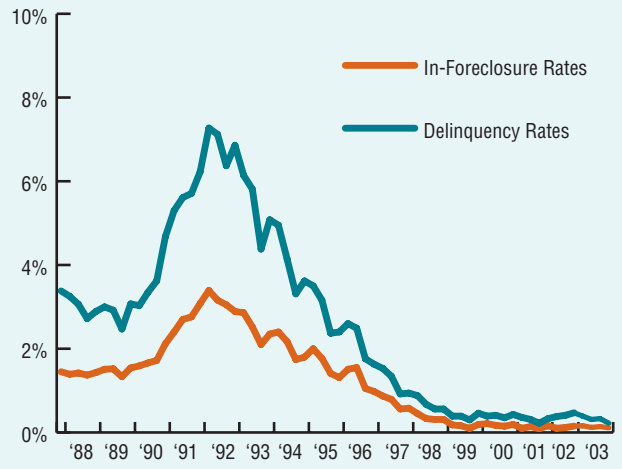
By 2007, higher capital reserve requirements loom for major U.S. money center banks active internationally. The Basel II accord, an international framework for lenders, could increase these banks' cost of owning CMBS as well as making certain acquisition, development, and construction loans. Critics worry that capital flows will be constrained if the draft regulations take effect. The Swiss-based committee working on the final accord continues to weigh criticisms, including issues raised by Congress, which will need to adopt the regulations for U.S. financial institutions. Everyone should stay tuned.

The market clout of life insurance companies diminishes. They "try to be competitive as a preferred debt source," focusing on first mortgages investing in higher-quality core CBD office, retail, and apartments. Borrowers may take less on loan amounts, but gain extra flexibility in refinancing or changing terms later.

Insurers' CMBS comfort level grows—both for converting portfolio loans into securitization pools as well as direct investment. "We are out of private real estate and into real estate paper," said a life company portfolio manager. "Interest in CMBS and REITs has increased considerably across the industry." In some cases, once-large insurer real estate departments shrink to a handful of managers, who oversee outsourced operations, whole loan portfolios, and securities accounts.

Insurance foreclosures and delinquencies register barely a blip. "They've been on the best behavior in the history of lending," says an interviewee. Others question the industry data, but recognize that insurers have been careful. "CMBS has the riskier stuff."

Exhibit 3-10 **Life Insurance Company Delinquency and In-Foreclosure Rates**



Source: American Council of Life Insurers.

*"Interviewees expect **CMBS** yields to edge lower for all investment-grade tranches."*

Commercial Mortgage-Backed Securities

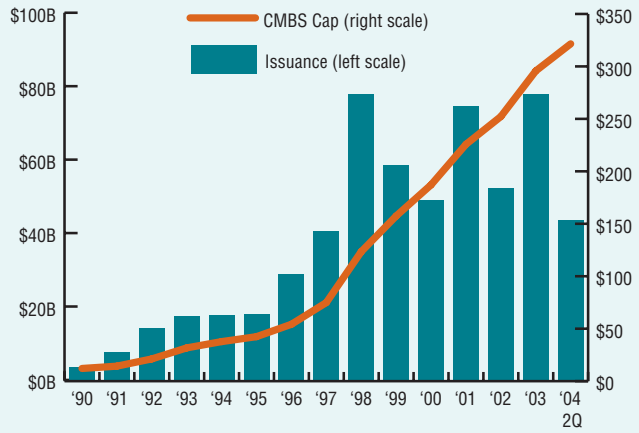
CMBS popularity increases steadily, and conduit lenders gain market share over other lenders, increasing origination volumes that translate into $1.5 billion plus weekly new issuance. In addition, more than $1 billion a week in secondary market activity offers "incredible liquidity" to investors. The number of B-piece buyers also has been expanding. "There have been no blowups, few delinquencies, no scandals," while rating agencies and government regulators keep CMBS activity "under the microscope." The CMBS markets have greater transparency "and can efficiently price risk," helping maintain discipline. A conduit lender says: "I can't think of any major threats to the business."

Wow, it can't be that good, can it? Well, no. "Margins are very thin. Conduits seem to be reaching for business." Interviewees expect CMBS yields to edge lower for all investment-grade tranches. "It's too late in the cycle to make below-grade CMBS investments—prices have been bid up beyond comfort levels." Interest rate shocks or geopolitical thunderbolts are a major risk since CMBS markets are tied directly to global capital flows—"money could rush out as fast as it has been rushing in." Problems with floating-rate borrower defaults could dampen investor enthusiasm, if rate hikes occur ahead of improving property-level cash flows. Expect widening spreads for slightly worse credit performance when some B-piece buyers get hurt inevitably. In the event of any downgrades, BBB bondholders and above should be well protected. These problems shouldn't create a crisis: "B-piece buyers to date have been well compensated for the added risk, and any losses have been minimal." CMBS, meanwhile, retain their credit edge over comparable corporate bonds.

Interviewees continue to question what would happen in the event of widespread delinquencies and defaults. With eyes wide open, borrowers knowingly accepted quicker responses on loan requests and larger loan amounts from CMBS lenders, giving up future accommodations in servicing and workouts that insurance and bank documents typically extend. Special servicer reaction to mass defaults has never been tested and fears remain over how complex loan agreements and abrupt foreclosure policies could lead to a tangle of lawsuits and uncertainty, crippling the market. "The industry is not complacent," says a conduit lender. "We want to ensure that special servicers take the opportunity to make reasonable decisions." Time will tell—most observers expect that the market can avoid substantial disruption, which would force servicers to drop the hammer.

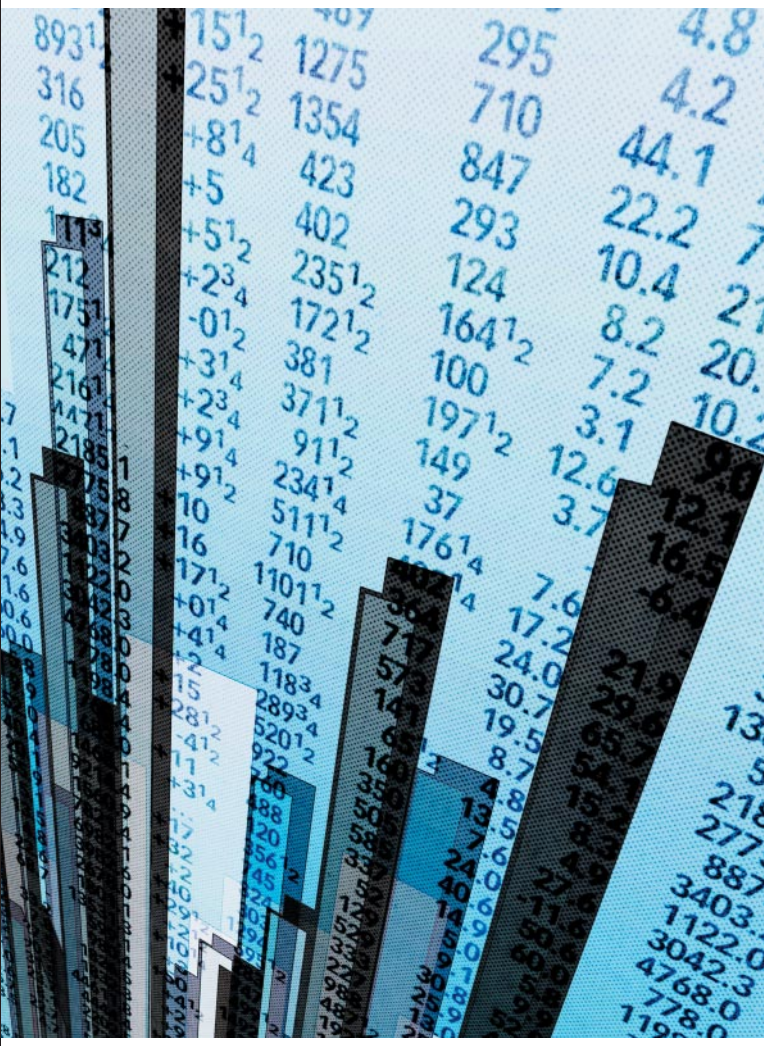
CMBS's rising prominence in fixed-income markets increases investor interest in real estate debt. Investment managers begin to develop funds, offering a diversified mix of CMBS, whole loans, mezzanine debt, as well as real estate equity and REIT stocks. These funds can provide more liquidity than typical core real estate funds with similar income-generating characteristics and greater diversification. Asset allocators will quibble over whether these hybrid funds fall under fixed-income or real estate in their models, but they will like the steady cash flow returns. Levered finance techniques also ratchet up returns on investment-grade CMBS tranches. These collateralized debt obligations gain traction among sophisticated investors—institutional and high-net-worth individuals.

Exhibit 3-11 **CMBS Market**



Sources: Federal Reserve, Commercial Mortgage Alert.

Note: Issuance data for 2004 include issuance for the first two quarters only.



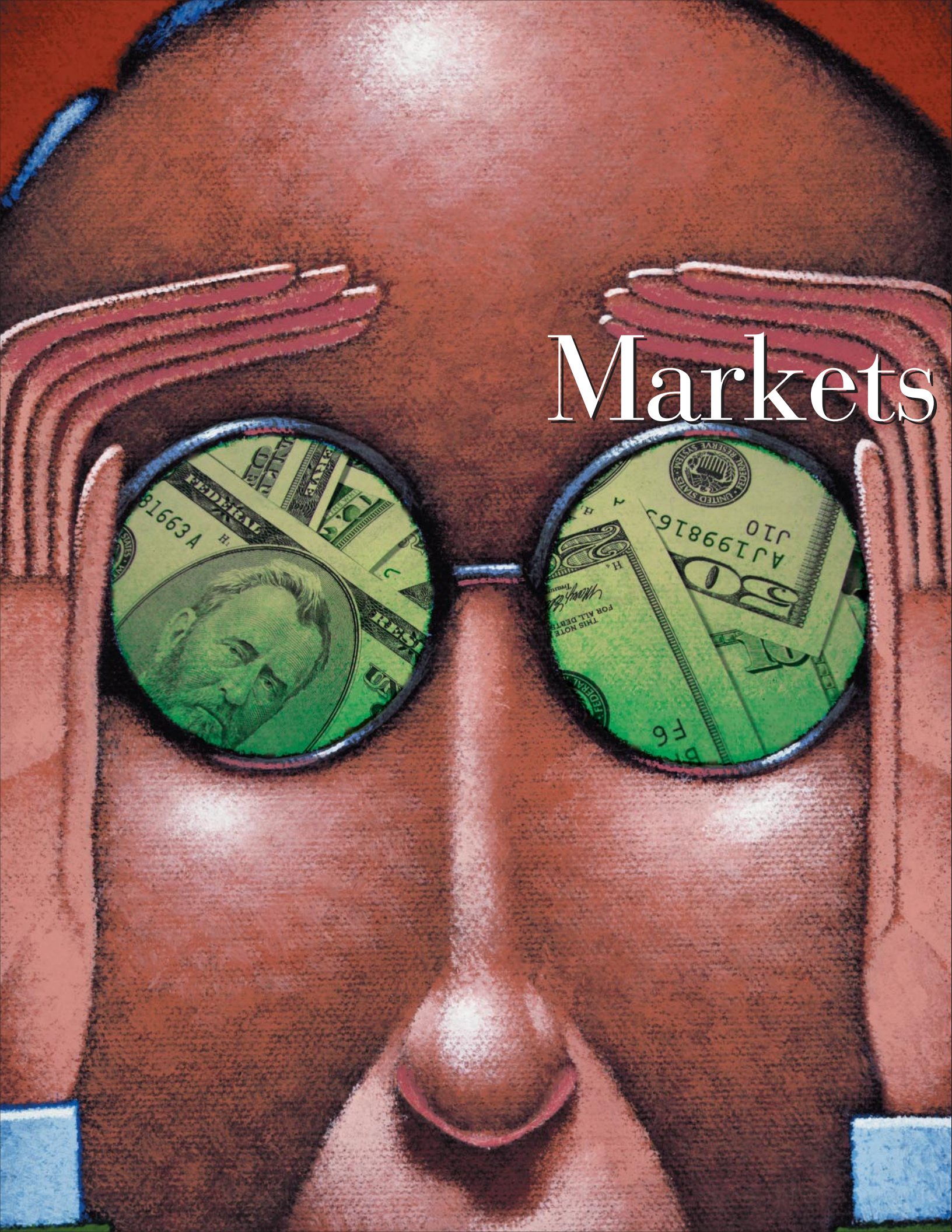
Mezzanine Debt

Less than a decade ago, mezzanine debt was a popular corporate finance strategy that gained notoriety in highly publicized corporate buyouts and takeovers. Presto, "mezz" is a mainstream structure in the new world of real estate risk tiering between first mortgage positions, various CMBS tranches, and equity. Robust demand for mezzanine money extends from private investors and entrepreneurs, who have leveraged up modest equity stakes to outbid institutional investors and REITs in the property acquisition markets. The community of mezzanine lenders, meanwhile, has expanded dramatically to meet the market—investment banks, mortgage companies, high-net-worth investors, and value-added funds all dole out mezz loans.

"Everybody is pushing the limit on standards, because of liquidity and competition," says a mezzanine lender. "It's hand-to-hand combat to out-hustle and get deals." The result is compressed yields, increasing risk, weaker structures, and lower returns.

Some equity investors financially engineer acquisitions at "ridiculous cap rates" with little money down, take on mezz and floating-rate debt, and plan to get their money out and more in a few years, "leaving the mezz lender holding the bag." In reverse strategies, some mezz lenders consciously loan to own. "A lot of mezz loans are in trouble," says an interviewee. "It's not big news and handled quietly." Sounds like mezzanine lenders may need a time-out, but some interviewees claim that properly underwritten loans still offer "the best risk-adjusted returns available," especially if space markets advance more quickly toward equilibrium.

Markets



"Everyone wants to be in the same places."

to Watch

The roster of top investment markets remains a lonely four, similar to last year: Washington, D.C.; New York City; southern California; and south Florida. "Big money continues to go bicoastal," says an interviewee. "Middle America is a hard sell. The nation's economy and power appear focused on the coasts. Smaller markets must make due on local country club money." Not surprisingly, the favored few not only have the best investment and development prospects, but also feature the best supply/demand balance, according to survey respondent rankings.

"Everyone reads the same reports, follows the same advice." Stock analysts "tend to favor REIT companies concentrated in top markets," extending the bias of pension funds and foreign investors to concentrate assets in these places. Not even a self-styled "avoid the herd" contrarian consultant can stop from backtracking: "Well, you can't avoid California—it's too unique and important a market." And while some interviewees recommend sidestepping the bicoastal land rush, few advise running against it. "Let's face it. In eight out of ten years New York will be good for investors, while in Dallas it may be three or four out of ten, and in a place like St. Louis it may be one out of ten."

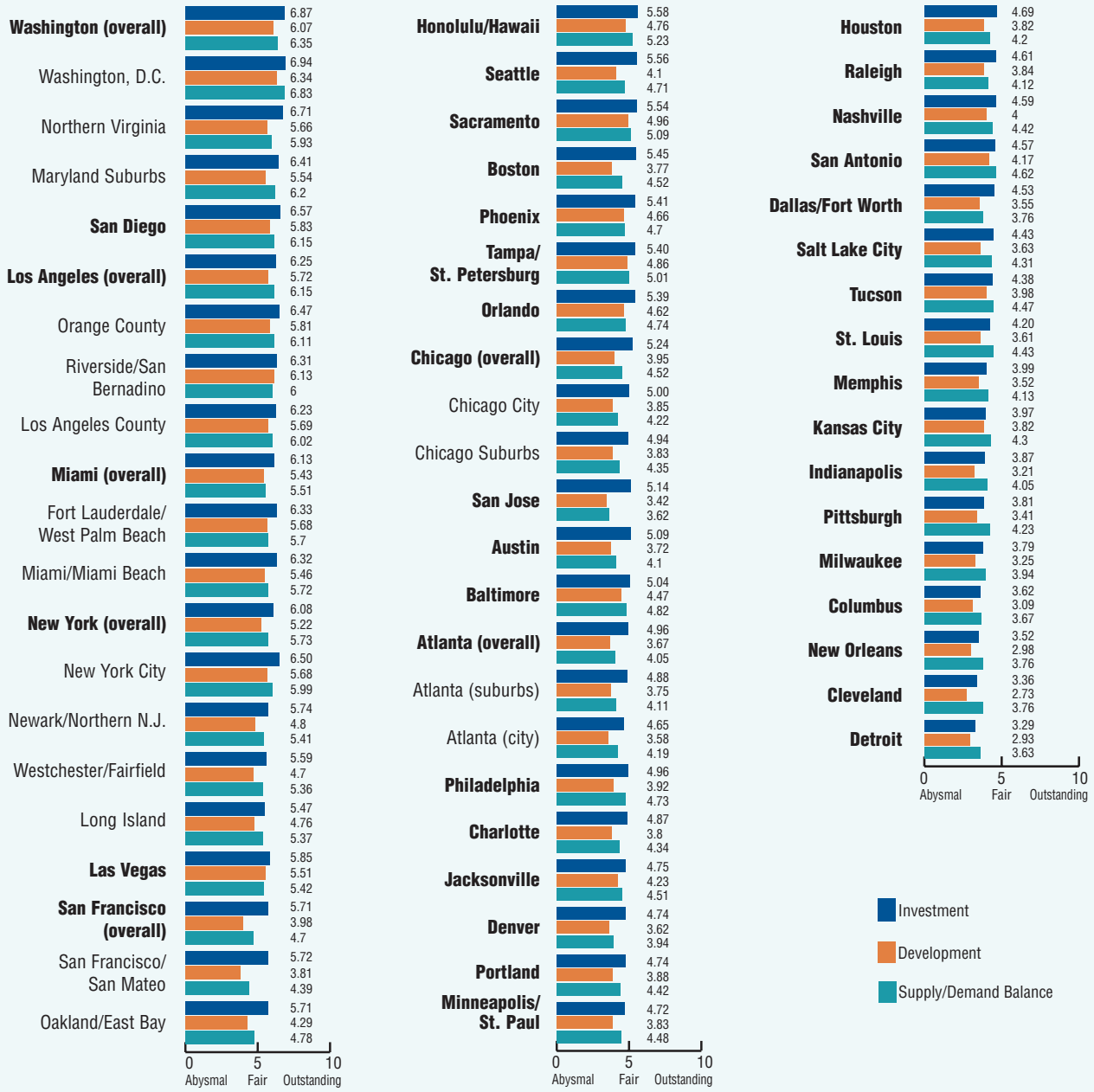
Global Gateways Strengthen

The top *Emerging Trends* markets feature international gateways with barriers to growth, solid economic underpinnings, and a draw for immigrant labor forces. New York remains the world's financial and cultural capital. Washington stands as cynosure of global power. Southern California marries entertainment, defense, and biotech industries into an economic behemoth astride the Pacific—the first port of call from the rising Asian industrial juggernaut. The Miami area's Palm Coast warmth draws aging baby boomers, while proximity to South and Central America attracts Latin businesses.

As technology and global capital flows integrate economies and industries across national borders, cities and markets enjoy better prospects if they can link their fortunes to the evolving international growth path. Some regional centers get left behind, shunted off the beaten path. It's the global version of what happened to many U.S. towns and villages bypassed by interstate construction in the 1950s and 1960s. Stagnation or worse, possibly Darwinian decline, faces some of these markets.

Exhibit 4-1 **Markets to Watch**

Prospects for Commercial/Multifamily Investment and Development



Source: Emerging Trends in Real Estate 2005 *survey.*

Regional banks, businesses, and even utilities consolidate as part of corporate Goliaths, which move to larger worldview markets to maximize clout, attract the best talent, and link to global networks. Even 24-hour standouts—Chicago and Boston—suffer recent serious losses of financial company headquarters to mergers and acquisitions. Places without substantial international airport hubs diminish in significance. Back offices and factories can locate almost anywhere now and typically the low-cost provider wins (that's often outside America). The deck is increasingly stacked against a Kansas City, Milwaukee, or Indianapolis, which pales in comparison to American powerhouse markets, but also faces difficulties competing to attract commodity jobs in offshore face-offs against Dublin, Manila, or places in India. At least Las Vegas has a gambler's chance: singular glitz and ersatz glamour make its Strip the international destination for high rollers.

"Some secondary markets have net out-migration," says an interviewee. "If people don't want to live there, I don't want to invest there." Investors "worry" about growth drivers, so they "focus on the larger cities" and the "coastal orientation makes sense, because that is where the majority of the population and the opportunities are." As capital flows, population growth, and employment opportunities gravitate to a confluence in select regions, the opportunity to diversify investments geographically becomes more limited. The best markets offer bondlike returns, while the have-nots offer nothing compelling—a lot more risk and limited, if any, upside.

Follow the Crowd

An expanding market employment base combined with geographic/planning restraints offers the best investment dynamic. For interviewees, that spells "southern California—the only place with both." But cities with barriers to new development continue to gain favor over "hot growth" markets. New York, Washington, San Francisco, and Boston are well positioned—they feature geographic barriers, planning controls, and modest employment growth prospects. Despite having expanding populations, Dallas, Houston, and Atlanta lose standing, because of unrestrained development and poor growth management.

Pricing has been "outrageous" in the leading bicoastal markets, but "at least fundamentals are relatively good." In other metropolitan areas, pricing has been lower, "but still outrageous and the fundamentals have been lousy." Investors may reluctantly "follow the crowd" into Washington, southern California, and New York, but interviewees say "the critical mass" of capital provides "investment liquidity," allowing for future disposition exit strategies and justifying pricing premiums. Just how rich pricing levels stay likely depends on interest rate moves. "At some point, T-bill yields will look better than the 5 percent and lower cap rates people are paying in these markets." For now, these places "equal low risk, low return, and low volatility" for investors.

Transportation access takes on added importance for corporations looking for headquarters locations. "Hub airports are essential" for international travel. Chicago, Dallas, and Atlanta gain an edge here. But avoiding the nightmares of traffic and long commutes gives advantages to places with mass transportation networks. "It's unreal how well Manhattan works because of its subways, rail links, and bus systems."

The coastal markets also stand as immigrant gateways, attracting hard-working, motivated newcomers who can energize local workforces, fill service jobs, and maintain a variegated flow of professional as well as executive talent. Languishing cities fall further behind as their best and brightest leave for greater opportunities elsewhere—again, the coastal centers provide the greatest lure.

Overall, the established set of *Emerging Trends*' 24-hour market characteristics continues to drive the success and resilience of the most attractive investment locations. These elements include upscale infill neighborhoods near commercial districts, convenient pedestrian-friendly retail, multifaceted recreation and cultural institutions—parks, museums, sports arenas, theaters and restaurants—and transportation alternatives to the car. Strong economic underpinnings inherent in the concentration of major corporations and businesses create the tax base to maintain infrastructure and lure affluent residents with jobs and opportunities. Also of importance, crime remains tamped down in these areas. As teen and young adult demographic cohorts expand over the next decade after receding during the 1990s, low urban crime rates may be tested.

Halo Effect

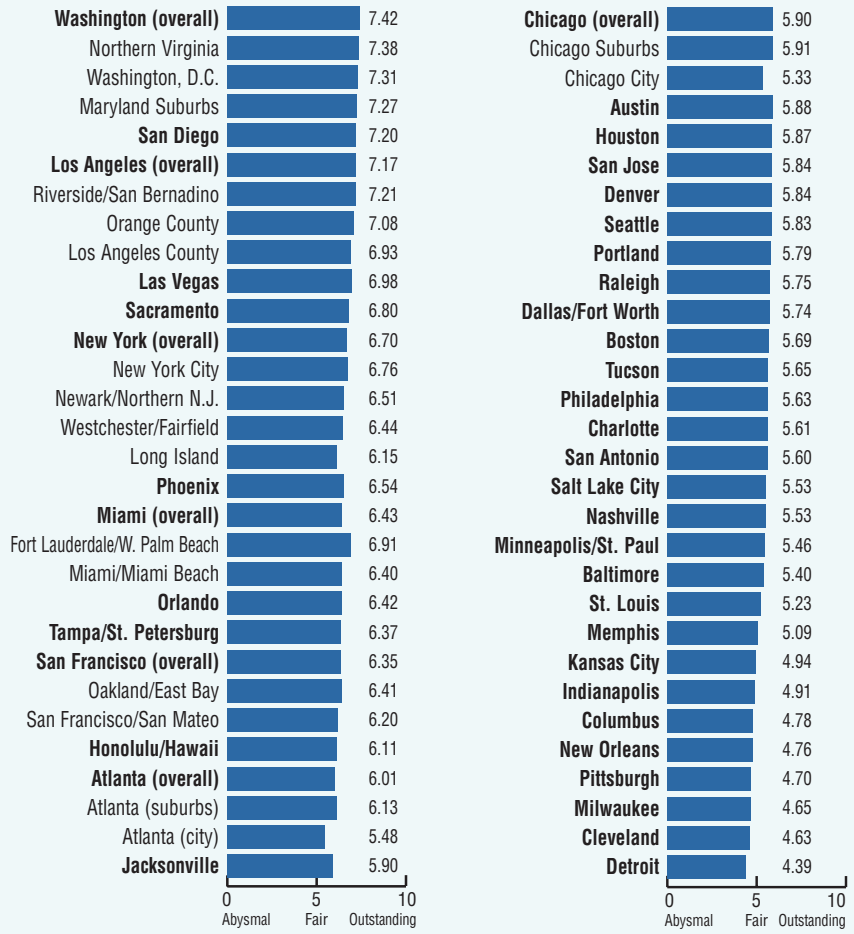
Favored market status extends in halos to surrounding suburban areas. While downtown Washington, D.C., and Manhattan get higher survey marks, the Maryland and Virginia suburbs as well as the Westchester, northern New Jersey, and Long Island submarkets trail only slightly behind the urban cores. Various southern

California and south Florida submarkets also cluster together in relatively narrow survey bands, testament to the national view that they comprise large, cohesive, and interdependent markets.

In suburban agglomerations, investors continue to choose submarkets with 24-hour characteristics over left-behind downtowns without residential underpinnings and fringe districts. Atlanta and Dallas try, but so far fail to generate enthusiasm for expanding downtown residential development. In Atlanta, midtown and uptown Buckhead are prime investment magnets—they boast affluent neighborhoods more convenient to multifaceted recreational and retail environments than either downtown or far-flung perimeter submarkets. Houston and especially Denver make strides in establishing more 24-hour downtown environments and take advantage of "the move-back-in trend."

Exhibit 4-2 **Markets to Watch**

Prospects for For-Sale Homebuilding



Source: Emerging Trends in Real Estate 2005 *survey.*

Hot Growth Markets Cool

Prospects for Sunbelt metropolitan areas may hinge on further developing 24-hour infill environments. In the 1970s and 1980s, these markets mushroomed to accommodate the tsunami of baby boomers, moving south to temperate climates away from flagging Rustbelt manufacturing areas and seeking a suburban environment in which to raise families. As the number of empty nesters grows and their echo boomer children delay marriage, the popularity of cul-de-sac homes could ebb, while the move back toward vibrant cores gains momentum. The original allure of these cities—lower cost of living; large, modestly priced homes on big lots; easy suburban lifestyles—has been diminished by traffic congestion and the blight of sprawl. Many transplants don't establish roots—they now look to resort retirement areas. Company relocations may have peaked, too. Are these hot growth markets cooling down? The current economic growth cycle could answer that question. All these markets desperately need to expand their mass transit systems. Like Atlanta's MARTA subway, nascent light-rail systems offer help in Denver, Houston, and Dallas, reinforcing opportunities for infill development around stations.

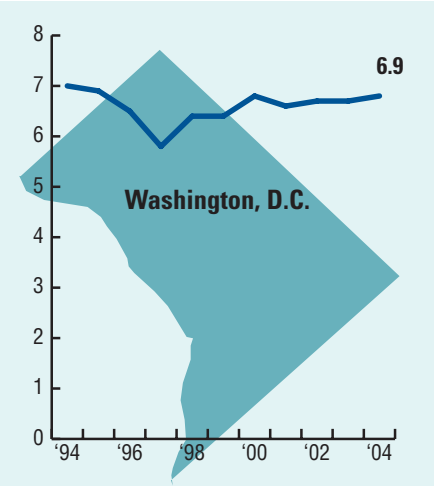
Homebuilder Choices Mimic Investor Preferences

Homebuilding prospects, not surprisingly, track *Emerging Trends* investment trends, according to survey respondents. Residential developers gain from barriers to entry, more vibrant local economies, and buyer demand for higher-priced product. Growth markets may offer cheaper land prices and allow for easier entitlements, but they also tend to overbuild and deliver lower pound for pound pricing. Predictably, stagnating metropolitan areas bring up the survey rear. Survey respondents peg Washington, D.C., and a collection of southern California cities as the nation's best homebuilding locations despite "bubble pricing." Las Vegas and Phoenix, two suburban agglomerations enjoying sizzling employment gains, sandwich New York near the survey top. They track ahead of popular Florida metropolitan areas, including Miami, Orlando, and Tampa. Sky-high-priced San Francisco beats out Atlanta and Chicago, two solid residential markets recently suffering from softened demand. Dallas (oversupply), Boston, and Philadelphia (hard-to-build Northeast markets) score only mediocre ratings, while Detroit finishes last, just ahead of Pittsburgh, Milwaukee, and Cleveland.

The Best and the Rest

Washington, D.C.

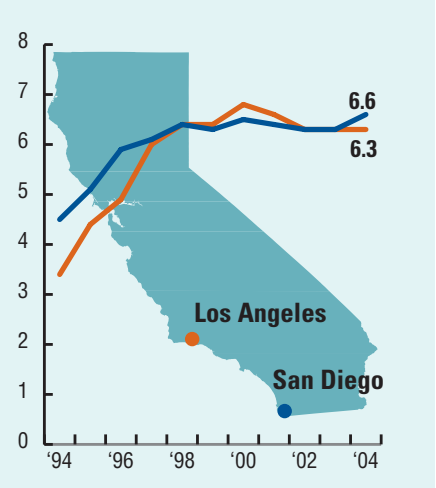
For the third consecutive year, the nation's capital ranks as the country's number-one real estate market for investment, development, supply/demand balance, and homebuilding. When economic downturns hit, this recession-proof government mecca always rises to the top of the survey. Now, the slow-motion recovery helps keep the District of Columbia on top. It may be real estate's equivalent of Treasury bills. Regardless whether Republicans or Democrats control this town, federal employees and lobbyist contingents proliferate. Budget deficits and tax cuts can't slow this engine down. Neither do the Homeland Security color-coded terror warnings. In fact, the metropolitan area leads the nation in employment growth and downtown rates as the only U.S. office market with a vacancy rate below 10 percent. Office investors who bought three years ago at seeming nosebleed levels have "hit the ball out of the park," attracting "nutty" resale prices. But "a ton of construction" tempers some outlooks. Condominium development "is on fire." Maryland and Virginia suburbs score well, too, "although prospects decline 20 miles outside the core." Suburban office vacancies track down into the less comfortable mid-teens. Apartment markets remain close to equilibrium. How long can this market "keep exceeding expectations"?



Southern California

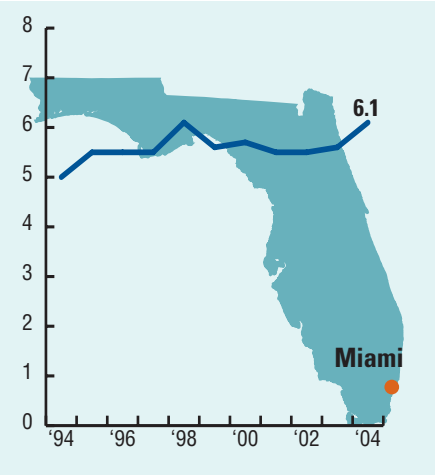
Some demographers predict this Pacific Coast powerhouse agglomeration could add the population of two Chicagos in the next 20 years. Development pushes well into the desert—finding infill tracts and entitling them can be daunting. Affordable housing remains difficult to locate even at the fringes. Demand exceeds supply and annual home prices have appreciated 20 percent or more in each of the past three years. Inland Empire and Orange County top national apartment markets. "For-sale housing is a no-brainer, but higher interest rates could slow things down." If ever an area promises to densify, southern California is it, NIMBY animus or not. San Diego noses out Los Angeles and Orange County as the region's top market. Biotech, defense, and engineering-related businesses step up leasing. Downtown expands residential neighborhoods, becoming "nearly a 24-hour city." The Gaslight District and harbor offer delightful backdrops, while the 75-degree, blue-sky weather is always "perfect." Downtown L.A. continues to struggle. "It's a 24-hour city every three days." The presence of new high-rise residential oriented to singles, a rail transportation hub, and Disney Symphony Hall suggests progress. But an absence of schools and supermarkets indicates a lack of critical mass. Companies favor submarkets closer to high-end residential neigborhoods like West L.A., Century City, Glendale, and Pasadena. The less executives need to battle round-the-clock traffic congestion the better for them. Regionwide, office vacancies remain in the mid to high teens. Rental increases may not register until year-end 2005 in San Diego and mid-2006 in Orange County. Los Angeles markets could take longer. The L.A. basin features the nation's

best industrial warehouse market with sub–5 percent vacancy. "L.A. and Long Beach ports continue to crank." Retail is "unbelievable" and hotels are "fabulous." Meanwhile, the country's worst traffic and air pollution, looming water shortages, and the state's ongoing fiscal problems raise questions about future quality of life that may confound even the Terminator, who has made some inroads in taming an "antibusiness" environment. But that's the future. "Right now, I can't think of a better place to own real estate," says an interviewee.



South Florida

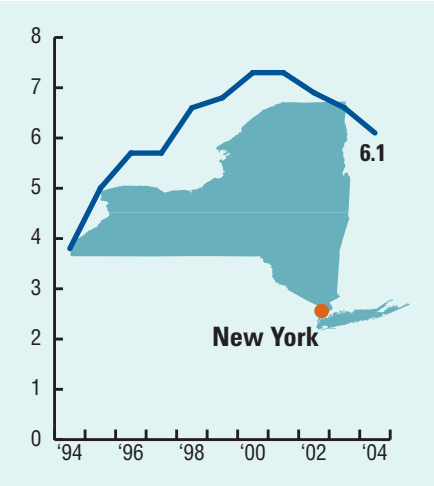
Hot as a pistol, Miami and south Florida score their highest *Emerging Trends* ranking ever. Luckily, the area dodged direct storm damage from Frances and Jeanne. Investors realize the area is hemmed in by geographic barriers—the ocean and the Everglades. Buildout, fueled by both domestic and Latin in-migration, leaves limited development opportunities. A 30-year spurt of rampant growth has left the region a hodgepodge of densely packed suburbs with embedded urban cores. "What does it tell you that they are now building high rises between Daytona and Jacksonville?" Hurricane threats aside, coastal areas with ocean views and golf resorts are ground zero for baby boomers securing second homes for later retirements—a smart move since demand will only intensify for the best locations. Institutional investors and private buyers focus on multifamily opportunities, driving up prices. In Miami, too much condominium construction crowds out office, which "offers better investment value." Good airports, cultural diversity, and a vibrant Latin business center link the area into international highways for commerce and tourism. Overall, the Florida story looks compelling—more than 900 net new residents pour into the state daily. Homebuilders love it. In Tampa and Orlando, tourists never seem to leave. The panhandle probably is the last, best development opportunity remaining in the entire country. But the state must deal with a host of discomfiting issues: growth management, water shortages, limited mass transportation, and care for increasing numbers of seniors who live longer and deplete retirement nest eggs. "The elderly population is a mixed blessing—they don't burden the schools, but they do stress the Medicaid system." Higher taxes and critical infrastructure issues loom like destructive tropical storms in the summer months. Some paradise is still better than none.



New York

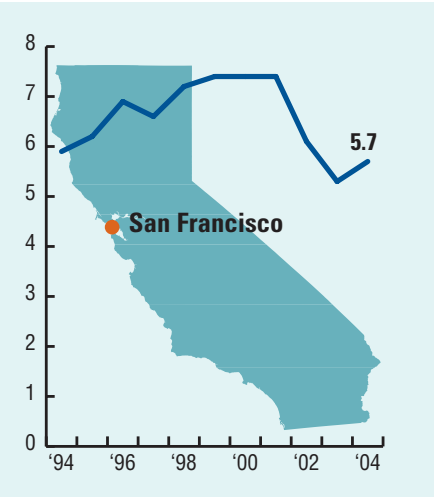
This global finance center "pounces at recovery," a good thing given the prices buyers have been paying on midtown office buildings. "All the investment banks" hunt for space to expand—"leasing could explode." Bank of America builds a major west side office project, "recognizing the city's financial clout and international stature." Goldman Sachs announces a new downtown headquarters. Landlords with well-leased midtown office buildings start to gain leverage, signaling rent upticks ahead—market occupancies edge closer to a healthy 90 percent. Higher-risk downtown lags after 9/11, but some interviewees like its potential. By the end of the decade, a new transit center promises to improve train and subway access comparable to midtown's Grand Central and Penn Station. "The government will continue to pour money in." Residential conversions slowly transform Wall Street caverns. It's by no means a 24-hour market, but stock traders now mingle with occasional dog walkers and even mothers pushing baby carriages. Manhattan condominium and coop prices average north of $1 million—buying activity continued through the stock market tumble and hasn't stopped for a breather. Higher mortgage rates promise to dampen enthusiasm and developers cut back on new projects. Affordable housing remains a major issue—luckily the city's premier subway and train system shuttles in service workers from surrounding boroughs and suburbs. Hotels rebound—occupancies zoom and room rates return to healthy levels. The city weathers a budget crunch and round of higher taxes, but failing schools remain a problem. Suburban housing markets may be overheated.

Office firms up with signs of improved leasing on Long Island and parts of Westchester County. The whole region looks solid. Caveat: if the stock market meanders and financial firms underperform, forecasts could fall short.



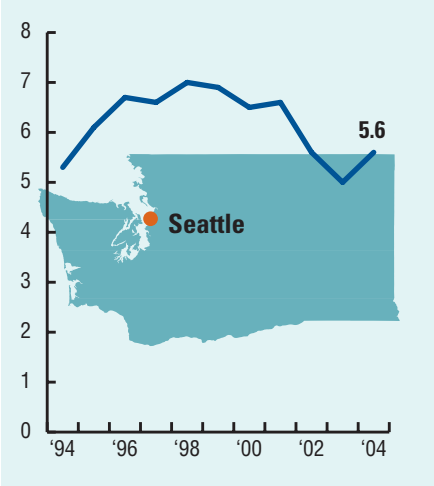
San Francisco

This classic 24-hour city "turns the corner"—the office market finally realizes some positive absorption, and vacancies slip below 20 percent. "Capital market inflation" has maintained lofty office prices, astonishing owners, who had prepared to take a bath. Many hold onto properties thanks to manageable debt service. "Prices are crazy without an economic recovery." Investors "bet that the city will bounce back within three to five years," and hope that rent rolldowns from stratospheric late-1990s levels (remember $100 a square foot? Try $35 today!) don't hurt too much. "Companies will come back, attracted by the quality of life." Planning controls and geographic realities make development difficult. "Everybody wants view [of the Bay] space—these are irreplaceable assets." But south of Market Street "may wait until 2015." Apartments are oversupplied, yet residential values have avoided declines, and retail beckons "a feeding frenzy." Silicon Valley looks like Houston 1986—"a lot of empty buildings." Interviewees expect a strong comeback… "eventually." While the timing ("not immediately") is an open question, the catalyst (high-tech businesses) is not.



Seattle

"Past its worst," this market has restarted in a "slow, broad-based recovery." Boeing and Microsoft step up hiring after a period of layoffs, "tech is stirring," and development has held in check—several major projects were mothballed or halted. Office rent growth will wait until 2006, but industrial should be sooner. "We'll be ahead of San Francisco." Concessions come down. Suburban Bellevue bounces back "more quickly than anyone could have imagined." Smacked around by high area unemployment, apartments show signs of a turnaround. "Absence of significant mass transit is a major liability as traffic worsens." People "definitely look to work closer to home." National investors view Seattle's edge of the Northwest location "as far away" and "almost in nowhere." But its Pacific Rim base makes for a strategic distribution center, facing prime Asian markets.

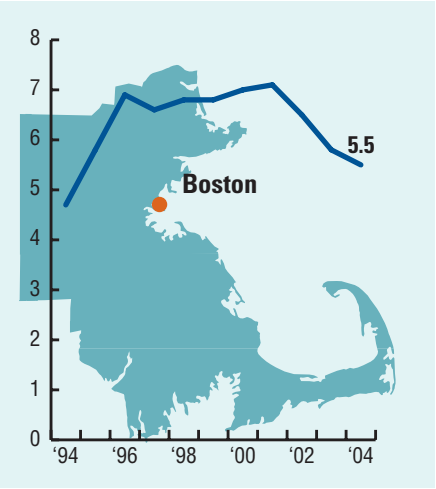


Boston

Like San Francisco, Beantown has been rocked by continuing job losses and tenant downsizings, but investors expect its 24-hour characteristics to fuel a rebound. The market needs sustained growth in its bread-and-butter financial/mutual fund companies to resuscitate it, and nerves fray over the impact of recent high-profile corporate acquisitions from out-of-town buyers: Fleet by Bank of America, John Hancock by Manulife. Consolidations and layoffs "could slow a quick recovery." But mid-teen office vacancies head lower, and a financial district "leasing recovery is underway." "Terrible" suburban office/R&D markets, including the

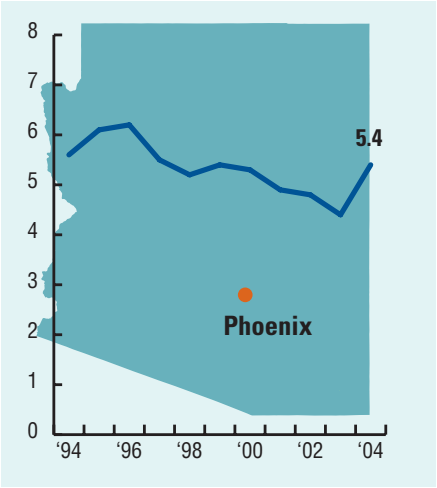
"Phoenix benefits from gains in new jobs and a concerted scaling back of **development.**

"burned-out" high-tech 128 corridor, add a sobering note. Multifamily softens as employment growth sputters, but retail remains healthy. After a heady run, Boston looks like a mixed bag. "You know it will come back—it's just a matter of when."



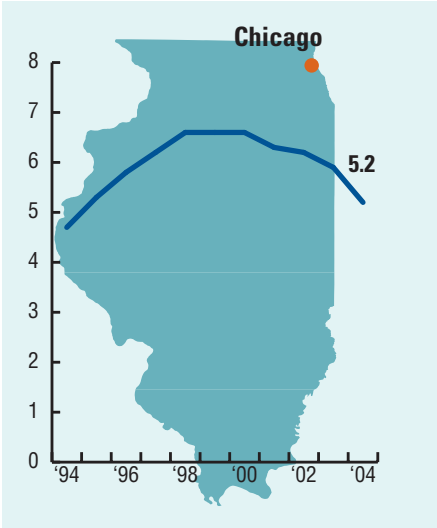
Phoenix

The best of the "hot growth markets," Phoenix benefits from gains in new jobs and a concerted scaling back of development. "We're not overbuilt for the first time in 50 years, other than high-end apartments," says an interviewee. "Zero office is under construction, all the food groups look in relative balance." A loss of local banks has "serendipitously" helped the market, constraining capital for new construction. Money center institutions steer clear "because of the bad rap as a boom/bust market." People, meanwhile, keep pouring into desert haciendas—for the eighth year in a row, 35,000-plus new homes were built, and the area absorbs 150,000 new residents annually. "Water is not an immediate problem." New houses replace farms, reducing irrigation requirements, but what keeps all those championship golf courses green and 400,000 swimming pools full? A desirable climate and reasonable cost of living attract retirees and snowbirds, with more on the way. Scottsdale stands out as the agglomeration's prime market, anchored by affluent residential neighborhoods. Downtown Phoenix is an afterthought—nobody lives there.



Chicago

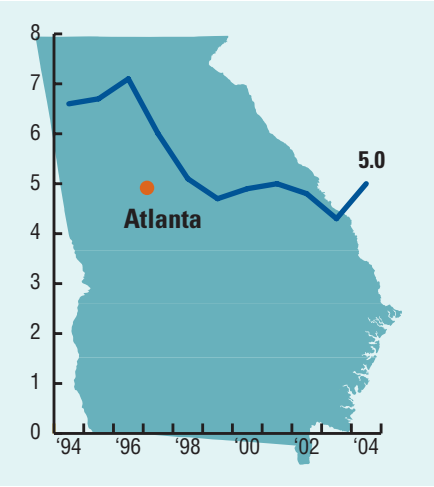
"No cheer in sight." Overbuilding and high vacancy buffet the Windy City, which perennially ranks as a top 24-hour market. Incredibly, the JP Morgan Chase takeover of Bank One leaves this de facto Midwest capital without a major bank headquarters. "Not much else besides law firms are growing." Free rent "has reared its ugly head downtown," while 20 percent–plus suburban vacancy "could take seven years to fill up even with modest growth." Developers keep erecting super Class A towers, which steal tenants from older Class A buildings. "More is on the horizon." Tenants look to lock in low rents in the best possible space. "It's a terrible landlords' market." But "trophy hunter, core" investors keep paying up for well-located buildings. "It's a vibrant place and central national location with a great airport." Get a grip—all signals point to a rocky few years. Condominiums and apartments also are overbuilt. For the longer term, move-back-in strategies take shape. Expect more office buildings near the lakefront to convert to residential with high-end condominium-style water views and good access to North Michigan Avenue shopping. Businesses prefer to cluster near primary train and subway stations in the Loop. Development opportunities will increase just west of the Chicago River. These districts also feature better access to suburban highways for commuters.



Atlanta

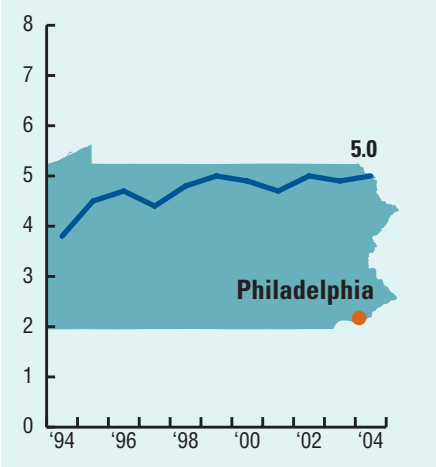
Investors wonder if Atlanta can recapture its share of company relocations and sustain prodigious population gains. Growth and more growth fuel its engine—homebuilding, office and retail development, and road and infrastructure construction have been the region's economic backbone for more than 30 years. Hiring resumes, but not at a torrid pace.

Horrendous traffic, sewer, and water issues hamstring prospects and cloud the city's reputation. "Sprawlscapes" mar the suburban idyll. "It grew up too fast, and now no one seems to know what to do." Housing and apartments are overbuilt across the metropolitan area, but desirable infill condominiums and townhouses in attractive midtown and Buckhead markets "get increasingly expensive." Office investors gravitate to those markets, too—"when it comes to Atlanta, you don't want to be anywhere else." Downtown hurts from lack of residential, an old story. At the city's southern border, Atlanta's busy international airport remains a sturdy ace in the hole, serving as a global transport hub and feeding a national distribution center at the junction of important east-west, north-south interstates. Logically, future development should fill in between the airport and downtown as northern suburbs now extend within hailing distance of remote Tennessee and South Carolina borders. Atlanta's future rests on whether it can redevelop a vital, multifaceted urban core at the center of its suburban jumble.



Philadelphia

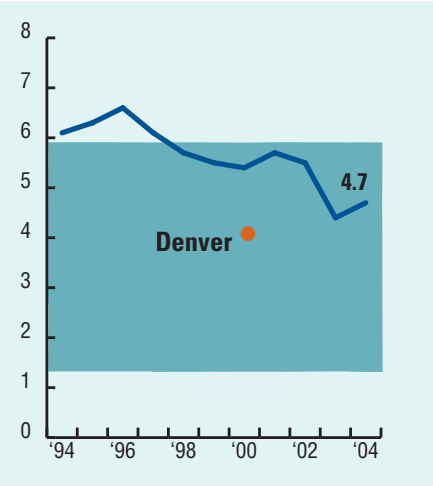
Lost in the glare of New York and Washington, Philly fails to register with most investors. Office and residential markets "are relatively stable and not volatile." Less charitable observers characterize the market as sluggish and stagnant. Several major tenants re-ink leases, but for less space. Downtown housing gets a boost from tax breaks, but high business taxes inflame corporate tenants and landlords. Office vacancy appears manageable, but hotels are "disastrously" oversupplied.



For Dallas, everyone recognizes the reality of **out-of-control** *supply side.*

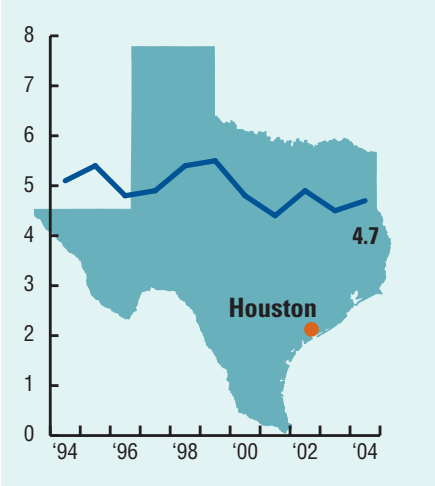
Denver

Ouch—office "is out of whack," vacancies "stink." Denver needs "a new theme" to incubate an upturn and spur job growth. Energy businesses led an early-1980s growth wave before flaming out. Telecom drove prosperity during the 1990s, but "blew up" in consolidations and downsizings. "It's a great place for small- and mid-cap businesses to develop. But then someone buys them and moves them away." Among suburban agglomeration markets, the city takes the lead in creating a "wildly successful" downtown residential district in LoDo—restaurants, shops, galleries, and apartments teem with activity near the new football and baseball stadiums. The pulsating district taps into demand from "the alive and well" empty-nester syndrome. "Its housing market is exploding" in "a paradigm shift to a 24-hour microcosm." No one discounts the positive impact of the city's expanding light-rail system to the suburbs and its LoDo hub. The rest of downtown suffers demand doldrums, while suburban markets wallow in a flood of empty space. Housing and multifamily markets overshoot, "but not badly." Attractive Rocky Mountain lifestyles and a reasonable cost of living raise hopes that demand can pick up, but the area sorely needs a catalyst.



Houston

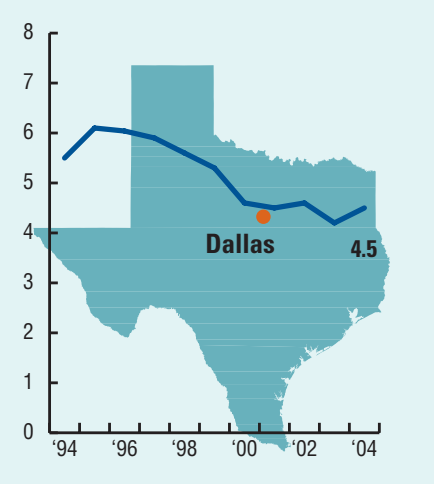
"The best of the Southwest." Well, no. Austin actually rates higher. But what does that say about Dallas? Office vacancies gyrate above 20 percent and apartments are overbuilt. Investors find solace in the Citgo headquarters relocation from Tulsa, an expanding downtown light-rail system, and new downtown condominium developments. But CBD residential still lacks a critical mass. The easy-to-build environment and lack of zoning controls concern institutional investors and give a wide-open playing field to homebuilders.



Dallas

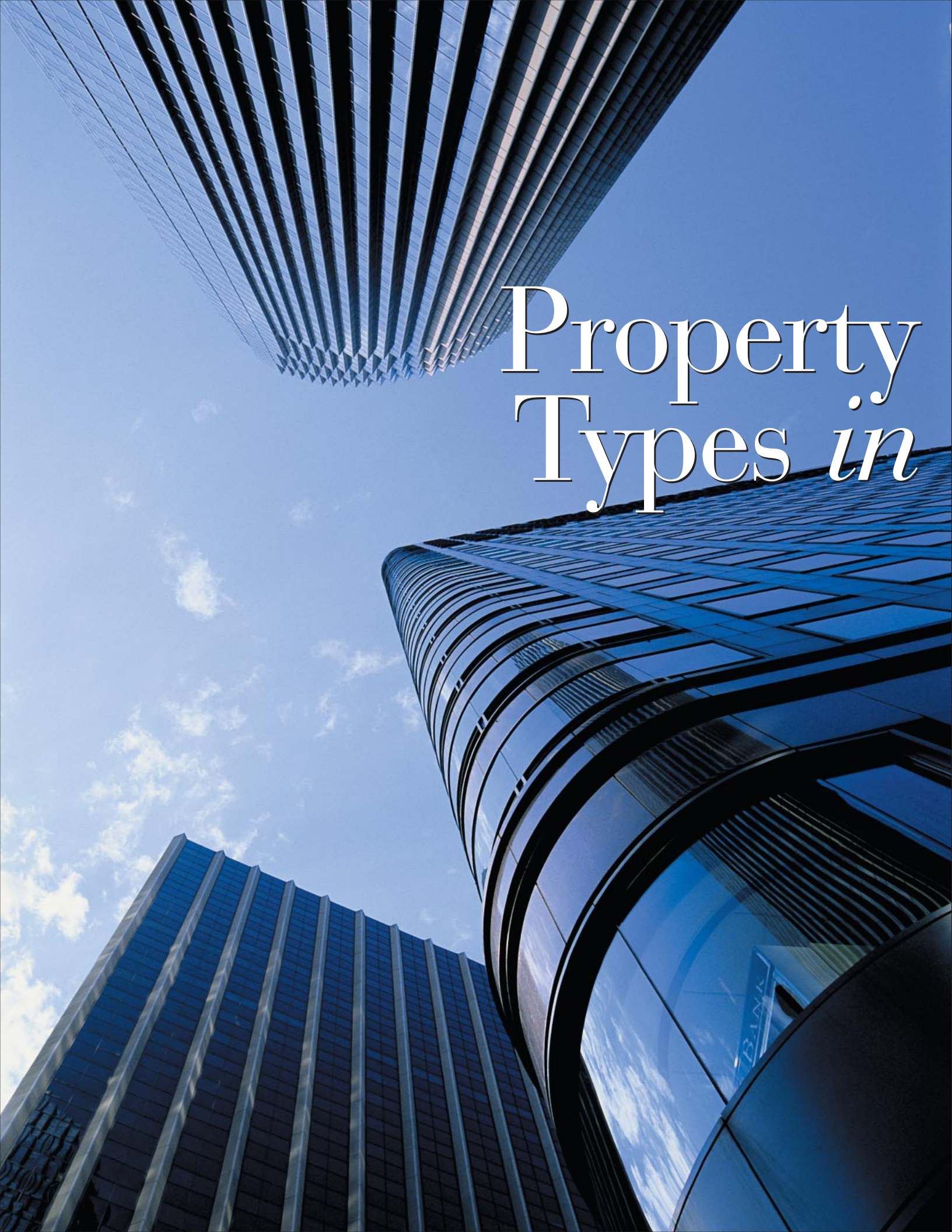
"Anybody can buy at 49th and Park Avenue in Manhattan and not look bad," says a Dallas developer. "Here it's a timing game, more challenging and fun." Care to negotiate with that man? For many investors, getting the timing right is more difficult, and fun has been hard to achieve. "The window of opportunity keeps narrowing. You've got to get in and get out faster and faster." Submarkets offer little distinction—"leasing comes down to what's cheapest for tenants." And you want to be a landlord here? DFW Airport helps attract big corporations that shy away from Austin, San Antonio, and even Houston because of fewer direct flights to key cities. Locals point to more growth—forecasts project close to 1.5 million additional residents by 2010. Apartment and single-family developers lick their chops. But not so fast: Recent job gains have been anemic—only 8,700 new jobs were added in the one-year period ending June 2004. Washington, D.C., meanwhile, added 83,000, Phoenix

42,000, and Houston 15,000. The region's total lack of development restraints—geographic or governmental—results in chronic overbuilding across all property types. Does office vacancy ever track below 20 percent? For Dallas, everyone recognizes the reality of out-of-control supply side. For 2005, the bigger issue is whether demand will reignite.



The Rest

Las Vegas receives high marks as the metropolitan area topping percentage employment growth. How long can Vegas buck the competition from new Indian tribe gambling enterprises and states, looking to close budget gaps and enhance revenues? Wayne Newton sings his heart out to keep people coming. Honolulu gains from a rebound in the Japanese economy and weak U.S. dollar—foreign and domestic tourists are back. Sacramento strengthens off state capital status and Arnold power. Tampa/St. Petersburg and Orlando benefit from the Florida influx. Baltimore benefits from D.C.'s aura and gains an enduring boost from harbor development. Austin's growth controls have limited impact, since surrounding suburbs seem to sprawl anyway. But the Texas state government and University of Texas solidify an increasingly attractive urban core. Charlotte and Raleigh stay in Atlanta's shadow, but the Carolina corridor grows as an inviting retirement destination—except for all those hurricanes. Nashville and San Antonio don't have scale or location advantages to get on radar screens. After Chicago, Minneapolis is the best in the Midwest. Survey respondent ratings scrap the Rustbelt, again.



Property Types *in*

"Infill and intown housing tops survey development scorecards."

Perspective

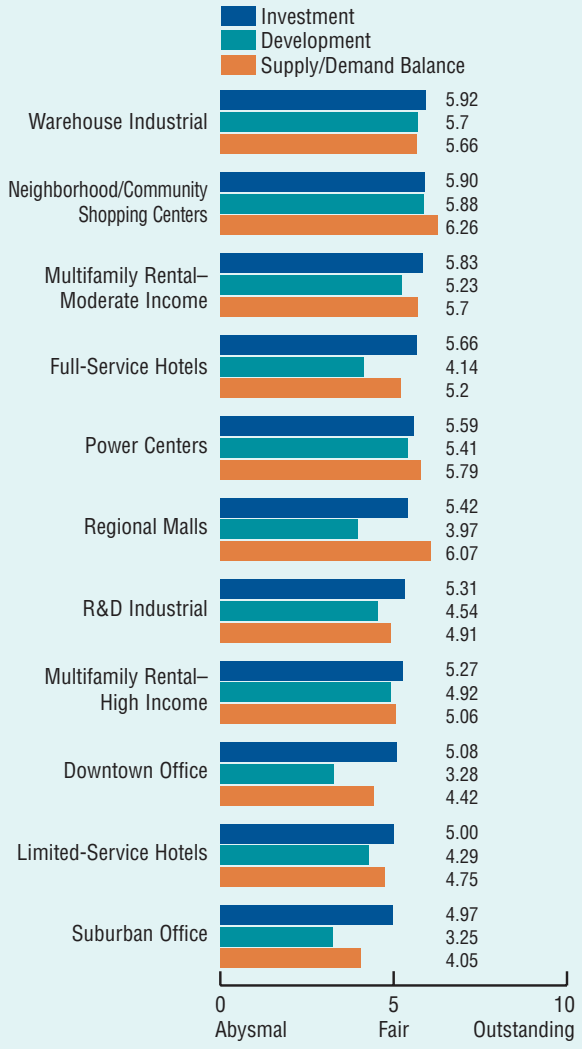
Investment prospects improve across all property types for 2005, compared with more tentative outlooks in the 2004 *Emerging Trends* survey. Interviewees expect an expanding economy to heighten leasing activity and increase occupancies in recently challenged sectors—industrial, apartments, hotel, and office—and sustain solid returns in retail segments. Investment ratings cluster in a narrow sub-six band (on the *Emerging Trends* rating scale, with one equaling abysmal to ten equaling outstanding) indicating modestly good near-term performance. (See Exhibit 5-1.) As markets move closer to equilibrium and interest rates increase, investors may face the anomalous scenario of realizing lower, albeit still very acceptable, risk-adjusted returns. Everyone will monitor capital flows and cap rate response to rate hikes. Development outlooks for 2005 improve marginally for most commercial categories, although office stays weak. The specter of rising interest rates fails to dim enthusiasm for homebuilding, which scores favorable modestly good to good ratings across most housing development categories led by infill/intown and moderate-income single-family housing.

Coupon Clippers Favored

Survey respondents continue to favor core-return investments—industrial warehouse/distribution centers (5.9 rating), neighborhood grocery-anchored retail (5.9), and moderate-income rental apartments (5.8). Given buyer demand and cap rate compression, these sectors offer "modestly good" bondlike, coupon-clipper income returns. Investors pay up for their predictable yields and steady performance. More volatile, full-service hotels (5.7) take the biggest survey leap. Interviewees anticipate continued gains in occupancies and room rates to register from stepped-up business travel and tourism. Enthusiasm lingers for all retail categories, which have benefited from the enduring consumer push. Power centers enjoy their highest-ever rating (5.6), slipping ahead of regional malls (5.4), which also score improved marks over last year's report. Office categories and R&D industrial face only "fair" outlooks. High vacancies and muted tenant demand portend an extended recovery. Overbuilt in many markets, high-income rental apartments receive relatively tepid marks (5.2). Limited-service hotels (5.0) always rank near the survey bottom—they're too easy to build and always oversupplied.

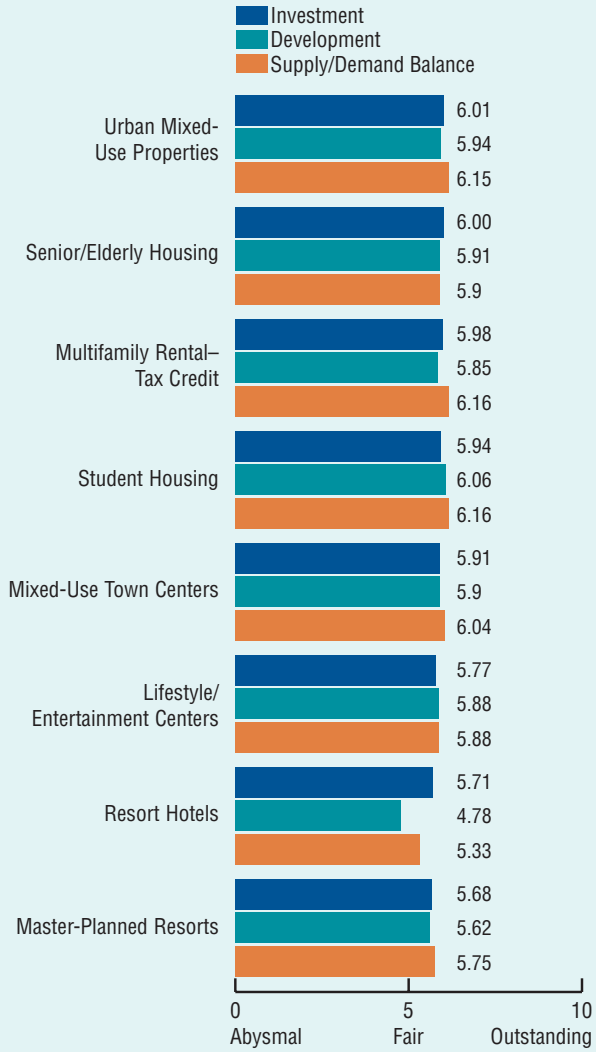
"Interviewees lean toward disposing hot retail sectors and **high-income** *apartments*

Exhibit 5-1 **Prospects for Major Property Types in 2005**



Source: Emerging Trends in Real Estate 2005 *survey.*

Exhibit 5-2 **Prospects for Niche and Mixed-Use Property Types in 2005**



Source: Emerging Trends in Real Estate 2005 *survey.*

Predictably, warehouse, neighborhood shopping centers, and moderate-income rental apartments score lower investment risk, while hotels, R&D, and office rate as dicier investment plays. Deal cap rates generally fall in line with risk/return sentiments: apartments, malls, neighborhood centers, and warehouse fetch the richest pricing ratios, while hotels lag despite optimistic forecasts. Investors will continue to pay premiums for well-leased downtown office over more commodity suburban. (See Exhibit 5-3.)

For 2005, hotels should garner the biggest gains in income growth and appreciation, according to survey respondents and interviewees. Office cash flows are expected to decline as rents roll

at apparent market zeniths."

Exhibit 5-3 **Capitalization Rate Characteristics in 2004**

	BID	ASK	SPREAD (basis points)	DEAL
Apartments–High Income	7.3%	6.6%	70	7.0%
Regional Malls	7.6	7.0	60	7.2
Apartments–Moderate Income	7.6	6.9	70	7.3
Neighborhood/Community Centers	8.1	7.4	70	7.7
Downtown Office	8.3	7.7	60	8.0
Warehouse Industrial	8.5	7.7	80	8.0
Power Centers	8.6	7.9	70	8.2
Suburban Office	9.1	8.3	80	8.8
R&D Industrial	9.3	8.5	80	8.9
Hotels–Full Service	9.9	8.8	110	9.3
Hotels–Limited Service	10.7	9.6	110	10.2

Source: Emerging Trends in Real Estate 2005 *survey.*

Exhibit 5-4 **Expected Change in Property Values and Income in 2005**

	Values %	Income %
Hotels–Full Service	4.6	5.1
Land	2.9	na
Hotels–Limited Service	2.8	3.1
Neighborhood/Community	2.3	2.2
Apartments–Moderate Income	2.0	2.1
Warehouse Industrial	1.8	1.6
Apartments–High Income	1.7	2.0
Regional Malls	1.3	2.1
Power Centers	1.1	1.6
R&D Industrial	0.7	0.6
Downtown Office	0.0	-0.2
Suburban Office	-0.5	-0.5

Source: Emerging Trends in Real Estate 2005 *survey.*

down. Surveys also anticipate that downtown office values will stagnate, and suburban values will fall slightly. Other categories generally will realize only modest income and value increases.

Buy, sell, hold attitudes are mixed on the various property sectors, despite the survey's strong overall sell signal. Interviewees lean toward disposing hot retail sectors and high-income apartments at apparent market zeniths, while holding other segments as markets improve. "Where else can you invest the proceeds?" Buying sentiment is extremely subdued except for land acquisitions—"prepare for the next development wave." Will capital flows catch on?

Development: Commercial Blahs, Housing Fervor

Commercial development activity may gain some momentum in 2005 given relatively dormant levels in most sectors, but interviewee enthusiasm remains restrained. Except for apartments, new construction has been controlled and disciplined in the face of uncomfortably high vacancy rates. Until markets achieve better supply/demand balance, investors are more focused on buying land, gaining entitlements, and planning projects rather than funding construction. Above-replacement-cost pricing on industrials could encourage new warehouse building in some markets despite high vacancies. Any retail development will trend to recasting dated concepts or morphing failed malls. Most office is a nonstarter absent large anchor tenants. Apartment builders will keep busy, anticipating an expected demand surge.

Development outlooks for the housing markets stay more buoyant. Optimism holds fast that interest rates will not rise dramatically enough to abate demand driven by changing demographic patterns and fervor for second homes. Interviewees keep their fingers crossed that hiring and wage gains materialize so that even more Americans can satisfy the national homeownership obsession.

Infill and intown housing tops survey development scorecards—the move back in toward 24-hour cores by empty-nester baby boomers and their out-of-the-nest offspring cannot be ignored.

Affluent baby boomers may downsize from suburban living to smaller apartments and townhouses near urban action, but they also seek vacation and weekend houses as well as condominiums, which can become their retirement homes. Leisure home projects take off.

Traditional single-family housing projects should hold demand as long as interest rates remain manageable. Americans continue to aspire to big houses on big lots. But fasten your safety belts over the impact of higher interest rates on starter home sales. Also, the baby boomer/echo boomer trends run counter to *Leave It to Beaver* suburban lifestyles.

Master-planned and new urbanist communities tap into rising homeowner demand for neighborhoods featuring more integrated land uses and access to convenient amenities. People seem willing to pay premiums for better planning.

"Vacancy rates remain stubbornly high for the sector, but will edge below **10 percent**

Industrial

Strengths

A strong income play and relatively safe bet, warehouse investments look like long-term bonds with excellent risk-adjusted returns. Owners "always have an exit strategy." Core buyer demand, especially from institutions, seems "insatiable," fortifying values. Despite lingering high vacancies—above 10 percent in many markets—rents hold up. Newer, high-ceiling product in major hubs fares much better. As company inventories rebuild and the economy improves, occupancies will rise. "Industrials track the GDP, and should do well at this point in the cycle." Offshored manufacturing doesn't affect domestic delivery since imported goods still need distribution networks.

Exhibit 5-5 Prospects for Warehouse Industrial in 2005

	Prospects	Rating	Ranking
Investment	Modestly Good	5.92	1st
Investment Risk	Modestly Good	6.08	1st
Development	Modestly Good	5.70	2nd
Supply/Demand Balance	Modestly Good	6.26	5th
Expected Income Change 2005		1.6%	
Expected Value Change 2005		1.8%	
Deal Cap Rate 2004		8.0%	

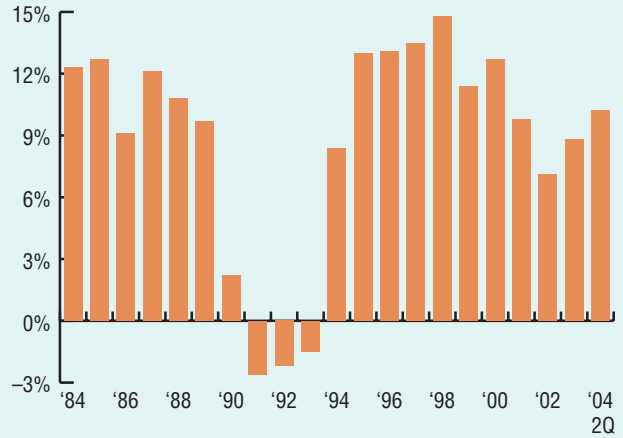
Buy	Hold	Sell
37.9%	34.9%	27.2%

Source: Emerging Trends in Real Estate 2005 *survey.*

Weaknesses

"Cap rates are so low, you can't afford to buy." Some recent purchasers may have overpaid. "Pricing is over their skis." Vacancies "are too high to feel warm and fuzzy." Industrials usually lead a real estate market rebound, but the economy hasn't cooperated—yet. Watch out for new development,

Exhibit 5-6 NCREIF Warehouse Returns



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

**2004 returns are four-quarter trailing figures as of second-quarter 2004.*

which could delay full-scale recovery. Construction may ignite in some markets, given pricing for existing product well above replacement costs. Investors have trouble accumulating sizable-enough portfolios to provide adequate diversification. In the current low-cap-rate environment, small one-off deals, which fail to create critical mass, rate as "the most overpriced real estate." "To buy meaningful portfolios, you must take the lemons mixed in with the cherries." Just-in-time technologies continue to erode viability of "old school" warehouse space. "Be careful, these are not necessarily buy-and-hold-forever investments."

Best Bets

Acquire or hold new, higher-ceiling space—24-foot clear is minimum, 30-foot clear is better. Wide turning radii and ample parking for oversized trucks are essential. Tenants want space that facilitates distribution, not storage. Concentrate on coastal intermodal markets—near ports, airports, rail lines, and interstates. Confluence points are ideal. "Follow the path of goods movement for the best locations." Investors gravitate to the top-tier "big box" markets, typically near 24-hour cities, which service primary population centers: Los Angeles/Inland Empire (numero uno), northern New Jersey, Chicago, and San Francisco. Miami and Seattle are also strong plays. Two important air/interstate hubs, Atlanta and Dallas, get marked down for "absent development constraints" and "excessive supply."

in 2005."

Exhibit 5-7 **Warehouse Construction Put in Place**

Source: U.S. Census Bureau.

Avoid

Older lower-ceiling, long-term storage space is extremely vulnerable. Tenant requirements—super-flat floors, flexibility for racking systems—have "become more funky, driven by logistics technologies." Obsolescence risk increases with developer appetites. Sell out or look to redevelop, if you can.

Secondary and tertiary warehouse markets fall victim to investor tunnel vision for overweighting major hubs. New distribution schemes also continue to cut out warehouse links and reduce demand for space in more fringe areas.

Development

Development offers opportunities with better rates of return than buying existing product. Recent buyers have paid well above replacement cost. New projects can offer bells and whistles, undercut existing competition on rents, and operate at a lower cost of capital. "Get good sites and entitlements." First-wave projects could score on long-term leases, before markets get overheated. Focus on the top markets.

Warehouse Outlook

Vacancy rates remain stubbornly high for the sector, but will edge below 10 percent in 2005. Development plays the wild card, potentially offsetting increasing tenant demand with new supply. Pension fund appetites will help support values, but steamy pricing may level off. An improving economy can only benefit the industrial markets. No wonder this sector regains the top investor sector ranking.

R&D Outlook

Interviewees pan "weird" R&D: "Hate it, just hate it." "What is it there for?" "Just lousy." Hmmm. Doesn't sound good, but maybe it's time to make a contrarian move. Historically, performance can accelerate quickly when high-tech businesses start expanding their operations—early 1980s and mid-1990s R&D returns were off the charts. R&D performance has slumped for four years, but returns have begun to recover after bottoming out in 2002. "Painful consolidations are over." 2005 may be a good year to rummage through the tech-wreck remains. Software, hardware, and chip companies remain America's best hope for energizing the economy and a comeback is inevitable. "At the very least, tight-fisted businesses will need to reinvest in IT to stay competitive." Some 20-something genius in a Silicon Valley flex office cube will figure out the next new something. "You've got to believe in the long-term health of R&D, it's just a matter of when." But next time, when your investment in that oddly configured R&D building starts delivering 20 percent–plus returns, just sell as quickly as possible.

Exhibit 5-8 **Prospects for R&D Industrial in 2005**

	Prospects	Rating	Ranking
Investment	Fair	5.31	7th
Investment Risk	Fair	5.16	9th
Development	Fair	4.54	6th
Supply/Demand Balance	Fair	4.91	8th
Expected Income Change 2005		0.6%	
Expected Value Change 2005		0.7%	
Deal Cap Rate 2004		8.9%	

Buy	Hold	Sell
26.4%	41.1%	32.5%

Source: Emerging Trends in Real Estate 2005 *survey.*

*"**Retail** is a solid hold, but a better sell."*

Retail

Strengths

Retail is the only property sector in relative equilibrium. Development still trends down after hitting near-record highs in the late 1990s. Consumer spending has been mind boggling, bolstering "strong credit" retailers that fill malls and power centers. Even dinosaur department stores resuscitate in the shop-till-you-drop fury. "Just as real estate people get rid of a Mercedes as a last resort, Americans give up going to the regional shopping center only if they have nothing to spend." Shoppers have been "using their homes as giant ATMs." After all the tax cuts and mortgage refinancings, future growth now depends more on whether the economy produces new jobs with higher wages. Interviewees are reasonably encouraged. Huge value increases may be over, but fortress malls pump income and infill-neighborhood centers, sheltered from new competition, print cash. You know the old story: Everybody needs that quart of milk and pound of hamburger meat.

Exhibit 5-9 Prospects for Neighborhood/ Community Shopping Centers in 2005

	Prospects	Rating	Ranking
Investment	Modestly Good	5.90	2nd
Investment Risk	Modestly Good	6.02	2nd
Development	Modestly Good	5.88	1st
Supply/Demand Balance	Modestly Good	6.26	1st
Expected Income Change 2005		2.2%	
Expected Value Change 2005		2.3%	
Deal Cap Rate 2004		7.7%	

Buy	Hold	Sell
28.9%	32.0%	39.1%

Source: Emerging Trends in Real Estate 2005 *survey.*

Weaknesses

"Pricing has been incredible without regard to risk." At this point, any investments are pure income plays—and length of retail leases holds back the rate of growth. Interviewees worry about the nation's "excessive credit card debt." Retail missed the last recession, but consumer spending may take hits from higher energy prices and rising debt service costs. Mall REITs corner the market on regional centers and shopping center REITs make inroads at controlling better grocery-anchored portfolios. Good buying opportunities "are few and far between." Short consumer attention spans force costly capex changes in retail formats, which then "get stale after three visits. When will tea replace coffee?" As if Wal-Mart incursions weren't enough of a competitive haymaker, now Target and other discounters enter the supercenter market, further threatening weakened grocery anchors. Supermarket balance sheets look shaky. A chain bankruptcy and/or mass store closings "could change everybody's view of neighborhood retail very quickly."

Exhibit 5-10 Prospects for Power Centers in 2005

	Prospects	Rating	Ranking
Investment	Modestly Good	5.59	5th
Investment Risk	Modestly Good	5.63	5th
Development	Fair	5.41	3rd
Supply/Demand Balance	Modestly Good	5.79	3rd
Expected Income Change 2005		1.6%	
Expected Value Change 2005		1.1%	
Deal Cap Rate 2004		8.2%	

Buy	Hold	Sell
14.3%	28.2%	57.6%

Source: Emerging Trends in Real Estate 2005 *survey.*

Best Bets

"Hold, hold, hold" the 200 or so fortress malls. Cap rates stay low. "It's all academic, since major mall REITs vacuum up most of the best centers" and "never sell or harvest returns." Don't waste your time trying to buy a market-dominant mall. One-off buyers can't compete against the big public owners in acquisitions or leasing. "The big guys have too much clout." Owners with small mall portfolios should take the opportunity to sell out or joint venture with a REIT powerhouse, which can use substantial portfolio leverage to sign up the best tenant lineups from major national chains. Consider disposing of all non-strategic assets.

Sell B and C malls at market top. "Many of these centers have no reason to be in business," says a REIT CEO. Despite the recent buying flurry for anything with a lighted food court, all the established downward trends—death spiral competition

Exhibit 5-11 Prospects for Regional Malls in 2005

	Prospects	Rating	Ranking
Investment	Fair	5.42	6th
Investment Risk	Modestly Good	5.68	4th
Development	Modestly Poor	3.97	9th
Supply/Demand Balance	Modestly Good	6.07	2nd
Expected Income Change 2005		2.1%	
Expected Value Change 2005		1.3%	
Deal Cap Rate 2004		7.2%	

Buy	Hold	Sell
9.1%	38.0%	52.9%

Source: Emerging Trends in Real Estate 2005 *survey.*

from fortress centers, high capital costs for little return, bleeding tenants—kill prospects for weaker malls. Buyers need to implement rational reuse schemes or will take a bath. Second- or third-tier centers with good access, visibility, and parking can be redeveloped into power or lifestyle centers or mixed-use projects with residential and retail components. "Their value is no longer as regional centers."

Sell power centers. They remain vulnerable to retail Darwinism, if consumers cut back and category-killer profits take a hit. Cap rates are too low under any circumstances. Despite higher risk from potential loss of big-box tenants, these centers are priced almost like grocery-anchored retail. Be selective about investments in popular lifestyle centers, which are sprouting in many locations. The market is definitely moving in this direction, but the formula is not as tried-and-true as that of other retail formats.

Sell neighborhood centers with weak supermarket anchors and/or located in markets vulnerable to supercenter incursions (areas with sites big enough for a stand-alone hypermarket). Watch the three- to five-mile radius Wal-Mart "kill zone." A minority view suggests scoping out markets already invaded by Wal-Mart to acquire neighborhood centers left standing after the dust has settled. "The damage will have been done."

Avoid

"Paying up for neighborhood centers is like playing Russian roulette." Investors may get yield, but the Wal-Mart threat is a huge risk at current pricing. In general, "retail has been overplayed." Survey respondents and interviewees warn about power centers, too: only 14 percent of survey respondents say buy versus a 58 percent call to sell.

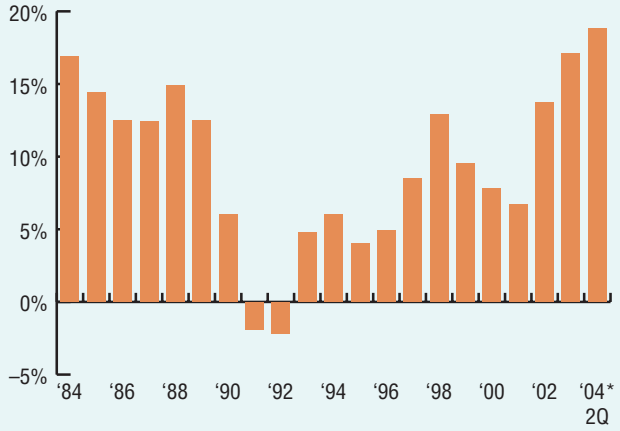
Development

America is still grossly overretailed on a sales-per-capita basis, but new strip centers and power centers keep getting built. Investors should focus on redeveloping tired or failed concepts, rather than bankrolling new construction. "Do we really need any more Home Depots or Bed Bath & Beyonds for a while?" Built-out suburban areas call for infill rehab concepts to revitalize badly aging corridors of strip centers. Lifestyle retail in mixed-use developments offers good potential to tap into the affluent move-back-in crowd. Developers bulldoze any lingering notions for new regional malls. With few exceptions, environmental and land use restrictions make these projects untenable in many places. Entitlements take forever.

Outlook

Americans spent through the last recession. Maybe finally they will need to take a breather in 2005 as fiscal stimuli—namely, the effects of tax cuts—lose some punch. A modest economic expansion may not offset temporary consumer fatigue, maxed-out credit, and higher gas and heating bills. Expect stabilizing property values and cash flows. Investor returns settle down to earth, facing more downside risk than opportunity for further upside. Retail is a solid hold, but a better sell.

Exhibit 5-12 NCREIF Retail Returns



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

**2004 returns are four-quarter trailing figures as of second-quarter 2004.*

"Apartments *will come back, but not real fast."*

Apartments

Strengths

Even if doctor syndicates back off as expected, institutional demand will stimulate ebullient pricing. Like industrials, buyers are never in short supply—the capital market risk is less than that for either office or retail. Higher mortgage rates hearten multifamily investors: would-be homebuyers may shelve plans and keep renting. Any economic gains boost renters' situations, too: echo boomers can leave home or stop doubling up. Concessions and free rent periods start to wear off in many markets. Everyone loves the demographic profile: the young adult renter cohort proliferates. "Baby boomers' kids are starting to graduate from college" and marry later. "You have a ten-year window of opportunity before a drop-off." Although richly priced, multifamily is "a great coupon clipper."

Weaknesses

"Just say 'no' for the next two years." Capital markets have "ignored the punishment" to rental rates. Some rental growth assumptions can't be sustained and new construction has not slowed since the early-1990s recession. "Pricing has already factored rental growth from rising interest rates." Multifamily pricing is "almost absurd" at sub-six cap rates without any diminution of new supply—developers continue to build. Institutions look to tertiary markets to force money out. Property values may flatten. Delinquencies have not peaked.

Best Bets

Focus multifamily acquisitions on B and C apartments in high-cost housing markets with ample demand from permanent renters: southern California, the San Francisco area, the entire Northeast 24-hour market megalopolis, and Chicago. Concentrations of prime immigrant renters support these markets, where entry-level buyers will be priced out of homeownership. Hold these investments to tap into increasing renter demand, and sell over the next five to seven years when the generation Y demographics start to look less favorable. These investments could be excellent value plays.

Exhibit 5-13 **Prospects for Moderate-Income Apartments in 2005**

	Prospects	Rating	Ranking
Investment	Modestly Good	5.83	3rd
Investment Risk	Modestly Good	5.85	3rd
Development	Fair	5.23	4th
Supply/Demand Balance	Modestly Good	5.70	4th
Expected Income Change 2005		2.1%	
Expected Value Change 2005		2.0%	
Deal Cap Rate 2004		7.3%	

Buy	Hold	Sell
33.2%	34.7%	32.1%

Source: Emerging Trends in Real Estate 2005 *survey.*

Exhibit 5-14 **Prospects for High-Income Apartments in 2005**

	Prospects	Rating	Ranking
Investment	Fair	5.27	8th
Investment Risk	Fair	5.32	6th
Development	Fair	4.92	5th
Supply/Demand Balance	Fair	5.06	7th
Expected Income Change 2005		2.0%	
Expected Value Change 2005		1.7%	
Deal Cap Rate 2004		7.0%	

Buy	Hold	Sell
17.3%	34.0%	48.7%

Source: Emerging Trends in Real Estate 2005 *survey.*

Condominiums make sense in high-cost housing markets like New York, D.C., and San Francisco. South Florida shows temporary signs of overbuilding and high levels of speculative buying, but over time anything with water views and barriers to entry works. Hurricane trauma also tends to remedy quickly. Baby boomers/empty nesters have lifestyle visions of urban pied-à-terres within walking distance of cultural institutions

and fine restaurants and wintertime retreats with ocean vistas near golf courses. But be careful—"condominiums are popping up all over the place."

Avoid

High-end condominium conversion plays in hot growth housing areas like Dallas and Atlanta. In these metropolitan areas, higher price points attract a limited market and higher interest rates could curtail already weak demand. Lower price points may sell better, attracting singles and empty nesters, "but not at $500,000." Converters get left with expensive rental units, which can go begging. "If you own apartments, that will be your competition." Chicago's condominium market is also overdone. "Everybody and his grandmother call me every day for condo financing," says a mezzanine debt investor. "You know it's time to get out" or at least back off in many markets.

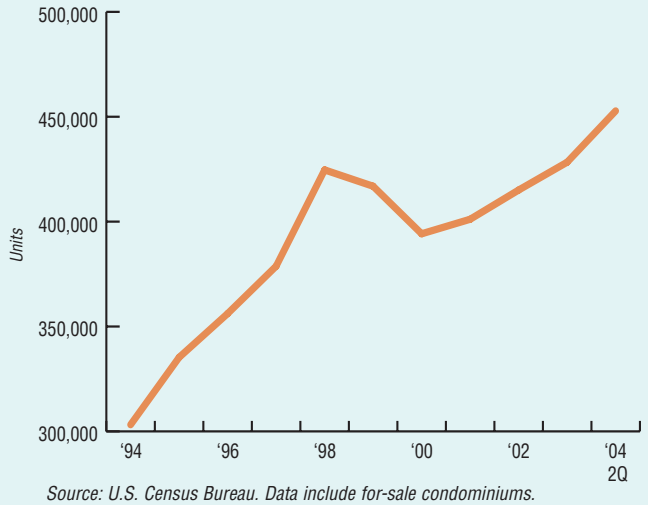
Development

The multifamily sector always puts the touch on construction lenders. "It's the one property sector where developers can get easy money." Less disciplined local banks can swallow the moderate loan amounts. Despite renter softness, developers build more than 450,000 units, up from about 400,000 in 2001. Affordable housing shortages run rampant nationwide, but high-end product is overbuilt. Demand will increase for moderate-income projects as mortgage rates creep ahead. Finding and entitling sites in prime infill areas becomes an increasing challenge. Any projects in southern California almost cannot miss, but it's tough to win approvals.

Outlook

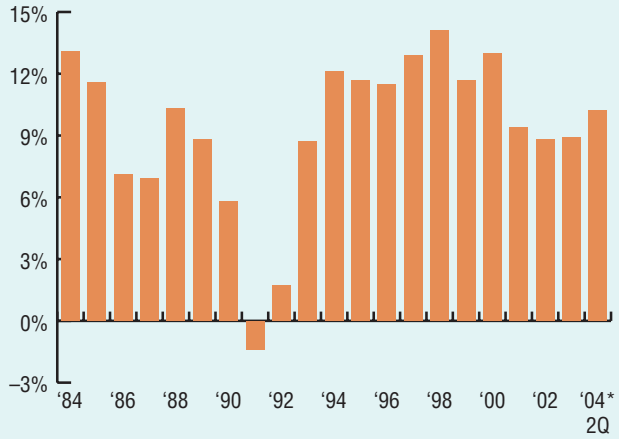
For 2005, interest rates may not rise enough and job growth may not be strong enough to hasten renter stampedes. Undeterred developers keep raising hurdles to better supply/demand balance. "It may take another year to sort out." Apartments will come back, "but not real fast." People need more security to leave parents and roommates. But for the longer term, "apartments make a good defensive play—demographics and interest rates provide a tailwind." Multifamily "will correct the best."

Exhibit 5-15 Multifamily Housing Starts



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

Exhibit 5-16 NCREIF Apartment Returns



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

**2004 returns are four-quarter trailing figures as of second-quarter 2004.*

*"Office will **underperform** other property sectors."*

Office

Strengths

Space markets bottom out. Owners sit comfortably, holding well-leased 24-hour downtown office, if their short-term rollover risk is limited. Low-cost leverage enhances their returns. "The market is two-tiered: trophy and everything else." Companies have either subleased or absorbed a majority of phantom/shadow (unused/leased) space, which had softened occupancies and deterred new leasing. Now tenants can fill vacant space as the economy picks up. "The switch will go on for big companies to make deals in late 2004 and early 2005." Low finance rates give owners breathing room to wait out the decline, and sell when tenancy firms and cash flows improve.

Weaknesses

Commodity suburban office drowns in high vacancy (still 20 percent–plus in some markets). Owners pray for a quick economic burst, but job growth questions furrow brows and test recovery forecasts. "The fundamentals create an uncomfortable feeling." Despite low rents and a tenants' market, investors can't find bargains. "Six to seven cap rates for office buildings in these kinds of markets can't be justified." Even some tertiary locations have high prices. Rents roll down, lowering net operating incomes as old leases burn off. Some owners "give space away" after factoring leasing commissions, tenant improvements, and higher operations expenses. "When tenant rep brokers get exorbitant commissions, it's a sure sign of a weak market. Landlords are getting beat up." Tenants have plenty of options to upgrade space and realize it is time to ink leases at the lowest possible rates. Landlords face a Hobson's choice of higher vacancy or unfavorable lease terms—they have limited pricing power until 2006. Office REITs re-sign tenants to keep up occupancy and current cash flows, and reduce potential broker leasing costs. At least, activity has picked up.

Besides their various outsourcing strategies, companies continue to dramatically shrink space per employee requirements "and workers have come to accept" more cramped environments. "I've moved into a cube," says an interviewee, who used to work in an L-shaped corner office with all the trappings. "I can see everybody, interact more, and create more opportunities. If I need privacy, I have a wireless headset and can move into a private conference room. It's all very cool." The days of coddling employees with running tracks, gyms, and other amenities are over. "Lower-cost structures are in." It all comes down to "using less space."

Exhibit 5-17 **Prospects for Downtown Office in 2005**

	Prospects	Rating	Ranking
Investment	Fair	5.08	9th
Investment Risk	Fair	4.96	10th
Development	Poor	3.28	10th
Supply/Demand Balance	Modestly Poor	4.42	10th
Expected Income Change 2005		–0.2%	
Expected Value Change 2005		0.0%	
Deal Cap Rate 2004		8.0%	

Buy	Hold	Sell
21.7%	42.6%	35.7%

Source: Emerging Trends in Real Estate 2005 *survey.*

Exhibit 5-18 **Prospects for Suburban Office in 2005**

	Prospects	Rating	Ranking
Investment	Fair	4.97	11th
Investment Risk	Fair	4.55	11th
Development	Poor	3.25	11th
Supply/Demand Balance	Modestly Poor	4.05	11th
Expected Income Change 2005		–0.5%	
Expected Value Change 2005		–0.5%	
Deal Cap Rate 2004		8.7%	

Buy	Hold	Sell
23.9%	37.0%	39.1%

Source: Emerging Trends in Real Estate 2005 *survey.*

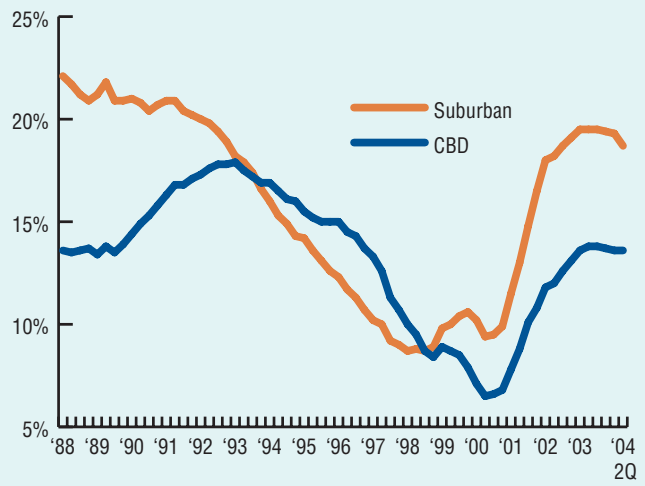
Best Bets

If you haven't leveraged up trophy core downtown buildings with coveted credit-tenant rosters, do it now while rates are still relatively low. "You may not get another chance to arbitrage returns like this…ever."

Some owners will crater in defaults under cash flow shortfalls. Keep circling for opportunities.

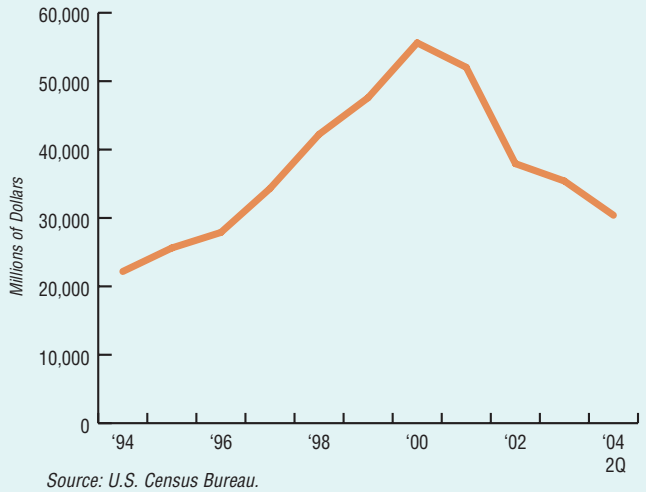
In Sunbelt meccas like Dallas, Atlanta, Denver, and Phoenix, the buy/lease-up/flip cycle may have turned the corner: "It's time to buy cheap, capitalize cheap, and figure out what to do with it later." These markets may benefit as corporations continue to

Exhibit 5-19 **Office Vacancy Rates**



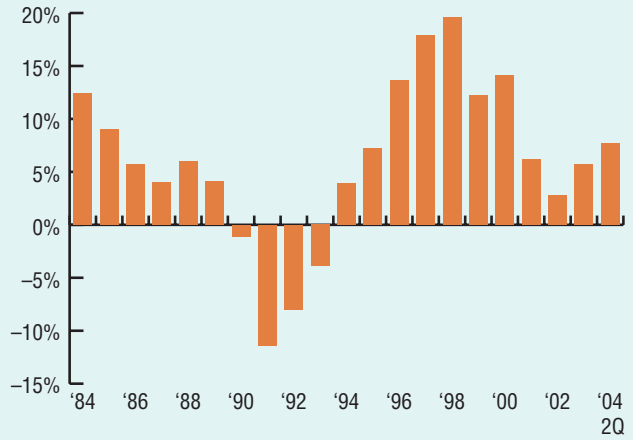
Source: Torto Wheaton Research.

Exhibit 5-20 **Office Construction Put in Place**



Source: U.S. Census Bureau.

Exhibit 5-21 **NCREIF Office Returns**



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

**2004 returns are four-quarter trailing figures as of second-quarter 2004.*

decentralize workforces domestically. Investors count on local job creation engines to fire up. Although customer-focusing headquarters stay in coastal prime markets, technology enables separation of workforces to cheaper places in domestic locations. "It doesn't sound new," says a tenant rep. "But it's really caught on now at the CEO/CFO level." Concentrate on finding value in primary suburban office hubs, and stay away from commodity buildings. Remember: once properties lease up, sell them quickly.

Avoid

Fringe, commodity buildings. "Class C is challenged and the economy will no longer expand you out of trouble." Office space must be able to accommodate technology systems and open floor designs that allow tenants to maximize efficiency and reduce employee space per capita. Owners should consider reuse strategies.

Development

Whew! New construction has slumped. Can you believe: "It's literally nonexistent in the Southeast and Southwest?" "Office development is a nonissue for the next three to four years." Slack building activity cheers optimists, who predict market equilibrium could return faster than expected.

Outlook

Office will underperform other property sectors. Owners hope for a repeat of 2004—values hold and tenant activity keeps improving. Cap rates will adjust modestly to account for lower investment cash flows. Two good years of absorption are needed before rents increase. Most interviewees delay recovery forecasts until 2006 and 2007, depending on the depth of current market distress. Negligible new construction helps to firm up markets.

*"Hoteliers celebrate restored **pricing** power."*

Hotels

Strengths

People have bought all the cars, clothes, and things they can; now why not take trips? Leisure travel escalates to record levels—people feel safer in the United States and the weak dollar curtails overseas excursions. Business travel also bounces back after an extended lull. CFOs loosen budget strings for meetings and conferences…finally. "A full-swing expansion in lodging demand" propels revenues, while modest construction activity keeps supply in check. Key hotel performance indicators—average daily room rate and revPAR—leap ahead, especially in the luxury and upscale full-service categories, flirting with 2000 peaks. Occupancies in the low 60 percent range jump well above break-even. Hoteliers celebrate restored pricing power. "It's tough to find rooms again."

Exhibit 5-22 Prospects for Full-Service Hotels in 2005

	Prospects	Rating	Ranking
Investment	Modestly Good	5.66	4th
Investment Risk	Fair	5.19	8th
Development	Modestly Poor	4.14	8th
Supply/Demand Balance	Fair	5.20	6th
Expected Income Change 2005		5.1%	
Expected Value Change 2005		4.6%	
Deal Cap Rate 2004		9.3%	

Buy	Hold	Sell
34.4%	42.1%	23.5%

Source: Emerging Trends in Real Estate 2005 *survey.*

Exhibit 5-23 Prospects for Limited-Service Hotels in 2005

	Prospects	Rating	Ranking
Investment	Fair	5.00	10th
Investment Risk	Fair	5.21	7th
Development	Modestly Poor	4.29	7th
Supply/Demand Balance	Fair	4.75	9th
Expected Income Change 2005		3.1%	
Expected Value Change 2005		2.8%	
Deal Cap Rate 2004		10.2%	

Buy	Hold	Sell
19.6%	42.0%	38.4%

Source: Emerging Trends in Real Estate 2005 *survey.*

Weaknesses

Many owners deferred maintenance in the post–9/11 slide. Some revenue gains require diversion to sprucing up rooms and public areas. "That peeling wallpaper and frayed carpeting need to be replaced, and so do the lumpy mattresses." Many institutional owners steer clear—running hotels is too management intensive and specialized. "All I want to know about them is when I check in and check out," says a pension executive. "It's too tough a business to invest in" with labor issues, marketing headaches, and constant capital needs. Owners and managers struggle to align interests. Limited-service hotel fundamentals improve somewhat, but interviewees permanently dismiss the segment as overbuilt and not worth the trouble. Event risk can short-circuit travel demand overnight.

Best Bets

All signals point to buy or hold. "Opportunity capital is all over this market," focusing on upscale segments. "Don't expect any huge bargains." The good "fly-to markets"—San Francisco, Boston, New York—offer the most solid opportunities in the sought-after full-service categories. Luxury-oriented resorts cater to growing numbers of baby boomers, who have more disposable income and time to travel.

Avoid

When in doubt, investors should shy away from lodging investments. Operators and savvy specialists could clean up in the cyclical upswing, but asset allocators and safe harbor investors should stick to the four basic food groups.

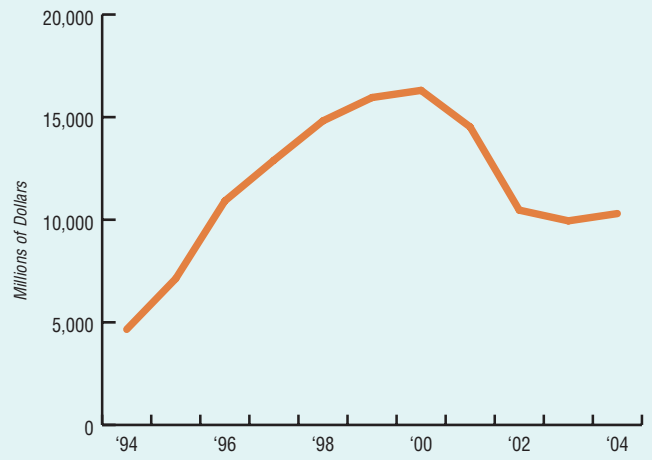
Development

New construction drops to mid-1990s levels. Lenders and investors backed off big time in the chill of 9/11 and the Iraq War. Now opportunity exists in recovery. "But you need courage and can lose a lot of money." Hotel development requires "skilled investing"—it's high risk. Expect activity to ramp up.

Outlook

Hotels should outperform other property sectors with a solid "two- or three-year run" of advances in net operating income, before new supply begins competing. Terrorism adds more risk to real estate's most volatile sector, and sustained higher energy costs would deter some travel. But overall positive economic signs suggest you'll have good time, if you book some capital at the inn.

Exhibit 5-24 **Hotel Construction Put in Place**



Source: U.S. Census Bureau.

"Housing markets appear in very good **supply/demand** *balance."*

Housing

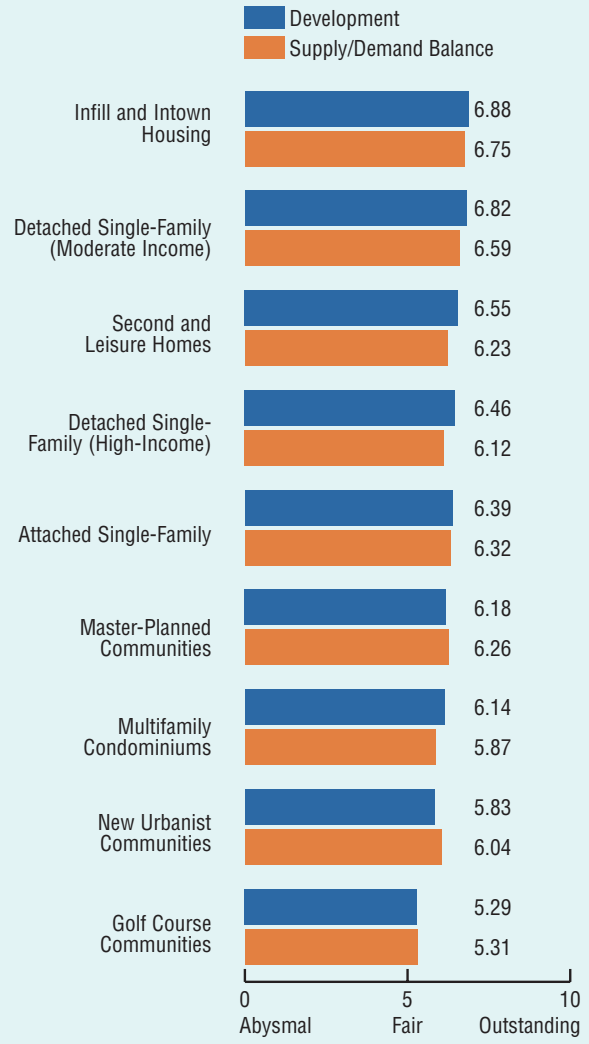
Strengths

As long as interest rates stay reasonably low, more Americans can buy starter homes, upgrade to bigger houses, or purchase vacation properties and weekend retreats. Heads spin when next-door neighbors sell out at stupendous prices. Remember when Mom and Dad bought the two-bedroom, two-bathroom cape for $10,000 in 1955? Now it's worth $500,000! Homeownership takes on meaning beyond shelter and a place you can call your own. It's Americans' number-one investment asset and almost a national imperative. The stock market malaise continues, who knows from bonds, and you can't depend on the 401K anymore. The home evolves from nest to nest egg. Various government subsidies and time-honored tax breaks continue to provide extra thrust to demand drivers. Upper-income baby boomers expand the second-home market.

Weaknesses

Ownership levels may have pushed the limits—almost 70 percent of Americans live in their own homes. That's extraordinary! Some recent buyers of starter homes borrow no-to-low equity down with adjustable terms at basement-level mortgage rates. These folks—stretched to the limit on car payments and family bills—count on property values to keep escalating. But higher interest rates and rising mortgage payments make them particularly vulnerable to default. Middle-class families get squeezed by higher health care costs and flattening wage gains, while the national poverty rate edges up. Higher energy costs crimp calculations about carrying mortgages. Will the end of low interest rate nirvana tap out the buyer market? Construction costs rise, pushing up new house prices. Developers could face resistance in passing on costs.

Exhibit 5-25 **Prospects for For-Sale Housing in 2005**



Source: Emerging Trends in Real Estate 2005 *survey.*

Best Bets

Higher interest rates and price points won't affect more affluent baby boomers as much. They anticipate lifestyle change hungrily and look to comfortable retirements. The leisure and second-home market has legs. Proximity (two to three hours' driving distance) to urban centers is highly desirable—these people still work. Grandma and Grampa also want grandkids close by. Recreational areas with water views are golden.

Suburban areas will become denser and more urban as communities cope with traffic congestion and infrastructure issues. People will pay premiums for master-planned communities that offer them amenities and convenience: pedestrian-friendly places with accessible retail, parks, and recreation, as well as mass transportation alternatives to the car. Suburban boomers gravitate to age-restricted townhouse developments, needing less upkeep and hassle, but ample comfort for childless households.

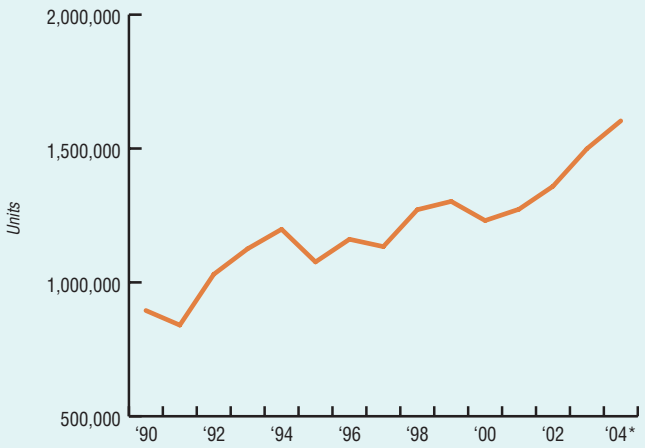
Growing generation Y numbers headed to college and grad schools make student housing a good short-term play.

Avoid

Demand could wane temporarily for starter homes on the suburban edge if interest rate increases offset job and wage growth. Commuting times and gasoline costs could start to put limits on how far areas can expand comfortably—unless, of course, you live in Dallas.

Don't bury the boomers yet. It's still too early to get on the bandwagon for assisted living projects.

Exhibit 5-26 **Single-Family Housing Starts**



Source: U.S. Census Bureau.

Note: Figure for 2004 is the seasonally adjusted annual rate for the first eight months.

Outlook

After eight consecutive years of record existing family home sales and a burst of housing starts that rival the go-go late 1970s era, the average observer might think that homebuying could slacken, especially as interest rates start to increase. But housing markets appear in very good supply/demand balance and interviewees do not expect mortgage rates to advance enough to stanch buyer enthusiasm, at least not in 2005. Interest rates will tell the story. If they rise too far too fast, the bubble deflates. Home values may start to level off for a while.

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ULI Order Number: E21
ISBN: 0-87420-934-X