2006

Emerging Trends *in* Real Estate®

Urban Land Institute

PRICEWATERHOUSECOOPERS

Emerging Trends in Real Estate® 2006

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Executive Summary

■ In 2006, real estate markets reach a pricing peak, cap rate compression ends, and performance ratchets down as value gains level off. The year promises to usher in a period of acceptable, but relatively lackluster returns for property investment portfolios. Sellers do better than buyers.

■ Cushioning markets against correction, still-ample capital flows become more restrained by year-end as buyer demand turns less frenzied and more rational. Real estate should retain its relative value edge over stocks and bonds.

■ Modest property cash flow improvements from rising occupancies in most property sectors will help offset any increases in cap rates, with interest rates expected to advance. Full-service hotels rank as the favored property type. Technology and corporate productivity initiatives, including outsourcing, continue to dampen office demand growth. Demographics and high housing costs favor moderate-income apartments. Industrial warehouses continue to rebound, tracking moderate economic growth.

■ Pressuring net operating incomes, higher energy costs will boost landlord expenses and could affect consumer appetites and travel budgets, potentially hurting retail sales and curbing some recent lodging gains.

■ Pricing above replacement cost for existing real estate may encourage a round of unnecessary development and threaten steady progress toward supply/demand balance in many markets by 2007 or 2008. Rising construction expenses, however, could dampen developer enthusiasm and extend the ongoing recovery.

■ The surge in house prices ends and condominium conversion mania hits the wall thanks to rising mortgage rates. Select overheated markets may deflate, but values just flatten in most areas. Homebuilder profit margins decline as costs skyrocket for construction materials.

■ Public capital markets' influence over real estate grows. REIT stock prices may correct after soaring gains, but these public companies will continue to expand market share of owned equity real estate. CMBS offerings proliferate, too, extending into more international markets. Pension funds remain poised to pick up some of the investment slack if private investors begin to pull back. Foreign investors continue to gravitate to the United States, looking for stability, while American capital moves offshore, especially to Asia, seeking more opportunistic returns.

■ Investors favor coastal markets on global pathways with barriers to entry: southern California; Washington, D.C.; and New York top the survey again. San Francisco rallies. Phoenix ranks as top hot growth market. Condominium overbuilding hurts otherwise-solid Miami. Prospects for other Sunbelt agglomerations improve only marginally. Chronic market softness dims interviewee outlooks. The Midwest struggles for relevancy in the face of economic decline.

■ Infill areas—near central business districts and suburban nodes—will become magnets for increased residential and mixed-use development as people look for greater lifestyle convenience in 24-hour environments.

■ Investors will continue to scavenge for opportunities in more niche property categories—seniors' and student housing, medical office, public storage—as long as core categories seem overpriced.

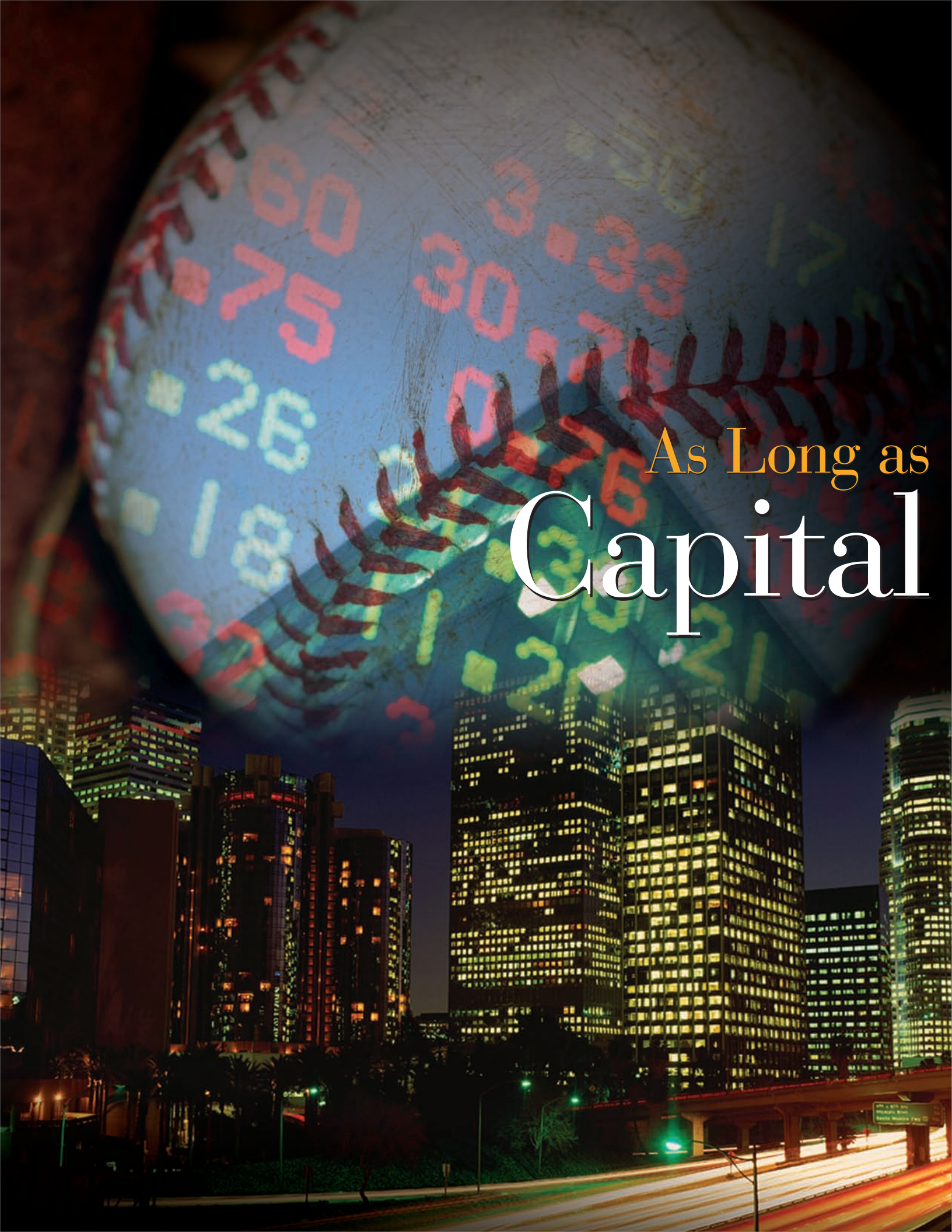
Preface

Emerging Trends in Real Estate® is a trends and forecast publication now in its 27th edition, and is the most highly regarded and widely read forecast report in the real estate industry. *Emerging Trends in Real Estate® 2006*, 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.

Emerging Trends in Real Estate® 2006 represents a consensus outlook for the future and reflects the views of over 400 individuals who completed surveys or were interviewed as a part of the research process for this report. Interviewees and survey participants represent a wide range of industry experts—investors, developers, property companies, lenders, brokers, and consultants. ULI and PricewaterhouseCoopers researchers personally interviewed over 170 individuals (see the end of this report for a list of those interviewed) and survey responses were received from 303 individuals, broken down as follows:

32.8%	Private Commercial/Multifamily Property Companies or Developers
16.9%	Institutional/Equity Investors or Advisers
13.9%	Real Estate Service Firms
9.9%	Lenders or Mortgage Bankers/Brokers
9.6%	Publicly Traded Commercial/Multifamily REITs or Operating Companies
8.6%	Homebuilders or Residential Land Developers
8.3%	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.



As Long as Capital

"We are in the eighth *or* ninth *inning of this [real estate investment] cycle with a chance to go extra innings. No one can say with a straight face that we are early in the* ballgame *anymore."*

Keeps Flowing, Everything Will Be All Right

After an "extremely" lengthy decade-plus cyclical upturn, with the last few years juiced by a healthy dose of record-low interest rates, the U.S. commercial and multifamily real estate markets appear to reach a pricing peak, and investment returns will ratchet down during 2006 in a slow but steady reversion toward the mean. Cap rate–driven appreciation is ending and investors must depend on increased property income streams to hold or push up values. Despite improving market fundamentals and continuing capital infatuation with real estate, *Emerging Trends*' interviewees signal caution throughout this year's survey over a looming transition to a period of more measured, possibly lackluster, performance. While appreciation plateaus, "the price per pound stays at lofty levels," rents may catch up nominally, but rising short-term interest rates and inflationary costs cut into performance. "The big dollars have been made from cap rate compression, [some] real estate is trading well above replacement cost, and pricing is ahead of where it should be at this point in the cycle."

The consensus forecast, however, suggests that real estate can maintain a relative value edge over stocks and bonds, at least in the near term. Real estate's improved transparency, run of excellent performance, and restored status as a significant asset class alongside stocks and bonds reinforce the majority view that the risk premium for property investments has been reduced, enhancing stability and capital liquidity and limiting the chances for investment losses.

Is Buyer Fatigue Around the Corner?

In fact, "lowered expectations" among interviewees for 2006 do not translate into "anything dramatic" or "dire." The current flood of available capital in both the equity and debt markets will sustain substantial investment demand and prop up values

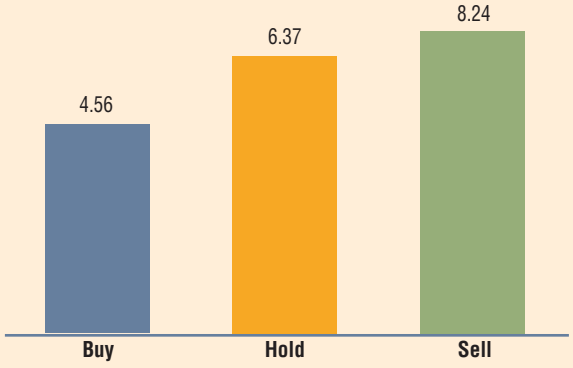
through the year. "Capital won't dry up suddenly, so there will be no radical declines." "The shear amount of equity cushions the market in the near term." Most property sectors should register improved occupancies and some rent growth, although advances may be spotty across markets. Expect capital to begin backing off during the second half of the year as a touch of buyer fatigue finally sets in over interest rate advances, possible cap rate erosion, and even heightened development. Concerns about an ebbing housing market may also create doubts about commercial real estate, especially if some condominium markets show marked declines, as anticipated.

Signs abound of a cyclical pricing crest in *Emerging Trends* survey results and interviews:

Sell Warnings. The sentiment for selling properties over buying widens further over last year to the largest gap in the survey's history. Not only does the sell rating advance to a record high for any category on the *Emerging Trends* transaction barometer, but also the buy rating drops to its all-time nadir (see Exhibit 1-1).

Exhibit 1-1 ***Emerging Trends* Barometer: 2006**

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



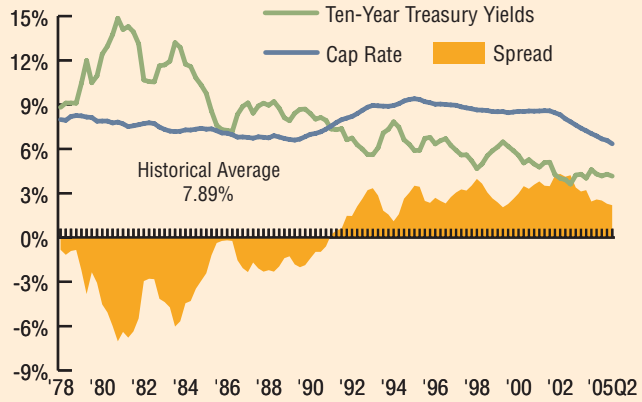
5 = fair, 6 = modestly good, 7 = good, 8 = very good.

Source: Emerging Trends in Real Estate 2006 *survey.*

Foraging Beyond Core. Wary of future return implications from stratospheric pricing, many investors increasingly shy away from core property sectors—apartment, office, retail, and industrial—and consider alternatives. Hotels suddenly zoom to the top of property rankings and appetites grow for largely ignored niche categories like seniors' housing, master-planned communities, urban mixed use, resort hotels, and student housing. These segments, in fact, score higher investment ratings for 2006 than any of the traditional property sectors. Self-storage properties and medical office buildings have never been on the radar screens of core real estate portfolio managers until today. Now, the surging demand for niche pickings suddenly has made them anything but cheap. "Postcard" A-list properties in tertiary cities also see pricing escalate to levels more appropriate to prime buildings in major markets where presumed greater liquidity commands lower risk premiums. "Everything is overheated."

Unrestrained Capital. Enduring disappointment over stock market returns continues to push capital in search of yield to income-producing real estate, which has "never been priced at such a high premium" to Wall Street equities. Current property cap rates anticipate substantial rebounds in future revenues that may be unrealistic in slowly recovering markets and a rising interest rate environment. Overwhelmingly, more than 80 percent of survey respondents view the real estate capital equity and debt markets as oversupplied, and almost 55 percent char-

Exhibit 1-2 **NCREIF Cap Rates vs. Ten-Year Treasury Yields**



Sources: National Council of Real Estate Investment Fiduciaries, Federal Reserve, Economy.com, PricewaterhouseCoopers.

acterize the equity markets as "substantially oversupplied." A real estate veteran calls the capital frenzy "unprecedented," comparable only to the late 1980s' "orgy" when Japanese investors bid up trophy office buildings and institutional investors drove down regional mall cap rates to sub–5 percent levels. It all ended badly in a market collapse. So far, the major differences today are restrained development (except in condominiums) and a lack of attractive investment alternatives. In addition, spreads between cap rates and Treasury bills continue to provide investors with a decent though shrinking risk cushion (see Exhibit 1-2). But when "money chases deals, underwriting suffers."

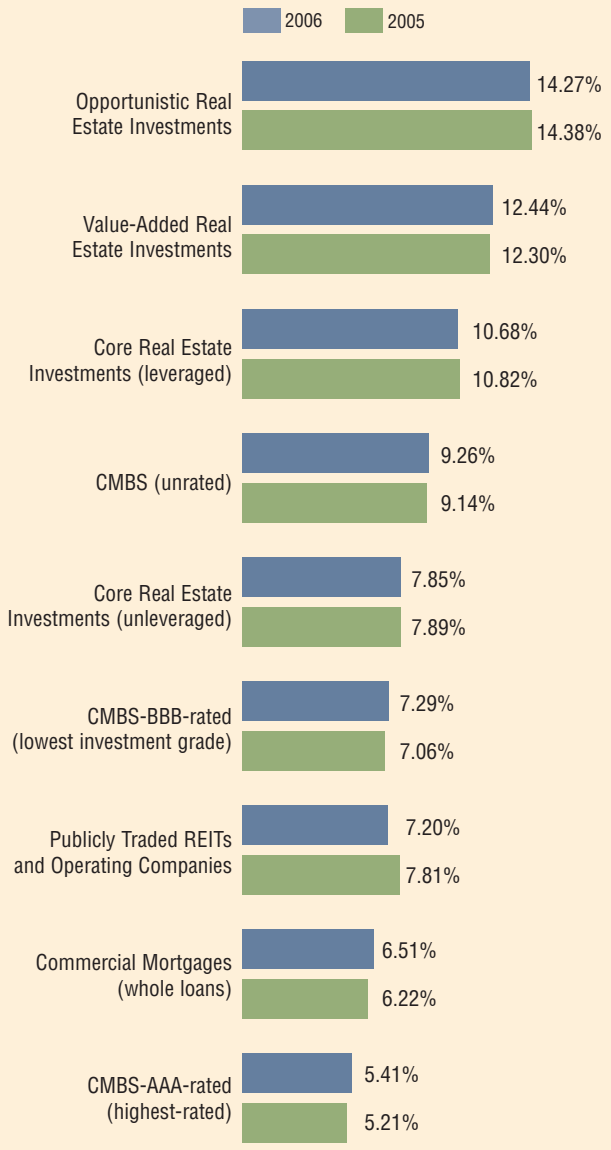
Condo Craze. Only select condominium markets show signs of significant overbuilding nationally. Lenders and rising construction costs have helped constrain development in other property categories, giving a chance for most sectors and markets to edge toward better supply/tenant demand balance. Still, "unrestrained condo activity has always signaled the top of the [real estate] market," says a well-known researcher, and raises yellow flags "about additional market excess." Condo-mania and construction, stoked by speculative buyers, threaten to unhinge multifamily markets in south Florida, Las Vegas, and parts of southern California. Signs of potential residential overbuilding and slackening buyer demand extend into Chicago, Atlanta, Phoenix, New York, and other metropolitan areas.

Development Dangers. The industry needs to monitor the supply side carefully for potential harm from overbuilding. "Timing is awfully ripe for a ramp up in new construction." Lowered cap rates make it cheaper to build new office, industrial, and retail projects than to buy existing product. Hotels also are poised for another development spurt. "So far, most development has not been justified by rents." But increasing occupancies and operating revenues may be enough to encourage skeptical money sources to fund new construction in all categories. If traditional lenders hold their discipline, hedge funds, opportunity funds, and real estate investment trusts (REITs) are cash flush and could fill the financing void, looking to boost their lowering return prospects. In slow-demand markets like Chicago and Philadelphia, new marquee office buildings already steal away local tenants, increasing overall vacancy. Chronically oversupplied Atlanta and Dallas resume office construction despite mediocre growth forecasts and empty buildings. Unnecessary development could upend some markets creeping toward equilibrium. "We may do ourselves in." On a positive note, high land and increasing construction costs could act as an indispensable governor, discouraging some projects. Rebuilding the Gulf Coast and New Orleans in the aftermath of Hurricane Katrina will siphon off supplies and materials, hiking costs further and leading to shortages.

Housing "Bubblettes." Many interviewees express concern that "unsustainable" housing prices will deflate, at least in some markets. Rising mortgage rates and tightening lending standards finally will put current nosebleed price points out of reach for increasing numbers of buyers and dash speculator activity. Some cash-strapped borrowers using floating-rate debt may get squeezed out of their homes as defaults increase. When the public realizes "beanstalks no longer grow to the sky," negative press could chill enthusiasm for real estate in general. Many "people in single-family America are extended beyond their means and it is the single-family homeowner/consumer that runs America." Shopping centers could feel an extra sting—retail buying has been fueled by new homeowners "needing stuff" to fill rooms and closets, and by existing owners, who have refinanced mortgages to buy "more things." As many markets continue to create households faster than they build new homes, demand for housing will not dry up, but may flatten.

Less Heady Returns. Performance expectations edge down across all investment categories compared with last year's survey. "There's no pop left." Anticipated unleveraged total core returns drop below 8 percent—"more like a bond." The higher-risk value-add segment levels off close to 12 percent, and opportunistic returns dip below 15 percent (see Exhibit 1-3). What happened to 20 percent–plus? Most advisers claim they still can achieve such gains, but only if they invest outside the United States, particularly in Asia. Performance may head still lower in 2007 as cap rates advance. But sustained healthy capital flows, absent some unforeseen event shock, protect real

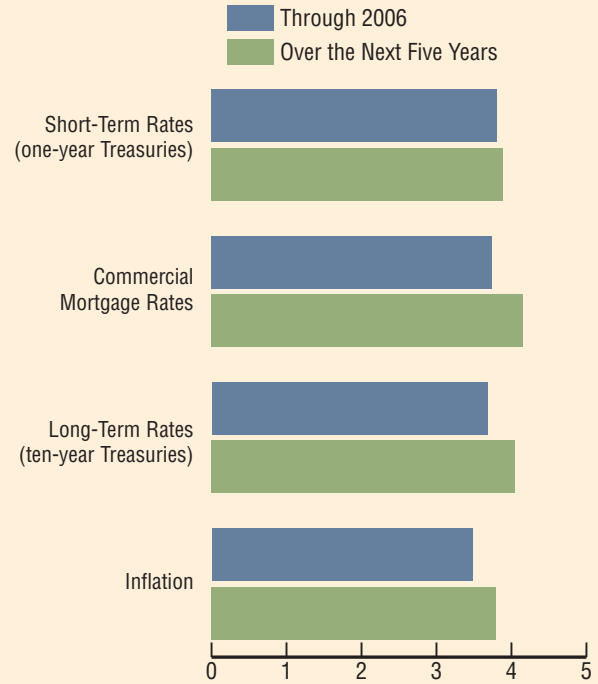
Exhibit 1-3 **Total Expected Returns for U.S. Real Estate Investments in 2005 and 2006**



Source: Emerging Trends in Real Estate 2006 *survey.*

estate from a correction. Forecast revenue growth should also buttress values for most properties. Given real estate's lowered risk profile and improving fundamentals, these returns remain solid, albeit "on the low side."

Exhibit 1-4 **Inflation and Interest Rate Changes**



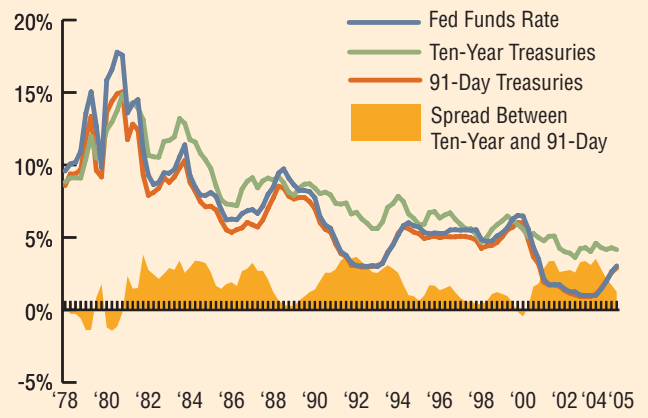
1 = fall substantially, 2 = fall moderately, 3 = remain stable at current levels, 4 = increase moderately, 5 = increase substantially.

Source: Emerging Trends in Real Estate 2006 *survey.*

"Everything Hangs on Interest Rates." No one disputes that low interest rates extended this real estate cycle (12 years and counting), which had showed signs of deteriorating after the 2000–2001 high-tech/telecom industry implosion, a situation that was exacerbated by 9/11. Low mortgage rates protected owners from defaults when rents and occupancies declined and buyers could enhance returns to heady levels by effortlessly leveraging up properties on inexpensive debt. Investors poured into the markets to take advantage. Cap rates plunged and appreciation soared despite tepid tenant demand and mediocre revenue growth in all sectors except consumer-driven retail. Owners and investors "hit the trifecta—cheap money, plentiful capital, and increasing values." Interviewees now reluctantly accept that "Nirvana is over" and forecast moderate increases for both short- and long-term rates in 2006 as well as over the next five years (see Exhibit 1-4). "Interest rates are the fly in the ointment." "They have nowhere to go but up." The higher rates go, the more likely some capital will grav-

itate away from property markets to bonds and other fixed-income instruments, exerting upward pressure on real estate cap rates and reversing some recent value gains. More expensive leverage, meanwhile, will impinge on various "easy money" financing strategies.

Exhibit 1-5 Interest Rates and Spreads



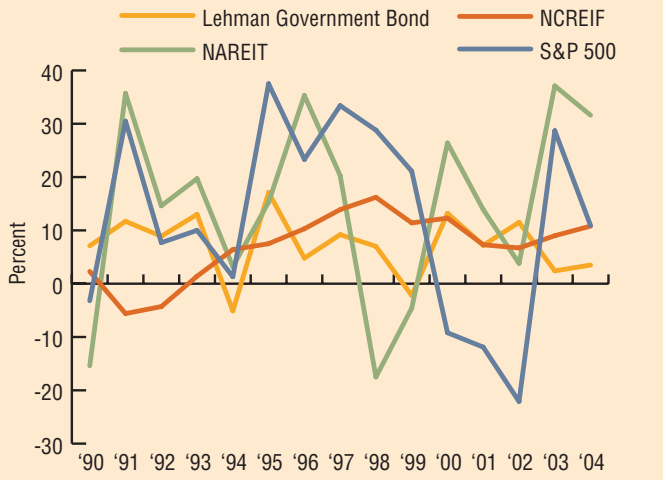
Sources: Economy.com, Federal Reserve Board, PricewaterhouseCoopers.

The Race Continues. If interest rates advance in 2006 as survey respondents expect, investors will count on improving occupancies and rental rates to increase net operating incomes and help offset any cap rate rises. This race between interest rates, fundamentals, and cap rate changes, detailed in last year's report, has so far been turtle paced, with fundamentals gaining a slight edge. The Fed's quarter-point advances have coaxed short-term rates higher, but the long bond has lagged and cap rates have jogged to record lows thanks to those prodigious capital flows. Modest property cash flow improvements leave NOIs only "marginally better than three years ago." Apartment rents increased in 2005, but most office and industrial market vacancies will not decrease enough to push rents until 2006 or later in some markets. At least concessions are declining. Retail property owners grow concerned about how inflated energy costs and uncomfortable household debt levels eat into consumer appetites. Only hotels rebound robustly. Higher utility and heating bills will raise landlord expenses and chew at property cash flows.

Relative Value Holds Sway. A majority of interviewees predicts that sustained market liquidity will moderate any cap rate advances, and those increases will not be on a one-for-one basis with interest rates. "Real estate will remain a loved asset class and remains reasonably priced compared to stock and bond alternatives." Certainly, property investments compare favorably to the securities market over the past ten years (see Exhibit 1-6). Add improving fundamentals to lower risk premiums and values can remain stable as interest rates increase further. All bets are off, however, if the stock market suddenly gets hot or interest rates spike and the bond market takes off. Interviewees express confidence that won't happen in 2006 (see Exhibit 1-7). Still, an underlying discomfort exists over recent pricing, "artificially increased" by cap rate compression and disconnected from market realities. Positives in cash flows have not been enough "to bail out a [cap rate] reversal." While some real estate pros think the real estate markets are overpriced, the capital markets think differently for now and prices have kept going up. And given low bond yields and high price-earnings ratios for equities in recent years, there is some rationality to lower cap rates from a relative value point of view (see Exhibit 1-8). But many real estate veterans are skeptical about current low cap rates. "You cannot rationally accept that this is a six-cap world. The opportunity going forward is in yield, not much if any in appreciation."

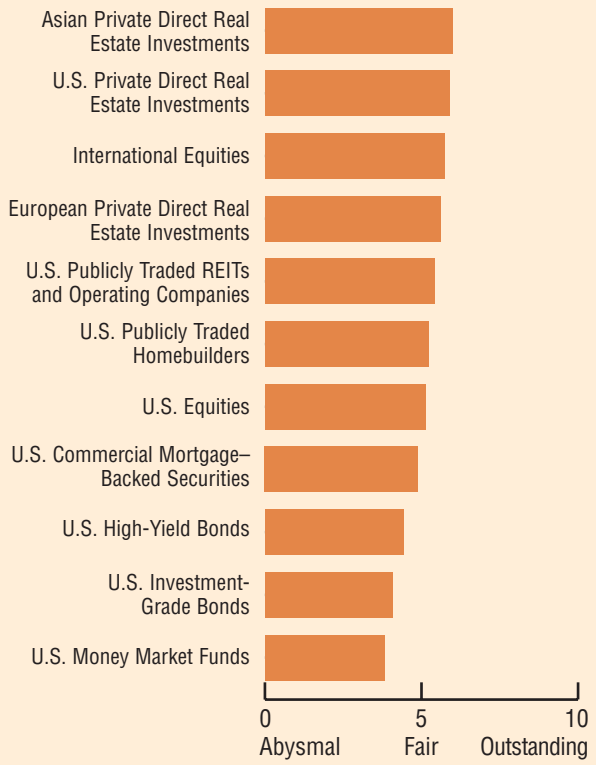
As long as capital keeps flowing, everything will be all right.

Exhibit 1-6 Returns: Real Estate vs. Stocks/Bonds



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

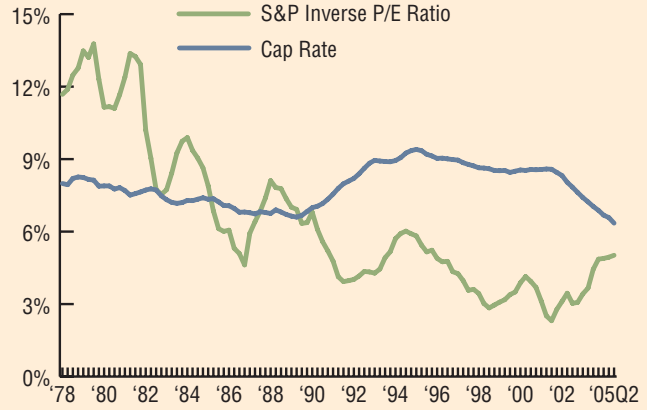
Exhibit 1-7 **Investment Prospects for Various Asset Classes in 2006**



Source: Emerging Trends in Real Estate 2006 *survey.*

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

Exhibit 1-8 **NCREIF Capitalization Rates vs. S&P 500 Inverse P/E Ratios**



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

Moderate Economic Growth, With Some Issues

"I'm optimistically confused. All indicators look right, but it doesn't feel right."

Four years into economic recovery, the *Emerging Trends* consensus expects moderate growth to continue through 2006, supporting improved real estate demand metrics, but not generating prolific gains. The consensus forecasts from leading economists suggests GDP growth of around 3.3 or 3.4 percent for 2006, and most in our survey seem to agree, expecting the economy to keep moving forward as it has been at a moderate pace:

"Healthy, but not robust."

"Pretty good, but not great."

"No recession on the horizon."

"Disappointed, but optimistic."

"Moving at three-quarters speed."

"Expansion has been at a sub-par rate, but there is still some gas left."

"Regardless of how you think we are doing, the U.S. is still the world leader."

Though hopeful, many interviewees remain stumped trying to identify new growth engines to replace dwindling manufacturing industries and pump life back into high tech. Others are encouraged by the economy's moderate expansion across a wider range of sectors, resulting in growth that could be more stable and sustainable. A number of issues bear watching as 2006 unfolds.

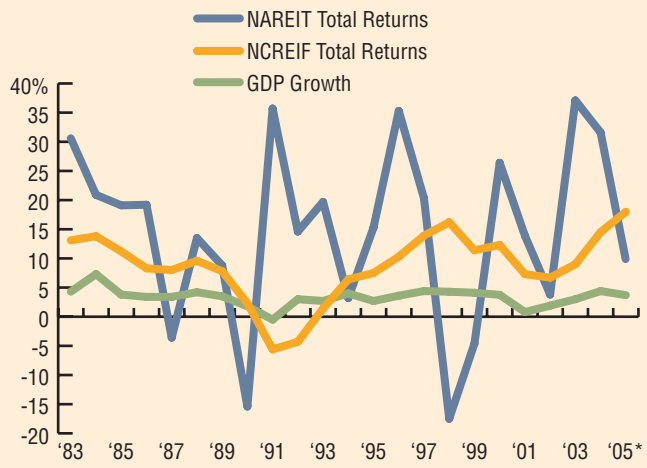
Consumers and Housing. Consumer buying and housing demand have been the bedrock of the ongoing economic recovery. Both look a little "long in the tooth." The refinancing wave has run its course as interest rates move up. Can house prices go much higher when mortgage rates increase? Rising energy costs may subdue buying power, and wage gains will need to

accelerate (see below). "The consumer is the big question mark. Can consumers keep spending, especially with rising energy costs? We're on the cusp."

Job Growth. If you take away all the jobs generated by the recent housing boom—construction workers, laborers, mortgage brokers, real estate agents, architects—the nation's employment growth would look more modest. "It's scary that we've made no progress in establishing a new jobs generator in the U.S." At least the pace of job growth has kept slightly ahead of the numbers of new workers entering the labor force, and the economy remains broadly diversified. Aside from real estate, the most active labor sectors have been health care (increasing baby boomer ailments), professional services (lawyers and accountants, thanks partly to Sarbanes-Oxley), leisure and hospitality (hotels are back!), and trucking (all those imports). Wage growth has also languished for moderate to low earners, barely keeping ahead of inflation, and household incomes have remained relatively flat over the past several years. But low unemployment combined with continued hiring eventually could start pressuring wages in the right direction to support continued consumer spending. Recent employment gains have been enough to spur increasing apartment rentals—room-mating declines and young adults move out of their parents' homes as they find more work. The hurricane catastrophes eventually will encourage supercharged employment growth around reconstruction in the Gulf Coast area, but not long-term office jobs.

Relentless Corporate Productivity Gains. Solid corporate earnings have translated into only moderate hiring in office jobs, and profits continue to derive from relentless cost cutting, "productivity increases"—including working employees longer and harder—and managing space costs, all of which has kept a lid on office absorption. Rising health care and benefits expenditures check company budgets for new full-time hires. Cubicle life becomes the accepted norm. "Companies are laser-focused on overheads—there's just no letup in trying to reduce occupancy expenses," says a corporate real estate adviser. No wonder office occupancy rates crawl up so slowly, except in the top demand markets. Technology advances promise to offer new strategies for further reducing square footage per employee. Next-generation gizmos will enhance worker hoteling and enable more outsourcing, including hiring more freelancers who can operate from home. Over the next five years, many companies will give workers laptops configured with wireless phones and Internet access that function almost anywhere.

Exhibit 1-9 Real Estate Returns and Econimic Growth



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

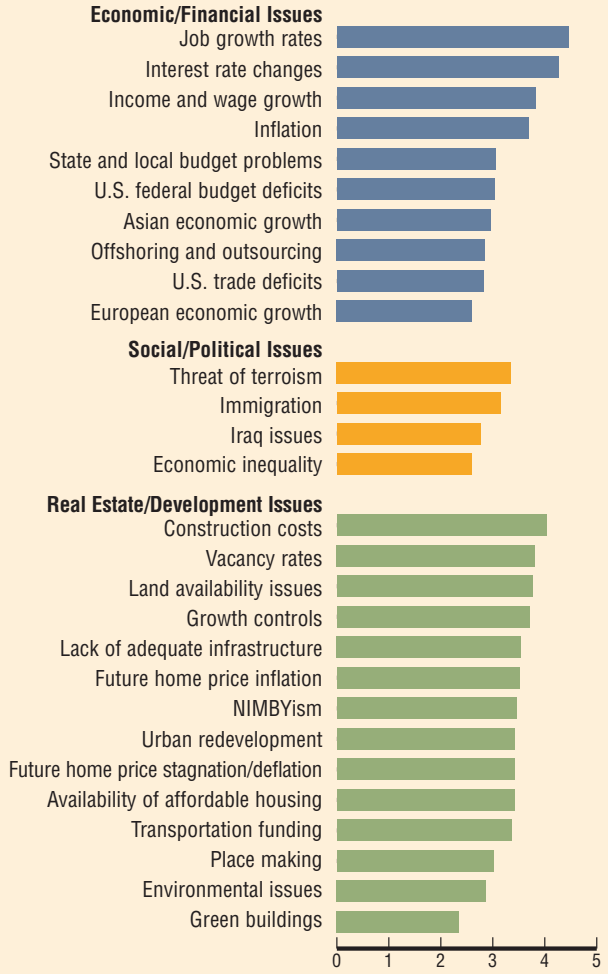
**2005 GDP data are projected; 2005 NCREIF data are annualized for the year ending in the second quarter of 2005; 2005 NAREIT data are year-to-date as of September 30.*

"You show up at the office when you need to, it almost doesn't matter where you sit—your E-mail and phone calls will follow you wherever you go, and you have access to all your computer files without plugging in." Graybeards may grumble about their lost windowed office, but for the younger wired crowd it all makes sense along with the paycheck. Building owners face the music—demand growth for office space will likely not rise aggressively as it did in the 1990s.

The Offshoring Reality. Most interviewees now accept that offshore outsourcing has become "a fact of life" and a part of corporate strategies, affecting job growth and office demand, at least on the margins. Survey respondents rated the issue as one of "moderate importance." Many interviewees expressed concern. "It's a big deal and growing," "a significant trend with no letup in sight." "Every knowledge-based job is vulnerable." "It's not just call centers and lower-skilled back office." The business economies are simple: Internet technology allows U.S. companies with the highest-paid workers in the world to transmit assignments overseas to well-educated workforces, operating in substantially lower-cost (wage, benefits, space) markets. "Work is exploding with U.S. corporate clients in China and India," says a property management consultant. U.S. developers

and investors also eyeball Asian opportunities to build out space to house all the activity. "Now you can move work around the world over 24 hours to get it completed—it's slick and efficient." Beyond the near-term impacts on office demand, offshoring threatens to reduce U.S. wage rates to allow American workers to compete globally. It has happened in the manufacturing sector (China and South Korea); it's now happening in some service industries. America needs to start producing that newer and better mousetrap to stay ahead. Some respondents hold a less pessimistic view of offshoring. They rightly point out that globalization will lead to more economic growth worldwide and more international tenants locating in U.S. markets. Coastal gateway cities should benefit especially.

Exhibit 1-10 Importance of Various Trends/Issues/Problems for Real Estate Investment and Development in 2006



1 = no importance, 2 = little importance, 3 = moderate importance, 4 = considerable importance, 5 = great importance.

Source: Emerging Trends in Real Estate 2006 *survey.*

Inflation and Recession Threats. Rising costs for concrete, steel, wood, and other construction materials lead some interviewees to warn that inflation may be making a comeback. Rising construction costs, and inflation in general, were top-rated concerns among survey respondents (see Exhibit 1-10). Housing prices, of course, have shot through the roof and gas pump shock naturally augments concerns. Katrina and Rita unleashed a one-two punch—pushing up both energy and material costs. Transportation prices march upward—anything that moves by truck costs more, including most retail goods. And what happens this winter when heating oil and natural gas bills arrive? Consumers may finally tap out and cut back on shopping sprees. Hoteliers worry that airline fuel expenses could escalate fares and short-circuit some business and tourist travel. Energy prices tend to be highly volatile, but a sudden rollback isn't a given as long as Iraq smolders. China's thirsty industrial engine vies for more oil, as its growing middle-class population trades in bicycles for cars, while the United States is hamstrung by undercapacity in its refineries. Inflationary pressures could force the hand of the Federal Reserve to raise the funds rate faster or higher over a longer period than currently anticipated. Aside from their inflationary profile, energy cost spikes also can upset the economy, having helped precipitate recessions in 1973 (Arab oil embargo), 1979/1980 (Iran hostage crisis), and 1991 (Gulf War).

Oil, Sprawl, and Housing. No longer a leading oil producer, America depends more today on imports than it did 30 years ago. While industrial oil consumption has fallen, all those cars, trucks, and SUVs—many driving around in congested suburbs—have more than picked up the slack in energy demand. Cheap gasoline has supported the horizontal spread of suburbs into exurbs around urban cores and jump-started the unrestrained growth of Sunbelt agglomerations since the ignominious gas lines of the late 1970s. Today, an extended period of higher energy prices could slow fringe suburban growth and dampen demand for big houses with their outsized heating/cooling bills. On top of projected rising mortgage expenses, increased gasoline and home-heating costs might tip the affordability balance for many people away from home owning to apartment renting at infill locations closer to work. Going forward, the distance between where we live and work will matter

more, and attractive mixed-use places (in both cities and suburbs) that offer more convenient urban lifestyles will benefit. Greenfield developers beware.

"Numbing" Deficits. Balance of trade and federal budget deficits have "been talked to death." Cassandras warn that foreigners (led by the Chinese) may rebalance investments out of the United States (now the world's biggest debtor nation), further affecting the buying power of the dollar and forcing major upward adjustments in interest rates. Low interest rates, meanwhile, have supported U.S. consumer spending on Asian imports, which allows Asian expansion and investment in U.S. Treasury bills, creating even greater imbalances. The decoupling of the yuan from the dollar bears watching, but many interviewees argue hopefully that deficit problems are a "future concern," "not a real-time issue." "We'll have to deal with them, but not yet." Keep your fingers crossed as Iraq and Katrina pile on more red ink.

Hurricane Havoc. The horrific Gulf Coast hurricanes are just the sort of "bolt out of the blue" that many interviewees fear could upset the economy temporarily and stall momentum in real estate market recoveries. Expect the storms' impacts to be decidedly mixed. The nation's reduced refining capacity threatens to sustain record or near-record gasoline and home-heating prices just as government economic stimuli—low interest rates and tax cuts—have lost some of their effect. This news offers little comfort to retailers, homebuilders, or even hotel owners—people may curtail car trips, air travel, and overall spending. Building materials can only become more expensive as the massive cleanup and reconstruction gear up, opportunely restraining development passions in slowly firming commercial markets. In most of the country, homebuilders may be forced to slow down, too. Federal aid and insurance payouts eventually will generate an economic jolt, especially in the affected area, where building activity will skyrocket. Property and casualty insurers, meanwhile, will increase rates on all property owners to recoup some of their massive losses. New Orleans's crippled port (number one for domestic cargo) and convention industry (number five nationally) will benefit warehouse owners and hoteliers in other markets—shippers and meeting planners will need to look elsewhere, at least temporarily. Apartments in cities in the South and Southwest will see a slight bump in demand from displaced storm victims. Nearby Houston could be the big winner. For affected residents, owners, and investors, Katrina and Rita have been devastating. Speculators and vulture investors will circle the scene looking for bargains. A shrunken New Orleans may need to rely even more on tourism and entertainment to shore up a flagging local economy. Gulf Coast shorelines will rebound—everyone treasures a water view until the next storm hits, and the Mississippi gambling industry will gain the necessary government backstops and tax concessions to rebuild.

Terrorism. London, Iraq, Madrid, 9/11, Israel—attacks continue, life goes on. Convinced that another strike in the United States is inevitable ("You can't be complacent; it's not a matter of if, but of when"), interviewees increasingly reconcile that any dislocation should be manageable and markets can rebound. "It's become a background issue that you really can't plan for." The way real estate pricing roared back after September 11, who can argue. . . .

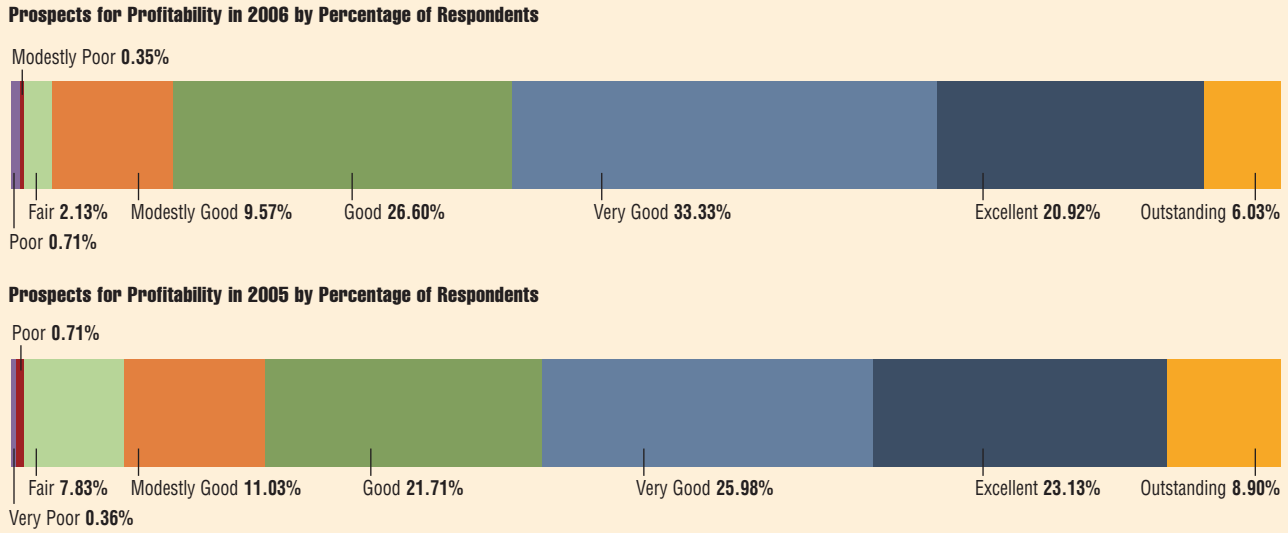
As long as capital keeps flowing, everything will be all right.

Real Estate Climate Remains Favorable

"Something is in the water. For all the advice about selling, more buyers appear." "It's a totally sellers' market." Says a frustrated buyer: "I can live with high and rising prices, low cap rates, and shortened due diligence, but I have a tough time with the utter arrogance of sellers who can and do retrade with impunity. They can get away with anything, because there is always someone else there to make their deal." The tremendous backlog in capital (see Chapter 2) suggests sales momentum can continue well into 2006, at least sustaining exceptional pricing levels for a while longer. "Much of what we sold 24 months ago, we are reselling today," says a broker. "It makes putting the sales book together easier—nothing much changes, not even the leasing." Business profitability prospects remain strong, and a favorable climate extends not only to brokers and investors, but to lenders and developers as well (see Exhibits 1-11 and 1-12).

"Pricing to Perfection." Recent stories about flipping properties have become legion. "I just sold a B mall at a cap rate 300 basis points below the purchase with the same competitive set, same anchor credit issues and weaknesses, literally no improvement over my holding period." "I sold a property bought two years ago with a flat NOI since, at a huge gain, all thanks to the finance markets." Brokers scratch their heads over successful sales strategies, which leave space vacant rather than trying to lease it up. "It's amazing. The buyer sees opportunity in the vacancy, so

Exhibit 1-11 Real Estate Firm Profitability Forecast



Source: Emerging Trends in Real Estate 2006 *survey.*

don't mess with his imagination." Meanwhile, cash-rich sellers have done so enormously well that instead of folding, they acquire something else. It's the relative value argument—I can't do better in alternative investments, so I'll stick to real estate.

Commodity Mentality. Concerns grow about the frantic pace of trading. "Many investors have no strategic plan beyond cap rates going down and have been spoiled by immense liquidity where everything trades." Properties "are not priced for risk when buyers acquire 50 percent leased buildings at prices for 100 percent leased buildings." Not only are investors counting on "aggressive cap rate assumptions," but they are also anticipating "significant rent recoveries" and using "substantial leverage." At best, many investors "risk selling for no more than they bought." "People are fooling themselves a bit." "They may not have a chair when the music stops."

Core Conundrum Redux. Conflicted owners of well-leased, income-generating core portfolios mostly steer clear of the disposition market unless they cull underperforming assets. "Arguably, it's the optimal time for them to harvest, but people are hanging onto most safe core assets. It's like not wanting to sell your house, because you'll have to buy another at an equally high price." Faced with billions of dollars in queued investor commitments, large core investment funds struggle to find acquisitions that make sense—"there's considerable risk from pricing." They expand the "core" definition using more leverage on deals and tread into shallower secondary markets as well as into niche segments. Proponents argue that core (locked-in credit tenants with good income streams) remains a better bet than value-add or opportunistic strategies that have rehab, development, and/or leasing risk. But core funds have enjoyed the benefit of significant appreciation from cap rate compression and are more vulnerable to some "give back" if and when cap rates rise. Several major institutions counsel a temporary "move away from core," "expanding the playing field to more opportunistic investments." Over the longer term, investors prefer the lower-risk core profile and solid, predictable yields.

Few Value-Add Bargains. More investors gravitate to value add, contending that these properties will be more resistant to cap rate reversion since their strategy is to upgrade lagging performance. "You can achieve slightly better pricing, fewer dollars are chasing deals with a little hair, and play into improving markets," says a pension consultant. "Right now, the risk is easier to understand and underwrite" with better return potential. "Even if you don't hit your target return, chances are you won't do any worse than core," says a value-add manager. But value-add investors have trouble finding reasonably priced deals, too, and must "go up the risk curve for lesser returns." "It's hard to get

can only increase demand and cost for materials and supplies.

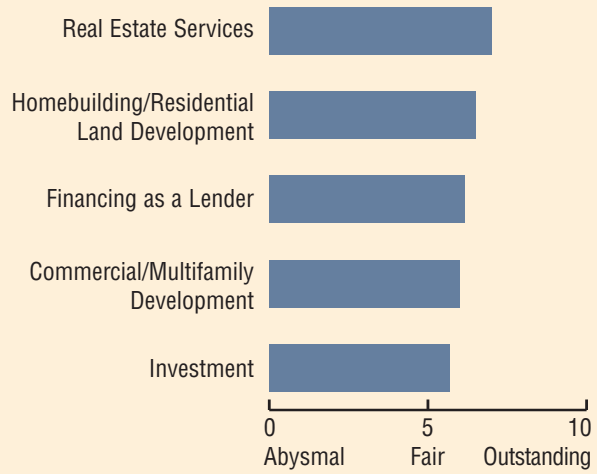
dollars out even if you look farther afield" into the niches or at dog properties in tertiary markets. Value-add investors have been gorging on selling B apartments to condominium converters and entitled land to homebuilders. Those gambits may be losing some momentum. Leverage, a major ingredient for enhancing value-add returns, likely will get more expensive, too.

Not in the U.S.A. For now, opportunity investors shift their sights overseas, particularly to Asia. Loaded with dollars, they can find only slim pickings back home: residential land, timber, marinas, golf courses, hospitality, and condominium development or conversions. "Everybody and his brother have set up private equity real estate funds—it's unbelievable the amount of money." "Many players don't even know what they are looking for." If development resumes, opportunity and hedge funds will be prime funding sources.

Development Gears Up. In 2006, development should be the lead signpost for real estate markets. If new construction stays limited and under control, recovering markets in office and industrial will move toward equilibrium with restored pricing power for owners and investors. But if developers start building into the capital torrent, then recovery would be stunted when projects are completed in 2007 and 2008. Relatively sluggish tenant demand and historically high vacancies in many markets argue against most development. "When you start building for an investor market, problems follow and that's been happening in condominiums and multifamily." "Restraints are coming off with so much crazy capital out there; development guys are gearing up. The compression of cap rates allows builders to proceed at lower underwriting, and acquisitions are well above replacement cost, even [after] calculating in higher material costs." Interviewees have been touting improved market transparency from stock and bond research, rating agency scrutiny, and the wealth of timely research information gleaned off the Internet. If evidence of new building wells up in Wall Street research and REIT/CMBS reporting, will it stanch investor and developer construction appetites? The test may come in 2006 and 2007.

Cost Concerns. Material and labor costs could be a significant leavening influence on new building in all sectors including housing. Interviewees continue to suggest that concrete and other building materials have shot up 10 to 30 percent, well above reported inflation figures. The same building boom has created labor shortages among skilled construction workers in some markets, stalling projects and boosting wage rates. The unprecedented hurricane destruction creates a massive need for rebuilding and can only increase demand and cost for materials and supplies. Nationally, land prices also skyrocket, "driven by loose money." Properties coming on line today will cost less than next-generation projects in two to three years. Until now, developers could pass on increased expenses through higher rents and sales prices, but the escalations begin to deter buyers. A sales slowdown because of pricing resistance on top of rising mortgage rates will cut homebuilders' margins. Commercial builders would also have more trouble justifying projects on the drawing board, if returns pencil out below expectations of lenders and partners.

Exhibit 1-12 Real Estate Business Activitiy Prospects in 2006



Source: Emerging Trends in Real Estate 2006 *survey.*

Growth Controls. Antigrowth influences continue to plague suburban developers, who increasingly face moratoriums and higher infrastructure fees. More localities reject developments attractive to families with children, which would raise school taxes. The burden for paying for new roads and sewers increasingly shifts to developers, as federal and state grants are curtailed in budget cuts. Better-capitalized developers—large regional and national builders—have more staying power than many local builders to navigate the system and get approvals. But small local players won't be muscled out of their backyards. They still have an edge in local relationships and market knowledge. Growth controls, land availability issues, and lack of adequate infrastructure were all top-rated issues—deemed to be of considerable importance—among survey respondents (see Exhibit 1-10).

Best Bets 2006

Investment

Sell NOW!

How much higher can prices get? All signs point to higher interest rates. Cap rates may not rise in lockstep, but occupancies and rents may not increase enough to prevent some depreciation, except on trophy properties in the top markets. Upside potential diminishes, while downside risk increases. Harvest gains now from the "phenomenal" recent cyclical run-up.

Back Off Acquisitions

Remember in 1980 when we thought money market accounts could yield 10 percent forever and in 2000 when the Dow had prospects for reaching 20,000 by 2005? Think back five years ago when all those Internet "paper millionaires" were planning to retire by age 29. Accepting reasonable relative value arguments that real estate's risk premium has lowered, too many recent deals "have blown away [risk/return] parameters." "It's very hard to make an investment today that won't have cap rate reversion." Under any circumstances, "avoid paying above replacement cost" and steer clear of broker-orchestrated auctions.

Invest in Asia

Pacific Rim countries represent "the only high rate of return possibility." China and India show substantial growth potential. The region gains greater economic clout and attracts investor flows despite volatility, questionable transparency, and currency risk. "China is the future" and India needs new space to house its growing economy and the outsourced jobs from the United States and elsewhere. A growing middle class in both countries spurs demand for better housing and more shopping centers.

Money Market Funds, T-bills

Take sales proceeds and wait for any market dislocation. If some condominium markets crater, pounce on opportunities. REITs will look better after a correction. But 2006 could be a good time to "pass on real estate" and take a breather.

Hold Core

High-occupancy core properties in prime locations (24-hour cities/coastal markets) may cycle into a period of fixed-income–like returns without much appreciation, but over an extended holding period their risk-adjusted performance profiles will wear well. Rents should trend up as vacancy rates decline further in most markets. Locking in extra fixed-rate financing could add positive leverage before interest rates rise any more.

Development

Develop Infill Housing and Mixed Use

The demographic trends continue—empty nesters move back into cities for more convenient lifestyles while their children delay marriage and build careers in urban nodes where nightlife and social action are attractors. High gas prices and suburban congestion also stimulate more interest in urban alternatives—namely, 24-hour downtowns and mixed-use districts. Transit-oriented development near subway or light-rail lines almost can't miss. "People congregate there." Supermarket and restaurant components in residential high rises "create stronger demand." In cities, the value-add play converts obsolete office buildings into residential space, and aged warehouse space into lofts. In subcities, developers add residential components to shopping and lifestyle centers. New mixed-use town centers in the suburbs are also one of the hottest development trends going today, but they are not easy to pull off and won't work just anywhere.

Develop Age-Restricted Communities

The vanguard of the baby boomer cohort is too young, healthy, and active for assisted living facilities, let alone nursing homes. But late 50- and early 60-somethings, who like the suburbs, relish easier lifestyles in age-restricted communities for seniors, whether consisting of townhouses, apartments, or villas. Roomy layouts are comfortable, but without the hassle of keeping up a single-family home. Interest in seniors' housing will only build over the next two decades, but developers need to avoid getting ahead of the demand curve.

Develop Resort/Second Homes

Condominium development is out of hand in some markets, but demand for unique waterfront properties and resort communities will be sustained in coming years by baby boomers,

preparing for retirement and enjoying the fruits of their peak earning years with tuition and child-rearing costs behind them. Anything has possibilities on beaches and lakes or with attractive mountain views within a two- to three-hour drive of major metropolitan areas. Despite the threat of hurricanes, prices skyrocket along the Florida palm coasts to Mississippi. Katrina-ravaged beachfront will bounce back. Forget about Cape Cod and Nantucket; even houses on Lake Champlain in Burlington, Vermont, sell for north of $1 million! Great Lakes retreats are coveted, too. Colorado and Mountain West ranches and ski chalets get gobbled up. "Noncommodity places and homes appeal the most." Hotel resorts with adjacent condominiums or homes also provide attractive services and amenities. Extra bedrooms are always a plus—in case the grandkids want to visit. Land banking in second-home country makes sense—demand for "special getaway places" will only grow, and these properties should show strong appreciation as longer-term investments.

Take Caution about Other Development

The capital markets may signal opportunity for new development, but soft occupancy rates and only slowly improving operating margins in many cities and suburbs reinforce the view "that commercial real estate doesn't need a new anything." Building upscale hotels may make sense in some undersupplied major cities and resort areas, but a spate of new office projects could easily sidetrack recoveries, except in the few already tight markets with growth prospects. Apartment developers need to be wary of recently converted condominium projects turning back into rentals. Growing obsolescence in warehouse markets presents opportunities for new space, but selectively. Again, vacancies are still high in many places. Demand for niche real estate—self-storage, medical offices, student housing—could easily be swamped if too much product gets built too quickly. Homebuilders need to read the tea leaves and back off.

Property Sectors

Hold Full-Service Hotels

Business center hotels have "roared back" and resorts gain momentum. Executive road warriors fill rooms and a weak dollar fuels foreign tourism. A lack of inventory helps drive pricing power ahead of any new supply, which will be several years off. Buyers confront rich pricing—RevPAR growth has not escaped anyone's notice. Sell limited-service or "dog-eared" product into the acquisition frenzy. Timing couldn't be much better. Investors, however, need to keep an eye on the impact that energy prices have on travel budgets.

Sell or Hold Apartments

Apartments are a mixed bag. Demographic trends support consistent, future demand growth and rising mortgage rates portend increased numbers of renters. But cap rates have pushed prices well above replacement cost and look unsustainable. Rental markets with heavy condominium development and conversions may backslide if speculative buying cools. The high-income apartment category seems particularly vulnerable. Selling sentiment outweighs the buy side, but holders should do well over time.

Hold Warehouses

A classic core investment, industrial real estate consistently delivers bond-plus returns. Investors almost can't miss holding onto facilities in major distribution hubs and ports. It's a good time to weed out or redevelop obsolescent space—properties with low ceilings, short turning radii, etc.

Sell Commodity Office

Despite recovering markets, cap rate compression significantly diminishes or even eliminates appreciation potential on many office acquisitions. Rent growth will have trouble keeping up with underwriting assumptions. Buyers seem willing to pay premiums for almost anything with walls and windows.

Sell Retail

After fabulous appreciation gains, retail takes a breather. Voracious consumer spending—fed by tax cuts, low interest rates, and mortgage refinancings—may keep up if wages increase enough, but don't count on it. Energy costs and rising mortgage rates could zip pocketbooks. "Retail has all the risk."

More investment capital will flow into **China** *and* **India** *from around the world and*

Outlook Through 2010

During the next real estate cycle, *Emerging Trends*' respondents predict that property markets will become more global and more public, and U.S. real estate markets will sustain interest from capital sources of all stripes attracted by steady property cash flows. Meanwhile, sprawl issues, congestion, and the potential for higher energy prices will accentuate the desirability of suburban town center developments and more convenient urban lifestyles. Following is a digest of interviewees' longer-term forecasts:

Relative Value Endures. Capital flows into U.S. real estate will remain ample, and market liquidity will decrease volatility as well as overall returns—cap rates trend below historic norms. "Real estate will be viewed as an inflation-indexed bond and a must for mixed-asset portfolios." Aging baby boomers, requiring greater safety and predictability from retirement savings, will seek more income-oriented investments. Pension funds will continue to increase allocations to real estate as payouts swell to expanding numbers of retiring beneficiaries. REIT- and CMBS-related investments—including more sophisticated synthetic bond products and derivatives—gain favor. Subtext: While pension allocations increase, defined-benefit plans look more like dinosaurs. Corporate entities replace defined-benefit formats with defined contribution/401K plans more suited to mutual fund/public market investments than illiquid private real estate. Public funds eventually will follow suit. So far, investment managers have struggled to structure private equity vehicles with liquidity features to meet the growing market demand.

Everything Globalizes. "Investment horizons expand dramatically" as foreign securities markets blossom. REITs only now sprout in Asian and European countries. "These markets will mature very quickly" when more companies go public. Cross-border transactions by investors and operators will become routine. Following the lead of lodging companies, retail, industrial, and office developer-managers will morph into international operations. They link strategies to the interests of growing numbers of tenant clients who operate worldwide. Subtext: "The rise of China could rewrite economic rules." More investment capital will flow into China and India from around the world and both countries will be a greater source of investment capital for U.S. real estate markets.

CMBS Dominate. CMBS markets also expand well beyond the United States, and domestic CMBS market share expands in commercial and multifamily lending. Offerings will increase in size, "accommodating megadeals while improving liquidity and transparency." In general, mortgage debt becomes more commoditized, securitized, and sophisticated with even more segmented risk to match investor appetites. Continuing industry integration "will make debt more of a driver" in the capital markets.

REITs Consolidate and Grow. REITs follow the globalization trend, becoming multinational with cross-border listings. The industry consolidates further into bigger, more institutional companies. Governance and regulatory hassles frustrate smaller companies, which go private or merge into bigger competitors. Overall, the REIT sector expands its market share of real estate ownership. Pension funds may allocate more to the asset class, but increasing numbers of defined contribution plans invest through REIT mutual funds.

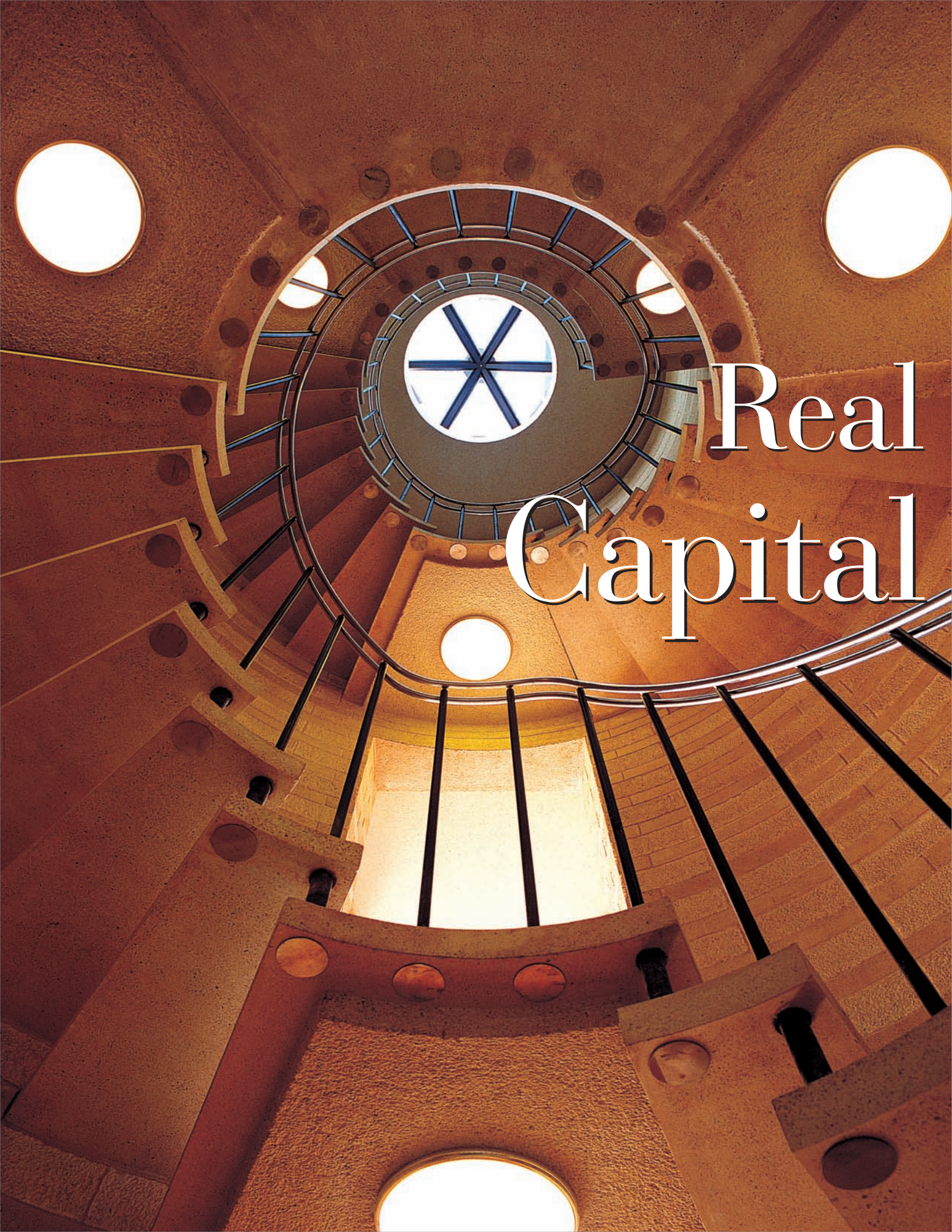
both countries will be a greater source of investment capital for U.S. real estate markets.

Focus on Infill. Some areas reach the limits of their patience over sprawl and traffic—communities in southern California "approach a crisis stage." Places without mass transit struggle. If gas prices stay high, people in outer suburbs may start joining "the move back in." Inner cities will clear or redevelop more old industrial sites and obsolete office buildings for residential neighborhoods with retail and office components. Leading-edge examples have been Denver's LoDo and Atlanta's Atlantic Station. Transit-oriented development gains momentum as more suburban agglomerations expand light-rail initiatives to reduce dependence on car travel. "LoDo is the future, suburban office parks are the past." Boomers and echo boomers will continue to dictate residential trends toward more infill.

More Suburban Mixed Use. In the outer suburbs, "Urban town centers will be the rage." "Big-lot housing becomes more a thing of the past." Again, escaping traffic and finding convenience push the trend. Pressure builds from people who want to live in places where they can shop, work, and play. These developments must creatively incorporate retail, other commercial space, parks, and recreation areas into projects with apartments and single-family housing. Closed military bases and ghost malls will continue to offer large tracts for redevelopment. Flagging office parks could also present possibilities. Sprawl won't die, but it becomes less acceptable.

Greater Energy Efficiency. Every time gas and heating prices spike, the ignored topic of energy conservation and efficiency gets resurrected. Energy experts endlessly debate levels of oil and gas reserves. Environmentalists cry wolf, but then prices always seem to dissipate. Will they fall again this time? An extended period of sticker shock at the pump and jaw-dropping utility bills would change behaviors and demand drivers for both home and commercial owners, reinforcing move-back-in and town center trends. Developers will need to stress more "green" development and rehab as tenants resist higher electricity and heating tabs.

As long as capital keeps flowing, everything will be all right.



Real Capital

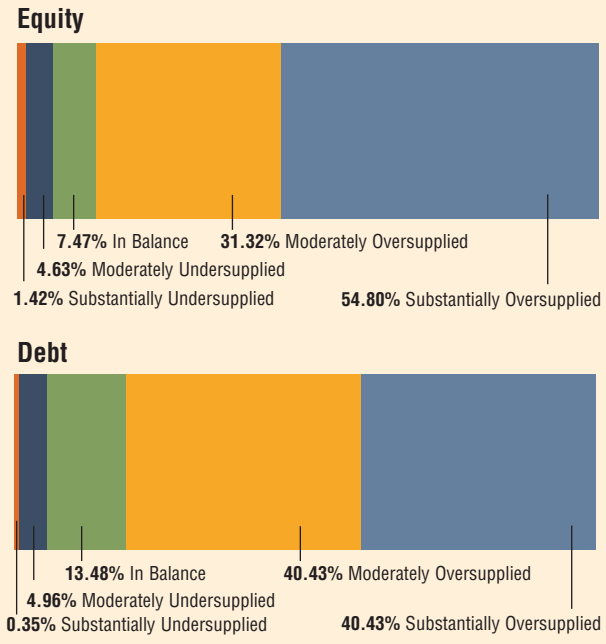
"Capital markets have embraced real estate in a bear hug.*"*

Estate Flows

Everybody into the pool, "capital galore" has "inundated" the entire real estate market, "all segments and niches." Huge amounts of money (an estimated $50 billion–plus from pension funds alone) "stack up on the sidelines." "Investment markets can't handle all the capital in play." "Solid returns become a self-fulfilling prophecy as long as capital gushes." Many interviewees contend that the "unabated capital frenzy" ensures that cap rates will stay low for the foreseeable future, certainly through most of 2006, barring an unforeseen exogenous shock. "The flows will continue because real estate is a good investment and now operating performance is beginning to improve." "Irrational exuberance stays alive for another year," as long as the "interest rate environment remains benign."

Emerging Trends surveys forecast a minor falloff in capital availability during 2006. "Capital will still be over flood stage, maybe five feet over instead of ten, but a flood is still a flood." More than 86 percent of *Emerging Trends* respondents predict the equity capital markets will be moderately or substantially oversupplied in 2006, while about 81 percent forecast the debt markets will be oversupplied (see Exhibit 2-1). On the equity side, survey respondents see private investors, opportunity funds, and pension funds leading the charge, while CMBS issuers, gaining market share, and money center banks dominate the debt markets. (See Exhibit 2-2.)

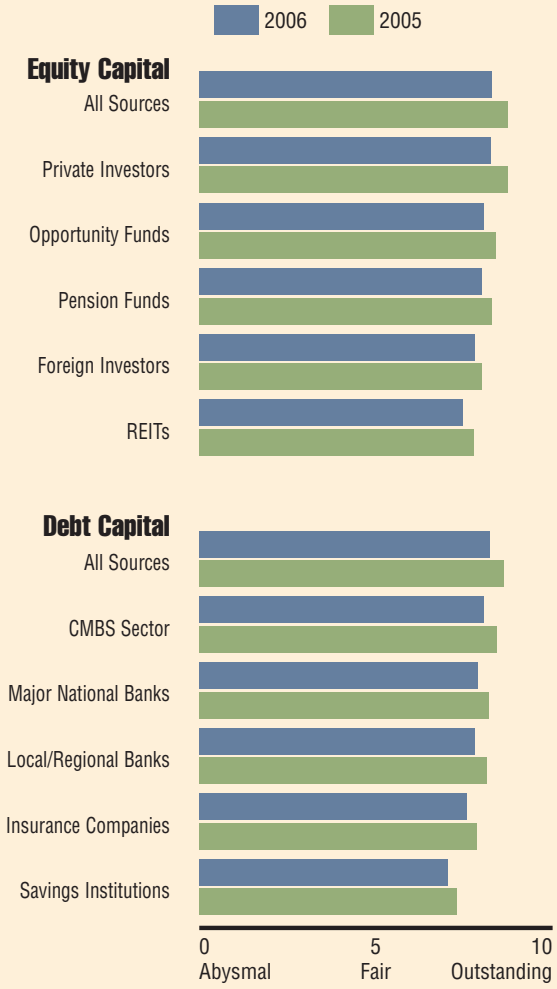
Exhibit 2-1 Real Estate Capital Market Balance Forecast for 2006



Source: Emerging Trends in Real Estate 2006 *survey.*

"A huge number of **opportunity funds** *are waiting for prices to fall, and as a*

Exhibit 2-2 **Availability of Capital for Real Estate in 2005 and 2006**



Source: Emerging Trends in Real Estate 2006 *survey.*

This extremely deep capital market for real estate also "creates a governor or floor," protecting investors from downside risk should property sectors weaken or some capital leave the market. "A huge number of opportunity funds are waiting for prices to fall, and as a result prices won't drop as much when and if they do." "It amounts to a buy-side backstop." A huge amount of real estate remains on corporate balance sheets, and some companies sell into this favorable market.

Is the End Near for Unrestrained Capital Flows?

For all the confidence about real estate's relative value and new-found transparency, many interviewees nervously sense "the end is near or very near" for unrestrained investment, which has bid up pricing to giddy levels, given current property revenues. "Everybody has been overreaching." "It's gotta stop, it's nuts." After more than ten years "with the wind at their backs," investors "assume very low losses." "Yield has become a more important metric than risk-adjusted return," especially in analyzing higher-risk CMBS tranches. "Everybody looks through the rear-view mirror instead of through the windshield."

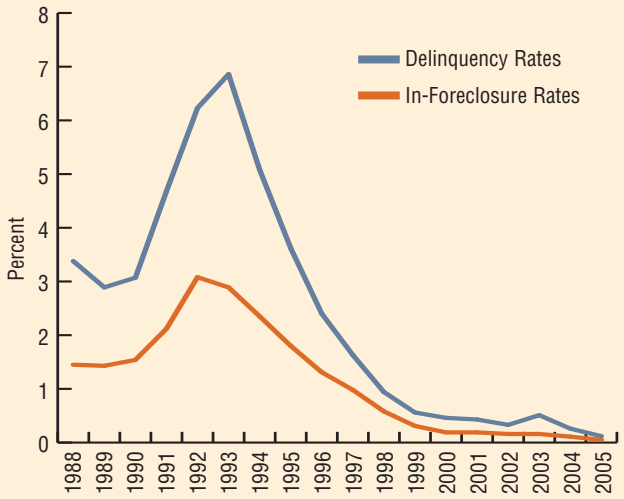
Judgments about the amount of "hot money" inflating the market vary. A reasonable estimate suggests that capital flows comprise 50 percent "cool capital" from long-term, experienced players; 25 percent "warm" money from new investors looking for diversification and real estate's touted benefits; and 25 percent hot, highly leveraged hedge fund and tenant-in-common (TIC) investors. "It's crazy, all the new people coming into real estate," says a Southwest developer. "I'm getting my shoes shined next to two oil guys who are talking about a condominium conversion project. Who are these guys? It leads to excess." "Herd capital" could pull back on a dime if adversity strikes or better opportunities in alternative asset classes come along. "Unregulated lenders—mezzanine and hedge funds—will disappear if there is an interest rate spike."

Lenders and investors have looked to limit their risk as they loosen investment parameters and pour money into property investments. Liberal bank and conduit underwriting—high loan to values, low debt service coverage, little or no reserves—permits buyers to "have less skin in the game." Increasingly, owners take the opportunity to "cash out" substantial property stakes, using refinancing stratagems, including doses of floating-rate debt. "They are basically selling most of their equity. It will be easy to walk away if trouble hits." Lenders participate in or issue CMBS offerings to take loans off their books and spread risk across bond markets. Upwards of 75 percent of loan originations become securitized. "Securitizing makes it easier to take risk less seriously when you make loans," says a leading banker. For CMBS bond buyers, complex tranche structures layer and diffuse risk further. Securitization creates "some moral hazard"—investors have "less at stake and shorter-term investment horizons."

result prices won't drop as much when and if they do."

Everyone draws considerable comfort from very low delinquency and default rates, which reinforce the notion that low interest rates helped owners weather patches of soft tenant demand, and ensuing market upturns now create solid revenue margins to more than cover debt service. (See Exhibit 2-3.) But these extremely rosy numbers may be a little deceiving. "CMBS delinquency and default stats have been clouded by huge recent issuance," says a leading researcher. The numerator of underperforming loans looks small compared with the expanding denominator and the overall size of the market. Take away the new issuance and problem loans would look bigger, but still very much under control. Also, the voracious transaction markets gobble up just about anything for sale. Owners can dispose of weak properties and avoid distressed pricing.

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

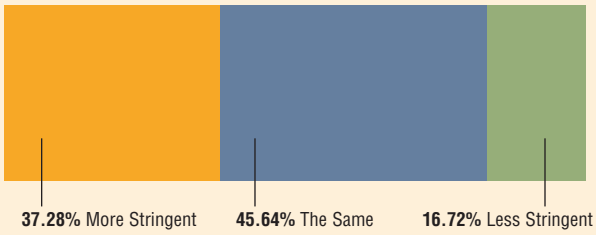


Source: American Council of Life Insurers.

A majority of interviewees expects underwriting standards to tighten (37 percent) or stay the same (46 percent) during 2006. (See Exhibit 2-4.) Only 17 percent suggest that standards will become less stringent. Generally, interviewees applaud lender discipline on holding the line on speculative development projects and keeping the market supply side in check. Bankers demand significant owner equity (20 percent or more)

Exhibit 2-4 Underwriting Standards Forecast

Predicted Change in Stringency of Underwriting Standards for Commercial/Multifamily Mortgages in 2006



Source: Emerging Trends in Real Estate 2006 *survey.*

and meaningful preleasing before entertaining construction loans, at least for office, retail, and industrial projects. Lenders get lower marks for bankrolling property acquisitions and refinancing properties. "Securitized lenders have relaxed standards more than conventional lenders."

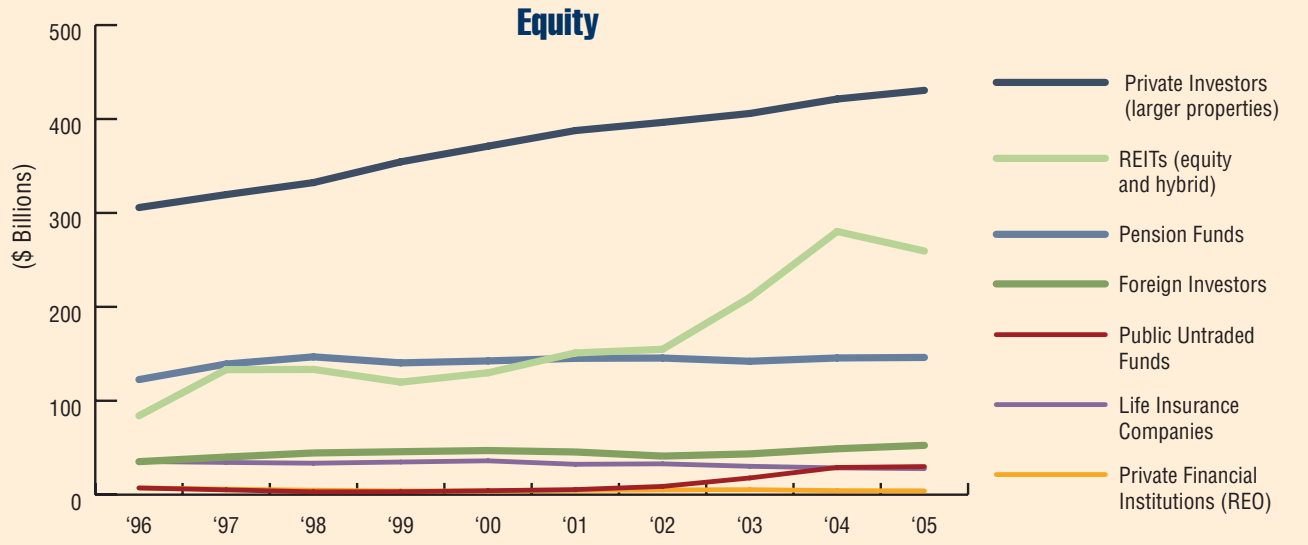
In recent years, enraptured borrowers have delighted in a bacchanalia of easy money, but the good times may be fleeting. Floating-rate debt looks increasingly less attractive in the face of rising short-term interest rates. If owners have resisted, it's still not too late to lock in fixed-rate mortgages. When it comes time to refinance in five years in a higher interest rate and cap rate environment, borrowers may be tested unless rents show significant growth.

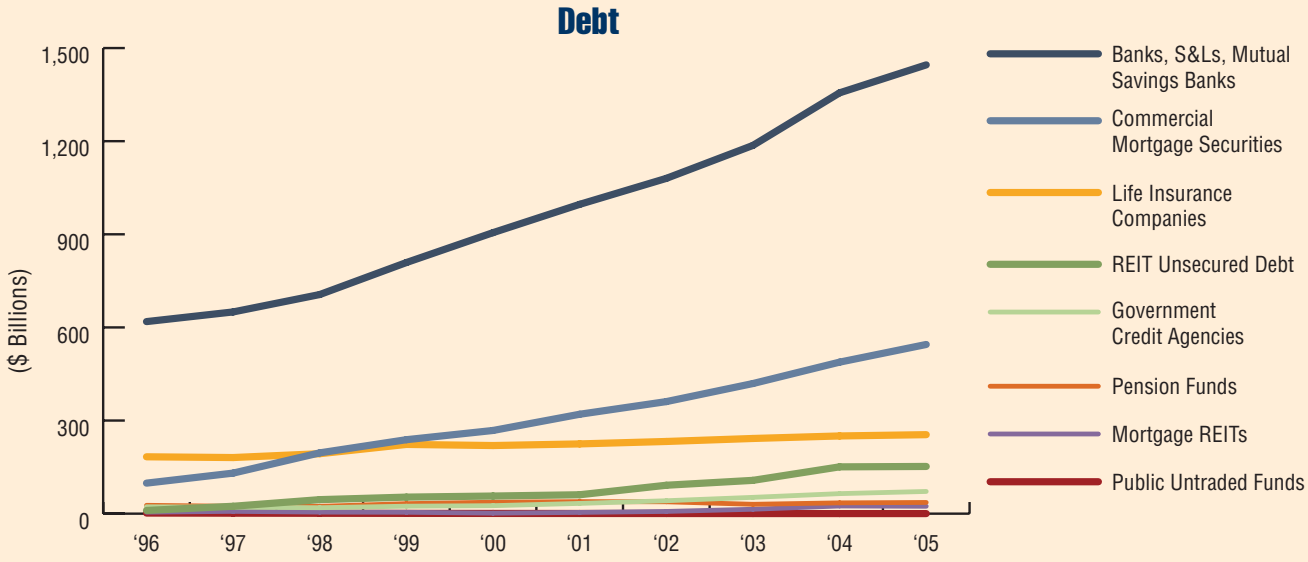
Private Investors and Syndicators

Over the past five years, many individual investor/syndicators have proved savvy dealmakers, buying at market prices and selling out quickly for excellent gains when prices skyrocketed. In hindsight, "it's not been stupid money." After initially lambasting syndicator groups for sucking up "all the deals" at what then seemed exorbitant amounts, more conservative investors, especially pension funds, now wish they had been so proactive. "Some syndicators look pretty smart today."

Capital Sources and Flows

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



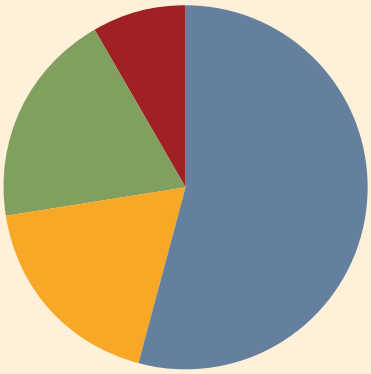


Sources: Roulac Global Places, from various sources including American Council of Life Insurers, CMSA/Trepp Database, Commercial Mortgage Alert, Federal Reserve, FannieMae.com, FDIC, FreddieMac.com, IREI, NAREIT, PricewaterhouseCoopers, and Real Capital Analytics.

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

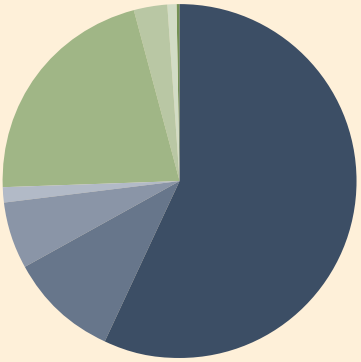
Exhibit 2-6 Real Estate Capital Sources

U.S. Real Estate Capital: $3,479.5 Billion



- Private Debt $1,888.5 Billion
- Public Debt $640.6 Billion
- Private Equity $661 Billion
- Public Equity $289.4 Billion

Debt Capital: $2,529.1 Billion



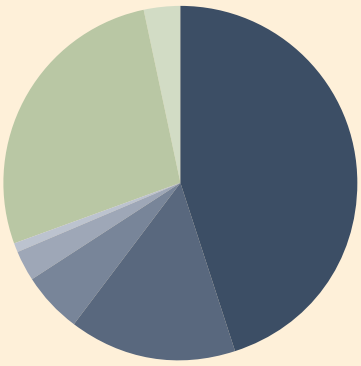
Private Debt

- Pension Funds $36.1 Billion
- REIT Unsecured Debt $152.1 Billion
- Life Insurance Companies $254.5 Billion
- Banks, S&Ls, Mutual Savings Banks $1,445.8 Billion

Public Debt

- Public Untraded Funds $0.2 Billion
- Mortgage REITs $23.8 Billion
- Government Credit Agencies $71.5 Billion
- Commercial Mortgage Securities $545.1 Billion

Equity Capital: $950.4 Billion



Private Equity

- Private Financial Institutions $4.1 Billion
- Life Insurance Companies $27.7 Billion
- Foreign Investors $52.5 Billion
- Pension Funds $146.1 Billion
- Private Investors (larger properties) $430.5 Billion

Public Equity

- Public Untraded Funds $29.9 Billion
- REITs (equity and hybrid) $259.4 Billion

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

Note: As of second-quarter 2005. Excludes corporate, nonprofit, and government equity real estate holdings, as well as single-family and owner-occupied residences. Data in this graphic are from a different source than in previous Emerging Trends *reports, and thus are not comparable with data in previous reports.*

Private capital takes all shapes and sizes. "The dollars are still out there. You really don't know who they all are." Syndicators continue to market pooled funds with large front-end loads to moms and pops through Wall Street brokers and financial advisers. Tax-advantaged 1031 tenant-in-common (TIC) joint ventures—often composed of wealthy professionals, have jumped on small- to medium-sized deals offered by local developers and operators. Small groups of high-net-worth individuals band together to buy bigger deals through advisers and developers. Other investors access the market through hedge funds.

Interviewees have shifted concerns about overreaching from the real estate fund syndicators to 1031 clubs and hedge funds. Tenants-in-common are "incentivized to pay more" by tax shelter schemes, and have actively bid up prices on "marginal deals," using large amounts of leverage. "It's the old syndication game by another name. Other investors cannot compete." "They don't exercise prudent due diligence, buying 'as is' without proper reviews on environmental or engineering." Other interviewees are slightly more charitable: "These freewheelers may not be dumb money, but they take on additional risk without a reasonable level of reward." "Most of the sponsors are reliable." These investors need to wonder whether their aggressive buying and financing strategies will work as well so late in the pricing cycle.

Stymied by tepid securities and alternative investment markets, hedge funds have turned to real estate to deliver promised high-octane returns. Portfolio managers typically are better schooled in deal structuring and Wall Street finance strategies than the finer points of bricks and mortar. "Not permanent players," "they fool around in a product they really do not understand," "churning deals, pushing up pricing, investing in development." "They could be a time bomb," or just suffer less than stellar returns.

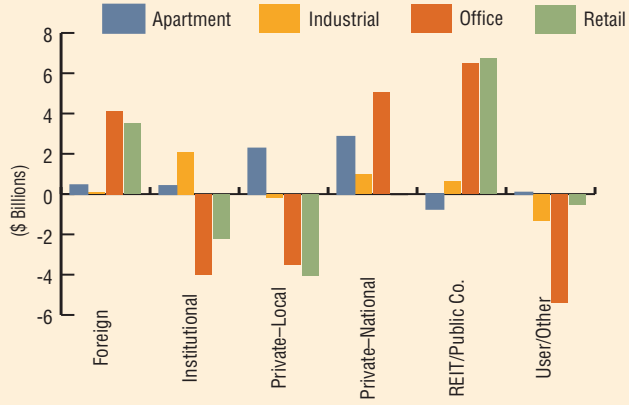
Not all segments of the private investor market are buying, however. National private players have been far more active in their acquisitions than local ones. (See Exhibit 2-7.)

Pension Funds

For all the considerable talk about raising allocations, pension funds have been active sellers of real estate, weeding portfolios and taking advantage of capital demand. While values have escalated and REIT capitalization almost doubled, the value of pension holdings has leveled since 2000 with no appreciable increase over the past year. Unquestionably, plan sponsors have hiked commitments, preparing to funnel big money into property funds and individual deals. Adviser open-end funds have brimming queues of institutional money waiting to invest. The problem remains finding economic deals to fit portfolio strategies, especially for core investors.

Always criticized as "late to the party," most plan sponsors view greater risk in underweighted real estate positions than buying overpriced assets. They want reliable income from property investments to pay out liabilities to increasing numbers of retirees/beneficiaries. "For pension funds, real estate is still a small part of their overall investment allocation," explains a consultant. "Chief investment officers are more concerned about getting diversification benefits than the repricing of recently bought assets." In order to allocate dollars more quickly, plan sponsors would prefer to pay all cash or use less leverage, but they realize they cannot compete on price without employing debt. "There's a lot of frustration." "If they stay in the traditional four core categories [office, apartments, industrial, retail], they will never be fully invested." Instead, plan sponsors allocate more to value-add funds and buy into niche property sectors. If and when more fickle capital leaves the market, institutional investors are poised to fill much of the void, buoying expectations for continued market liquidity and stabilized values. "There is so much money teed up" to keep the revelry going.

Exhibit 2-7 Net Capital Flows by Source and Property Sector



Sources: Real Capital Analytics, PricewaterhouseCoopers.

Note: Net capital flows third-quarter 2004 through second-quarter 2005 inclusive.

active sellers of real estate, weeding portfolios and taking advantage of capital demand.

REITs

After winnowing and selling holdings in recent years, REITs have stepped up acquisitions, extended operations overseas, increased joint ventures with institutions, and continued mergers and consolidations. Soaring stock prices beg for correction. "REITs are more susceptible to hot dollars leaving than the private markets and could lead pricing down." Spiking total returns, averaging 20 percent annually, have made these property companies Wall Street darlings. "REIT prices will need to adjust if interest rates increase or the stock market rallies. The group is overvalued on an NAV basis." Much-prized dividend growth, REITs' enduring raison d'être, lags the run-up in their stock prices. Not surprisingly, companies begin to tout total returns and downplay the disconnect in "deteriorating" yields. But "prices need to fall to improve dividends." "How much more appreciation can they have?" In 1997–1998, when REITs were hyped as growth stocks after handsome gains, prices plummeted.

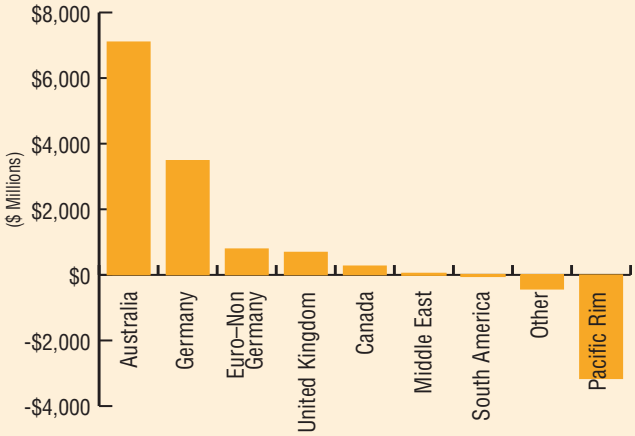
Hot stock capitalizations revive REIT acquisition appetites—purchases can be accretive and the companies have been prominent net buyers. Joint ventures with institutional partners remain a popular way to raise lower-cost capital, and increase internal rates of return. Some REITs raise money through private equity funds in a further convergence of public and private capital. Sarbanes-Oxley "headaches" and a host of other regulations burden small-cap REITs, which cannot easily absorb compliance costs and deal with reporting/accounting hassles. These companies are ripe for acquisition or may go private. Larger-cap companies look ever more institutional and less entrepreneurial as founding families give way to professional managers.

The most active buyers have been retail and office REITs. (See Exhibit 2-7.) Swallow-hard pricing at home sends some mall and industrial REITs overseas "to find growth." They also can apply their management expertise to underserved markets. "It's only the beginning of more cross-border activity and listings." Australian REITs expand activities in the United States, expecting to enhance their Sydney stock prices.

Foreign Investors

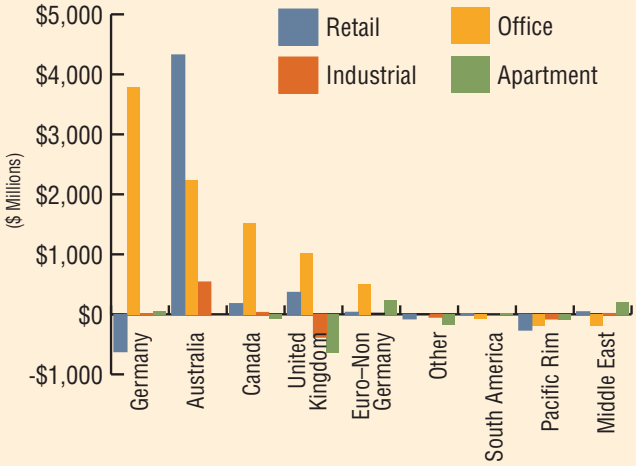
Australian investors, in fact, lead a charge of aggressive foreign capital into U.S. markets, leapfrogging German investors as well as Middle Eastern, Irish, and other European players. Favorable exchange rates energize Aussie pension funds, who, like other overseas investors, gravitate to the large, diverse, and stable American property markets. German syndicators have backed off—they can't stomach low cap rates. Saudis and other oil state investors quietly continue to invest "huge" amounts in their "American safe haven." Some South American money

Exhibit 2-8 Foreign Net Real Estate Investments, 2004 to 2Q 2005



Source: Real Capital Analytics.

Exhibit 2-9 Foreign Net Real Estate Investments By Property Type, 2004 to 2Q 2005



Source: Real Capital Analytics.

Lenders appear to **squeeze** *profits from volume in a competition to put out money.*

focuses on south Florida. Finally, Asian institutional money reawakens (net sellers recently) to opportunities in the United States. Investors from Korea, Japan, and Malaysia increase activity, joining Singapore, which has been a consistent player. China will come soon. "It's inevitable." Foreign buyers concentrate in familiar coastal cities, acquiring mostly office and retail.

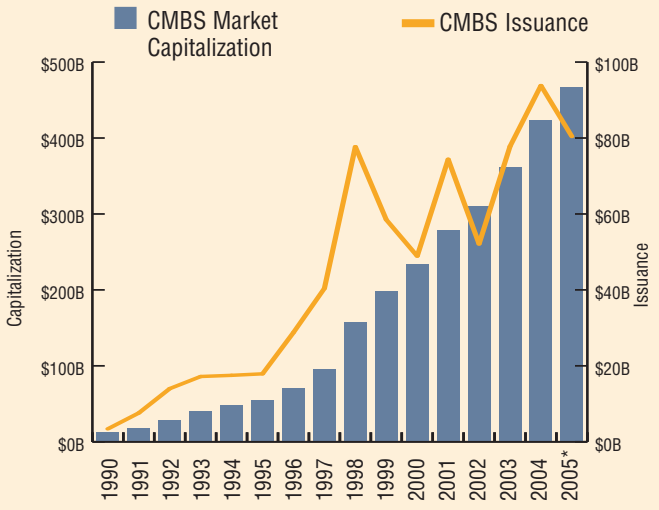
Banks and Insurers

Lenders appear to squeeze profits from volume in a competition to put out money. If banks or insurers don't make loans, borrowers can solicit a host of other sources to structure financings, including commercial mortgage–backed securities (CMBS) conduits, mezzanine lenders, and even hedge funds. "Banks have no pricing power, spreads are too narrow." "Debt is given away" and "no one seems to be worried." "Risk has not been priced into most deals and reserves have been cut back." Even interest-only loans creep into the commercial sector. Calming most concerns, defaults and delinquencies stay "benign" as fundamentals improve. "A condo bust may hurt some local banks in south Florida, but otherwise bank risk is spread out in securitized pools and syndications."

Most developers tout "prudent" bank lending practices for construction loans in office, retail, and industrial, "but the dam has burst in multifamily and single family." "For now, banks have controlled development, but there is a lot of money still to lend." Banks and insurers keep moving loans off their books into securitizations and the vast global capital markets suck up the real estate bonds so lenders can redeploy the proceeds liberally. Insurers continue to increase investments in CMBS at the expense of more traditional whole-loan lending, which requires larger reserve requirements from industry regulators.

For the first time, some interviewees question whether banks' institutional memories begin to fade over profligate lending practices, which precipitated their early 1990s financial debacle and the S&L industry collapse. "Today's lending is without question the most aggressive in the past 15 years." The Federal Reserve sends signals of increasing unease. As long as property revenues grow, borrowers will be well positioned to cover debt service, even as interest rates increase. Lenders, meanwhile, jettison risk into the securities markets. What, me worry?

Exhibit 2-10 CMBS Market



Sources: Federal Reserve, Commercial Mortgage Alert, PricewaterhouseCoopers.

Note: Issuance and market capitalization data are for both commercial and multifamily mortgages.
**Data for 2005 are for the first two quarters only and not annualized.*

CMBS

CMBS offerings proliferate—2005 issuance could exceed the record 2004 pace by more than 50 percent. (See Exhibit 2-10.) Although spreads narrow, investors devour CMBS for their premium yields over comparable corporate bonds, treasuries, and other fixed-income alternatives. The bond markets perceive no greater CMBS risk thanks to low delinquencies and improving property sectors. For conduits and investment banks, the decade-old "dream has been realized." CMBS have become a "mainstreamed" core fixed-income investment product. "Even pension funds have warmed up and become buyers."

Nothing short of revolutionary, the CMBS impact on U.S. real estate markets has been mostly responsible for providing a strong, consistent source of liquidity to property owners. During the past decade, a rigorous industry infrastructure has evolved to arrange, analyze, research, distribute, and support offerings. "The markets have become quick and efficient with great transparency and information." B-piece/unrated buyers have remained disciplined and "fairly stringent," kicking out

bad loans from mortgage pools. Rating agencies add considerable oversight. But some interviewees suggest investors and rating agencies should "push back more" on offerings. "Deterioration in credit quality could be with us for a long time." "Securitization has helped spread the risk, but now many lenders have weakened their standards." Conduit lenders wonder whether discipline can hold together. "The market still has not been tested. We've had everything going our way since the start 13 years ago—a long up-cycle, low interest rates, and now improving markets."

CMBS markets expand overseas into Europe and Asia, but cross-border investing "has a ways to go." Impediments include currency and tax laws.

Mezzanine Investors

For mezzanine investors, "discipline becomes the name of the game." Underwriting standards appear to slip more precipitously and some lenders may misprice risk. Oversight is minimal and the market is less transparent. "The only place we see questionable loans is [with] mezz, where lenders are not subject to rating agencies," says a leading mortgage banker. "Imprudent" condominium lending has fueled the conversion market, and may come back to haunt. Mezz loans—based on inflated valuations, interest-only payouts, low reserves, and no escrows—have made it easy for borrowers to cash out large portions of their equity stakes near market pricing peaks. Some mezz lenders could get left holding the bag, which is fine with traditional lenders higher up on the capital stack.

As long as capital keeps flowing, everything will be all right.

Markets to

"An institutional bias **predominates** *for selected cities, but secondary markets see plenty of action."*

Watch

Any discussion of the nation's top real estate markets reverberates like an echo chamber—"Coastal cities, coastal cities; barriers to entry, barriers to entry; D.C., New York, southern California, D.C., New York; coastal cities, coastal cities . . . ." "Everyone is using the same data and reaching the same conclusions."

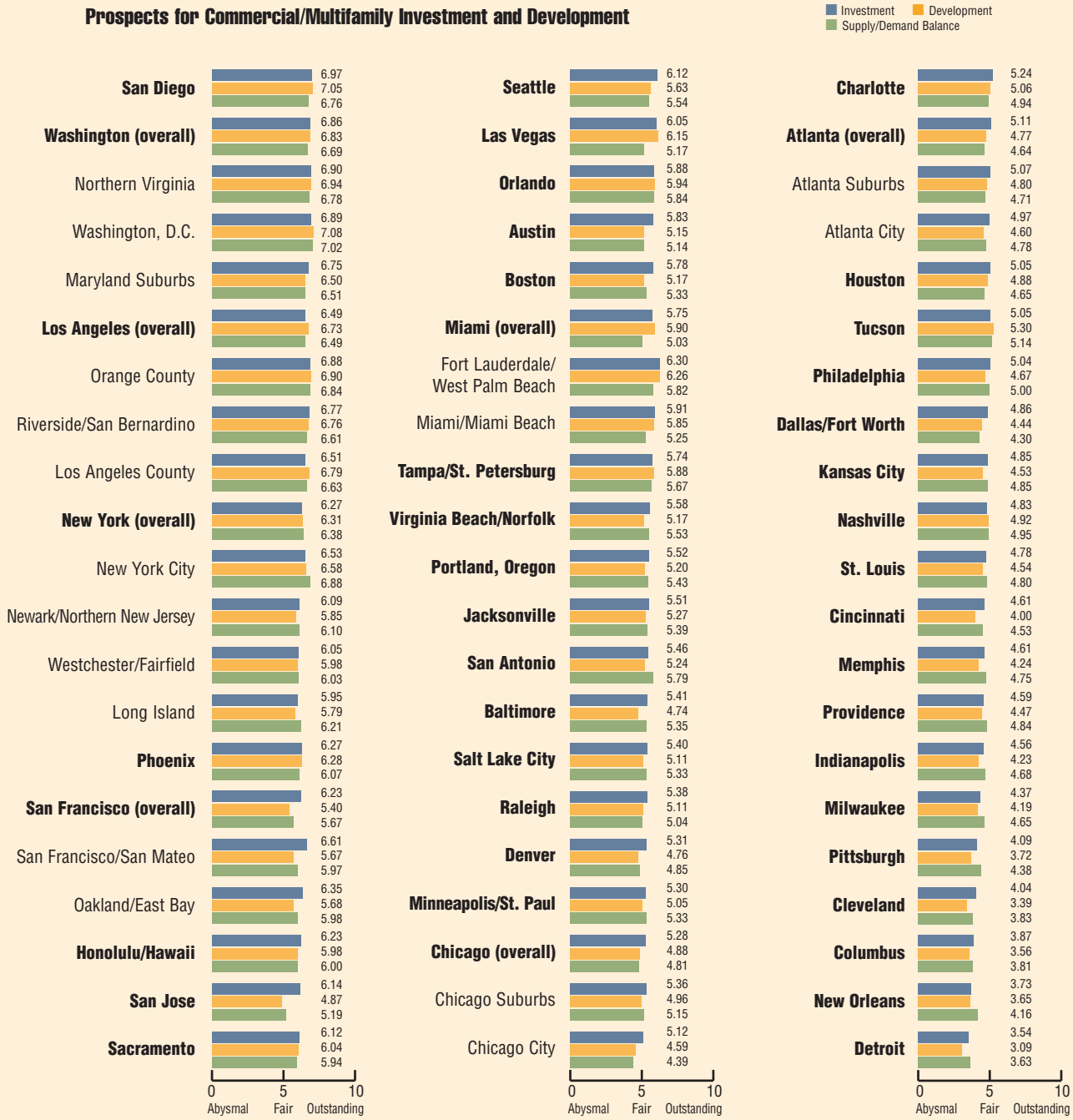
Corporations continue to consolidate operations along global pathways. They prefer larger cities with transportation and communications hubs, facing Asia, Europe, and Latin America. New York dominates finance. Washington, D.C., is the world power capital. The top California markets gain from their Pacific Rim perches and strength in technology, entertainment, and a host of other sectors. Miami and south Florida benefit from proximity to South and Central America. For investors, the concentrated demand in a few major markets "has made it hard to generate yields." "Everything has been picked over."

In fact, hungry capital knows few limits today and hunts for deals in lower-growth and even no-growth regions and submarkets, bidding up prices almost everywhere. Of the 63 metropolitan area markets and submarkets in our survey, 57 have fair or better investment prospects. "No overlooked markets exist." "An institutional bias predominates for selected cities, but secondary markets see plenty of action." "I'm investing in Birmingham and Boise." The only steer-clear places are increasingly the Rustbelt manufacturing citadels. Nevertheless, investors sniff around for transactions in some of these cities, too—"anything to put money out." They sideline concerns about limited exit strategies and shallow tenant pools, taking solace in recent market gains. "Even the softest markets show signs of coming back with rising occupancies, improving absorption, and slight rent improvements."

Many investors look beyond top cities searching for **value**.

Exhibit 3-1 **Markets to Watch**

Prospects for Commercial/Multifamily Investment and Development



Source: Emerging Trends in Real Estate 2006 *survey.*

Coastal Cities Still Preferred, but Foraging Increases

Emerging Trends' market ratings for investment, development, and supply/demand balance reflect heightened prospects for commercial/multifamily sectors of most metropolitan area markets—they generally improve across the board from the 2005 survey. Here are the key highlights:

Southern California Leads. For the first time ever, San Diego climbs to the top of *Emerging Trends*' market rankings, just ahead of perennial leader Washington, D.C. Greater Los Angeles follows closely, with its booming Orange County leading the way. Southern California parlays extraordinary climate, geographic barriers (desert, mountains, and ocean), deepwater Pacific ports, and an extremely diversified economy (entertainment, defense, biotech, finance, services). Dynamic demand and constricted supply translate into the nation's best place to invest. But interviewees worry about debilitating traffic congestion and the region's car dependence. High costs and rising taxes strain lifestyles, while increasing numbers of poor immigrants, mostly from Mexico and other Central America countries, transform the state's demographic profile.

East Coast Stalwarts. D.C. and New York become ever more strategic as America's primary global gateways. Corporations and world elites "need to be there" and investor hoards follow. These core markets exemplify stability and prosperity—they swim in liquidity. Yields plunge, but holdings look very safe. Buildout along the Atlantic Coast through the Northeast megalopolis creates desirable barriers to entry. "You almost can't go wrong on anything within 100 miles of the coast." Philadelphia and Baltimore continue to get lost in the shadows. Boston suffers from recent corporate consolidations, but retains its attractive 24-hour profile and strong talent pool of workers.

Looking Beyond Prime Markets. Many investors look beyond top cities searching for value. Several smaller and medium-sized Sunbelt and coastal markets gain in rankings, notably Phoenix, Honolulu, Sacramento, Seattle, Las Vegas, Orlando, Austin, and Tampa/St. Petersburg. While hampered by a lack of development restraints—geographic and land use controls—these areas remain preferred places to live and work. California spillover is especially notable. Phoenix's, Las Vegas's, and Sacramento's solid rankings recognize the increasing flow of people and back offices moving to less expensive places in inland California or in states adjacent to California. Expect this trend to linger as problems such as traffic, aging infrastructure, and cost of living intensify in Los Angeles and San Francisco. The spillover eventually extends to Seattle, Portland, Boise, and Salt Lake City, moving as far east as Denver. California has more than enough staying power, but the state must cope with retooling mature markets, while social services, education, and other government-related costs escalate.

Ups and Downs. Among major markets, San Francisco makes the biggest leap in the ratings and Miami takes the largest fall. The entire Bay Area, including San Jose, seems poised for a rebound after the scorch-and-burn tech industry collapse five years ago. South Florida holds onto positive longer-term trends for growth, but condominium overbuilding poisons immediate forecasts. A proxy for lodging markets, volatile Honolulu strengthens dramatically from a tourism upsurge and more stable Japanese economy.

Sunbelt City Malaise. Atlanta, Houston, and Dallas remain buried in the rankings' lower quintiles. Denver and Charlotte register marginally better. All see ratings improvements, "but nothing to do cartwheels over." Construction rises to ever-stretching horizons, outstripping demand no matter how prodigious. "Texas's population may be growing, but the markets are still oversupplied from 20 years ago and they are still building." Denver and Atlanta are the same story. "There is never enough growth to catch up and the oversupply doesn't allow for much appreciation." Actually, growth trends have been more lukewarm than hot lately—well below 1990s peaks. Some office employment growth continues, but at a slowed pace. Investors always look to time these markets and

put money to work. "Texas and Atlanta on a return basis are not so great," says a pension executive. "But there is always product to buy and sell, which helps meet allocation targets." The combination of habitual market softness and current ample buyer demand appears to limit upside on time-tested value-add strategies in the current cycle. Houston enjoys a temporary boost from New Orleans's misfortune.

Midwest Distress. Peek at the bottom of the market rankings. It's a veritable congregation of Midwest cities. Jobs leak away, young people leave, the population ages and stagnates. Over the past 30 years, these markets' industrial backbones have been slowly crushed by overseas competition and technological advances. Colder, uninviting climates chill interest from new businesses. Would your workforce prefer to live in Milwaukee or Detroit over La Jolla or Raleigh/Durham? The handful of overseas manufacturers looking for U.S. beachheads gravitate to right-to-work states in the South and Southwest where union labor rates won't eat into profits. "The vast central region appears mired in poor demographics with little immigration or economic growth." The remaining bedrock auto industry lists dangerously. For investors, "there is low to no growth and low liquidity." Chicago slumps from top market status to just behind high-plains neighbor Minneapolis/St. Paul. Both cities are buffered by a diversified group of nonmanufacturing businesses, but regional tribulations threaten to sap their vitality.

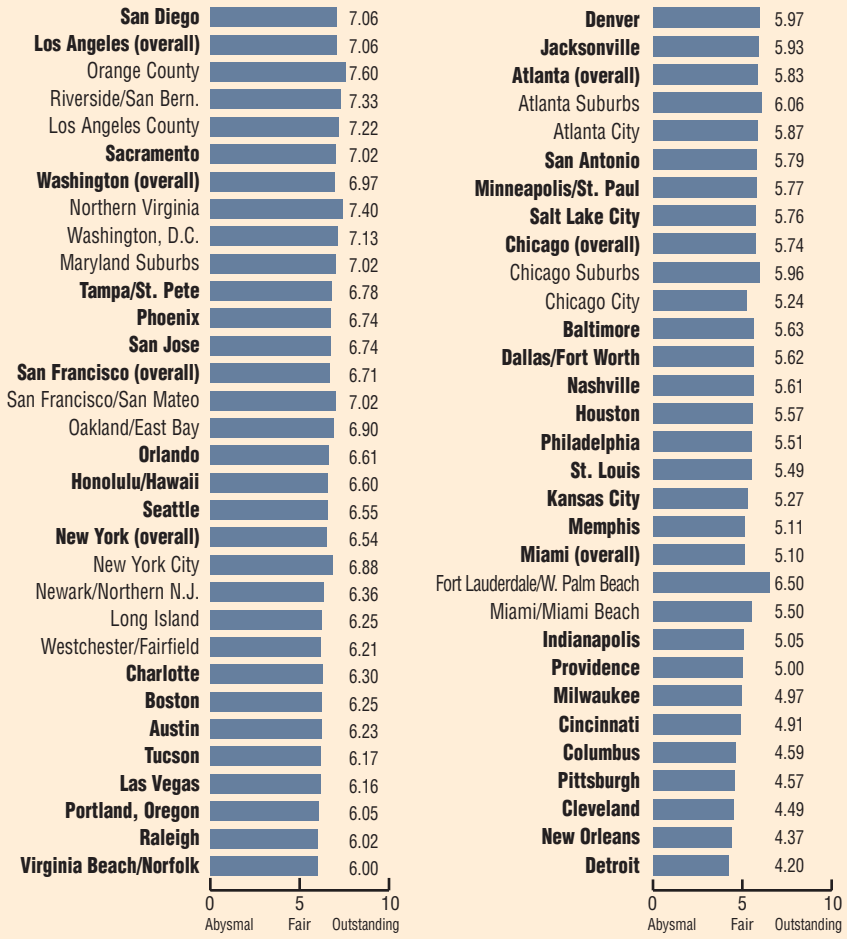
Airports and Ports. Globalizing trends put premiums on access to world markets. Cities with international transportation hubs have clear advantages over markets without. Businesses increasingly require convenient access to airports with direct flights to Europe and Asia. National routes or service to Canada and Mexico are not enough anymore. Interior cities like Dallas and Atlanta would be also-rans without their large airports and lineups of international carriers. Charlotte, Tucson, Salt Lake City, and Portland, meanwhile, suffer from second-tier status—overseas travel means extra time connecting through airports with better international links. Chicago is bolstered by O'Hare; Miami's Latin gateway is anchored by its airport. Foreign businesses base most U.S. operations near familiar destination points where executives can come and go with less aggravation. Small wonder why more convenient coastal markets gain at the expense of interior cities. The nation's increasing import traffic from Asia reinforces the strategic importance of West Coast ports at Los Angeles–Long Beach, San Francisco–Oakland, and Seattle. Northern New Jersey (Newark) solidifies its standing as the most significant East Coast industrial market, serving a major port and international airport with north/south/west interstate access and cargo rail service.

Bright Lights, Big City. The bright lights, big city phenomenon, documented repeatedly in *Emerging Trends* recently, gains momentum. Young people continue to flock to large 24-hour business centers to launch careers, joined by empty nesters who want greater convenience through proximity to offices, restaurants, museums, and stores. These burgeoning demographic cohorts don't worry about schooling kids in better suburban districts. High-rise apartments, condominiums, and converted lofts attract significant demand not only in the more attractive traditional 24-hour cities, but also in subcities and revitalizing urban cores in areas surrounding these cities. Regional housing prices and rents soar. Arlington County in the Washington, D.C., area and Seattle's Bellevue submarket exemplify the trend. Now, even downtown Los Angeles shows signs of residential life after years as a moribund, post-nine-to-five ghost town. Infill housing in these "bright light" cities, especially near mass transit stops, will gain further appeal if energy prices remain uncomfortably high.

Homebuilding Markets. Rankings for homebuilding markets generally follow the lead of *Emerging Trends*' commercial/multifamily survey, but market ratings temper as interviewees expect housing demand to moderate. Southern California housing markets—the nation's most expensive and in-demand ones—dominate the top spots. Orange County and Riverside/San Bernardino lead the survey. Scarce land and difficult entitlement processes almost guarantee successful projects once completed—buyers gobble up whatever gets constructed. Pricing heads out of sight—some interviewees wonder what will happen when mortgage rates increase and lenders pull back on interest-only loans and other financing structures that have allowed buyers to make deals. Defaults could soften these ultrapricey for-sale markets. "But there is not enough housing for people who want it." The high-growth Washington, D.C., metropolitan area sandwiches between tight northern California cities (Sacramento, San Jose, and San Francisco). Hot-growth Phoenix scores well, too, buoyed by

Exhibit 3-2 **Markets to Watch**

Prospects for For-Sale Homebuilding



Source: Emerging Trends in Real Estate 2006 *survey.*

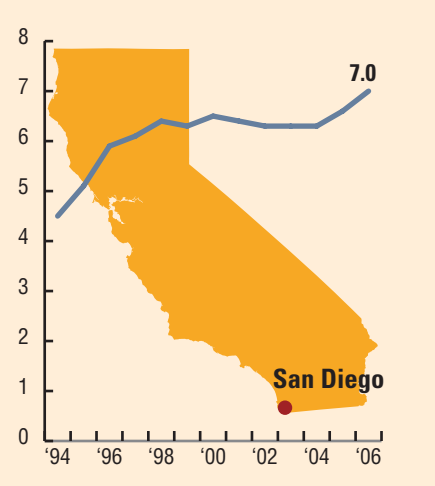
California out-migration. Florida mainstays Tampa and Orlando (high growth) also do well, but Miami falls most dramatically in the survey—interviewees fear the speculative condominium boom in south Florida threatens to undercut pricing and values. Seattle moves up the list significantly, and New York City (the ultimate barriers-to-entry market) and its suburbs rank near the top again. After a sizzling growth spurt, Las Vegas drops a few notches—again over concerns about condominiums. Atlanta and Dallas no longer seem so high growth, and Chicago wobbles. The rest of the Midwest trails badly.

The Gulf Coast will become a hotbed of activity, rebuilding from Katrina's devastation. New Orleans was one of the survey's lowest-ranking markets even before the hurricane. It's too soon to know how many people displaced from the city will return, but homebuilders will likely have no shortage of work.

Major Market Review

San Diego

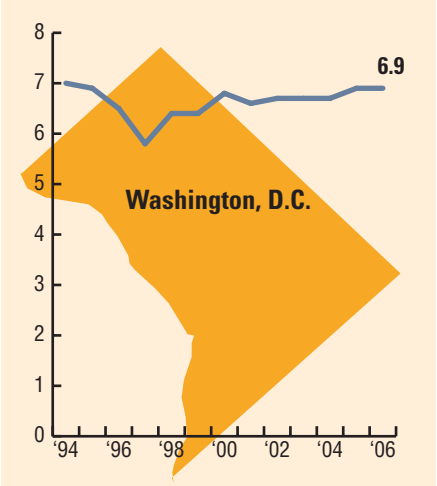
Prodigious absorption tightens the office market in this "great lifestyle town" where "everyone wants to live but can't afford it." Overall vacancy heads toward 10 percent, but a significant amount of new development is underway and could slow momentum toward equilibrium. Government offices, law firms, and accountants support downtown, while aerospace and biotech industries shore up demand in northern subcity nodes where the county's center of commerce shifts toward LaJolla's desirable executive neighborhoods. R&D is oversupplied, but the warehouse market strengthens—spec industrial development occurs to the north and south, where land is less expensive. Limited land availability and solid job growth create a tight retail market—shopping center rental rates hit new highs. "The county is actually under-retailed." Warehouses rate a solid "buy." Housing appreciation finally slows after setting a torrid pace. Expect further leveling. Fewer than 10 percent of locals



can afford to buy the area's median-priced house. The froth blows off the condominium wave, too, although new downtown housing helps create more of a 24-hour environment, boding well for future vitality. "Horrendous commuting times result from people moving to fringe areas in search of better housing affordability." City corruption scandals create fiscal shortfalls and hurt bond ratings—costs increase for badly needed new infrastructure. The "miniature" airport restricts the city's ability to compete as a major commercial gateway.

Washington, D.C.

"Stability personified," this "core investment" market benefits from low perceived downside risk—despite chronic political noise about cutbacks and belt tightening, the federal government keeps expanding. "Huge velocity in government leasing leaves few large blocks of space available." Lobbyists and consultants proliferate like weeds, and international firms increasingly want a D.C. presence. High tech blossoms again near the Pentagon and in other Virginia suburbs. Biotech strengthens its foothold around Bethesda close to the National Institutes of Health. The area continues to enjoy excellent employment growth prospects and features high per-capita incomes. Retail scores well. Hotels benefit from familiar, must-see tourist attractions in addition to stepped-up business activity. Housing costs climb. Overall, the D.C. area remains "a top investor choice, but hard to buy into since occupancies stay high and income growth stays strong, so you really pay up." Some concern grows about a peaking market—construction cranes signal new office development and prices for existing buildings rise well above replacement cost. "The area is much too expensive, yields are too low," and decentralizing defense agencies, concerned about homeland security, plan significant job transfers outside the Beltway. The Arlington and Alexandria submarkets could soften over this planned, six-year realignment. Traffic congestion worsens and antidevelopment forces engage in pitched battles with developers over sprawl. Suburban areas along the Metrorail mass transit system look golden.



Los Angeles

New downtown skyscraper construction resumes after a nearly 15-year hiatus. The lackluster business district suddenly flickers with 24-hour life. Developers take advantage of the demand for infill housing, building almost exclusively residential projects. With only 25,000 residents, downtown L.A. has plenty of room to grow before becoming the new poster child for "the move-back-in trend." The 25-plus condominium and apartment towers underway or on the drawing boards may be "too much too fast." Speculative investing in new units and regional housing raise some concerns, although demand shows no letup anywhere in southern California. Downtown office vacancy remains mired in the mid teens. Any office revival also rests on success with creating a residential core to nullify the need for numbing commutes from surrounding areas. Not surprisingly, 24-hour subcity office nodes like West L.A., Glendale, Burbank, and Pasadena, convenient to prime bedroom communities, continue to fare much better than downtown. Orange County office "stays on fire." Tenant expansions, not company relocations, drive leasing gains. "California is too expensive for companies to move in." Overall, the Los Angeles area ranks a solid "buy" for office properties (see Exhibit 3-3). Hotel occupancies stand near record highs. The "awesome" L.A.–Inland Empire area strengthens its hold as the nation's number-one warehouse market, with vacancies hovering under 5 percent. The crush of Asian imports drowns the port and warehouse districts in ship and truck congestion. "Freeways and rail lines are overwhelmed." The gridlock leads to greater Inland Empire tenant demand for larger distribution buildings. Land is hard to find for any type of develop-

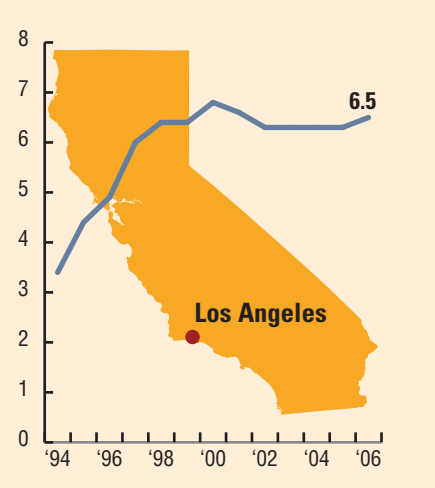
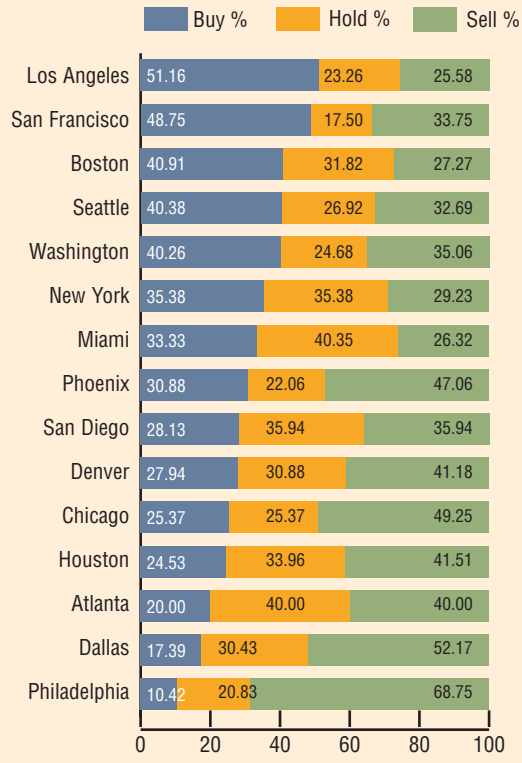
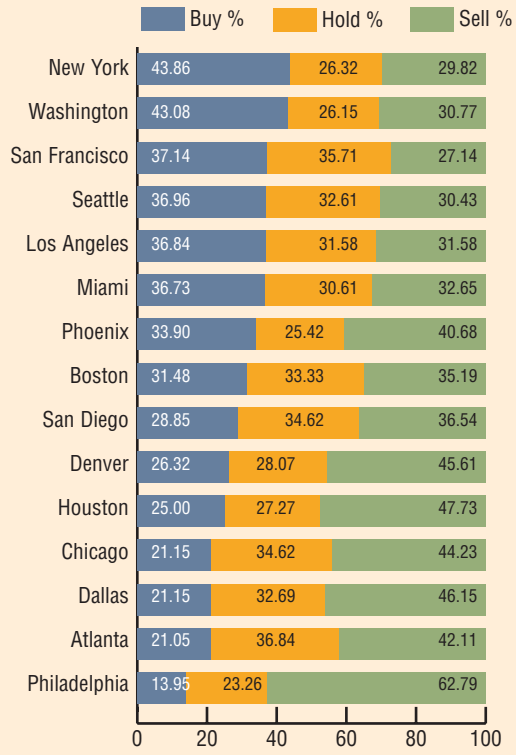


Exhibit 3-3 **Office Property Buy/Hold/Sell Recommendations by Metro Area**



Source: Emerging Trends in Real Estate 2006 *survey.*

Exhibit 3-4 **Retail Property Buy/Hold/Sell Recommendations by Metro Area**

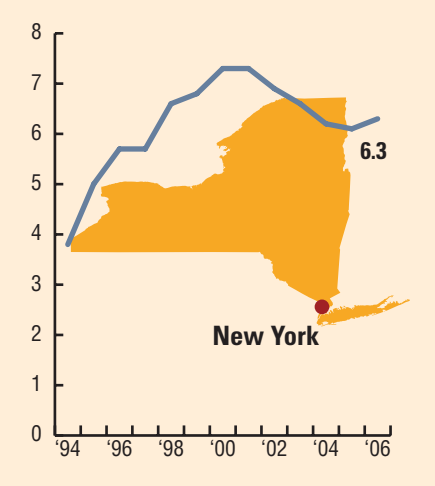


Source: Emerging Trends in Real Estate 2006 *survey.*

ment—prices skyrocket in secondary and tertiary locations. Retail prices are "crazy." Traffic bottlenecks tie the area in knots—people desperately look to work closer to home. Southern California's future concentrates around stepped-up high-rise infill development and greater density. Over the long term, the regional skyline will look more vertical and projects will be more mixed use in nature—downtown's new residential towers are just the beginning.

New York

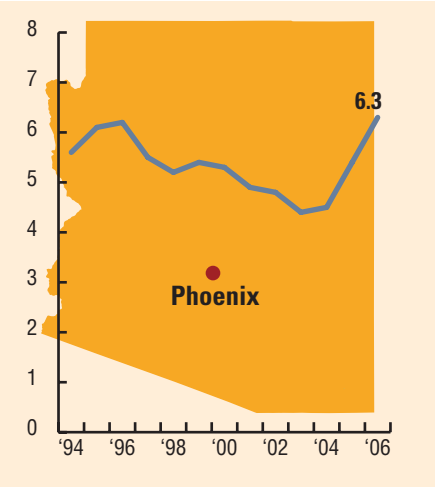
"Every night feels like New Year's Eve; the city's never looked better or seemed more exciting." The midtown office market could be the nation's strongest—leasing is "white hot." Rents advance as tenants lock in new leases ahead of schedule, hoping to avoid future increases in a sub–10 percent vacancy market. Landlords revel in pricing power. Like in D.C., office pricing in New York "is way too expensive." For now, downtown "bumps along," surviving off government tenant subsidies and incentives. Older office buildings convert to residential uses, also helping firm occupancies. A new downtown mass transit hub will help eventually, promising to link Long Island and New Jersey commuter rail/trains. But it is still years away from completion. The financial district really



doesn't need all the new office space planned to replace the World Trade Center. More residential and retail would better enhance the fledgling 24-hour environment, spurred by the success at Battery Park City. The city's coop/condominium markets have "been off the charts." But new development and conversions of upscale hotels into chic housing may be enough to level off pricing . . . finally. As guest rooms reconfigure into living and dining room suites, the lodging sector booms—occupancies zoom north of 80 percent. New hotel construction will heat up to fill the void. Retail also scores well (see Exhibit 3-4).

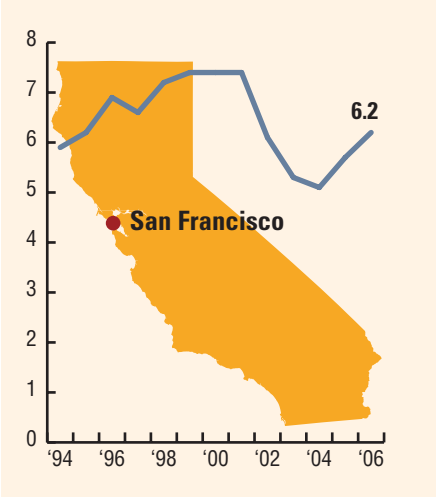
Phoenix

The market's story is "amazing" growth, growth, and more growth . . . in population, employment, and housing. Forecasts suggest the metropolitan area's population could double to 7 million people in 20 years. Home affordability and lower-cost lifestyles draw middle-class Californians fed up with congestion and high housing prices. Construction and tourism also propel the local economy, and the retiree surge supports health care industries. Reflecting the service employment bent, per-capita incomes trail the national average. "Phoenix is 20 years behind San Diego in creating urban experiences"—downtown has little retail or residential and the sprawl model rules. More multifaceted subcity cores will evolve in Scottsdale, Tempe, and Mesa, eventually featuring high-rise residential and mixed use. Following the southern California suburban agglomeration model, traffic woes will mount as development continues to spread. Water shortages also loom down the road in this desert mecca, which has few barriers to entry.



San Francisco

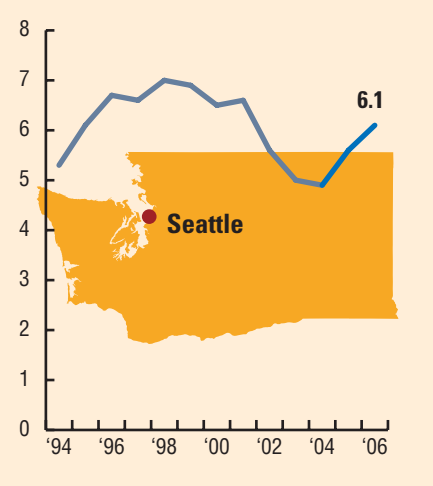
This premier 24-hour city shows signs of rebounding from its 2000 high-tech implosion. "It's a dark-horse top market." Financial and biotech firms expand operations, and the state's billion-dollar stem cell research initiative could be a major boost. Office markets—both downtown and suburban—register vacancy declines from high to lower teens, and rents increase modestly, especially for prime Bay view space. Investors pour in, anticipating "a nice recovery," and drive up prices to Nob Hill heights. "Sentiment has turned around." "But there is still ample oversupply." In a tight housing market with jobs increasing, apartments look sound (see Exhibit 3-5). Tourists never tire of this West Coast gem and neither do business travelers—hotel occupancies snap back. The warehouse sector firms more slowly than expected, but shipping activity should advance as the local ports pick up overflows from L.A. and Long Beach. The city's future will turn more on international trade and links to Asia.



Seattle

Seattle transforms into a 24-hour city on the make—developers build more intown housing, both apartments and condominiums to meet the growing demand from people who want to live closer to work. "A fundamental shift has occurred." The nearby Bellevue subcity follows suit with a spate of mixed-use and apartment developments. Healthy job growth sets the stage; the region's major employers—Microsoft and Boeing—expand and port activity increases thanks to Asian trade. "The city is definitely on the global pathway." Geographic barriers—water and mountains—restrain supply. A "slow and steady" office market leaves recovery in rents "some time off." Microsoft concentrates activity on its own campus and Washington Mutual leaves a 900,000-square-foot leasing hole by moving into a new build-to-suit headquarters. "Biotech growth hasn't materialized." But institutional investors "have discovered the market," leaving "no stone unturned" and driving up prices. Still a lower-cost alternative to California markets, the city should continue to enjoy consistent population and income growth, propelled

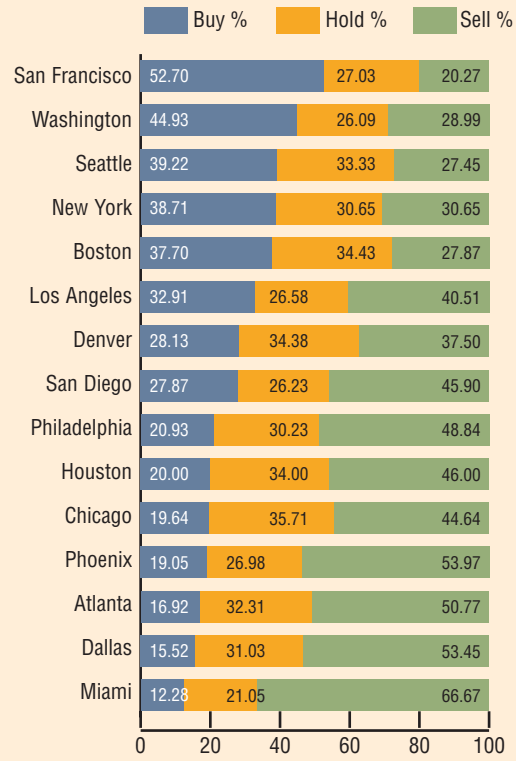
by an increasingly diversified economy. All four major property types see strong investor demand and garner high "buy" ratings in the survey.



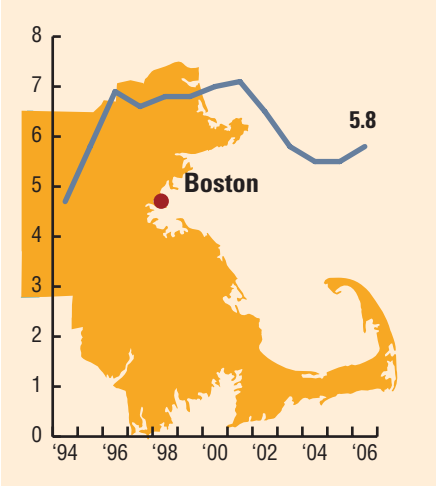
Boston

Institutional investors like this city's 24-hour characteristics, abundance of colleges and universities, intellectual talent pool, highly skilled labor force, and financial services backbone. Capital interest remains intense, especially for downtown towers. But mergers and consolidations have taken the starch out of the office market. Gillette's purchase by Procter & Gamble promises another round of job slashing following on the heels of merger/consolidation/takeovers involving market mainstays John Hancock and the Bank of Boston. "It's been a double triple whammy." High business costs and weak population growth raise concerns, but financial firms start to hire again and downtown vacancy edges down toward the lower teens. The biotech-dependent suburbs "are a world of hurt," struggling until that industry rebounds. Investors need to consider playing the volatile R&D sector for cyclical upside. High heating bills would crimp consumers and home sales during a cold New England winter. Housing costs could back off. Buyers eye the office market as a preferred "buy" sector (see Exhibit 3-3).

Exhibit 3-5 Apartment Property Buy/Hold/Sell Recommendations by Metro Area



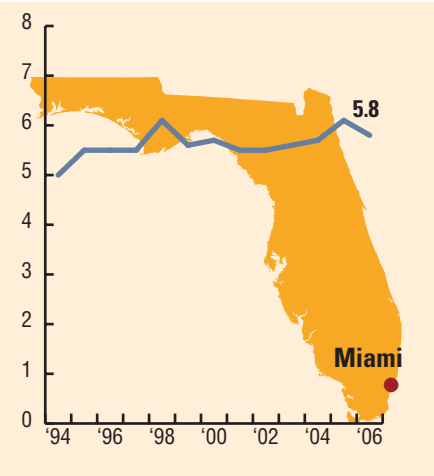
Source: Emerging Trends in Real Estate 2006 *survey.*



Miami

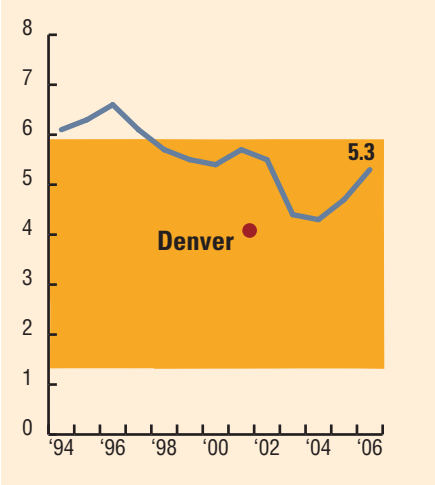
The only major market to show a decline in the survey, south Florida suffers from a heavy case of condominium jitters. Interviewees fear rampant speculation sets the stage for a "crash" or "debacle" that will oversupply multifamily markets. A high-profile condominium developer admits: "We may get hurt." Miami ranks dead last for buying apartments (see Exhibit 3-5). Aside from "bubbly" residential, other property sectors look extremely solid. Miami's international gateway continues to draw office tenants engaged in Latin American trade. "Latin-based companies make Miami their number-one headquarters choice." Office vacancies could drift into single digits and "development is under control." Passage of CAFTA bodes well for increased import/export activity and the local warehouse market hums. Hotels thrive off international business and tourism. South Beach is still popular with the global jet set. Retail vacancy is miniscule. Miami's growing importance

vis-à-vis Latin American commercial capital can only accelerate future market expansion. Unlike Orlando and Tampa, Miami/Fort Lauderdale is largely built out—the Everglades and ocean constrict new supply. More vertical infill redevelopment promises to urbanize the entire area over time.



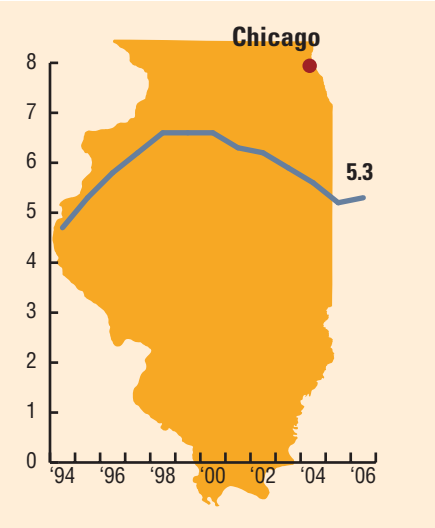
Denver

A quality of life magnet, Denver struggles to sustain its core business environment. Local banks and financial companies "get blown out by M&A." The city's once-formidable telecom beachhead gets lost in industry consolidation. "Everyone wonders what will happen to Qwest," which is ripe for takeover. Entrepreneurs, close to ski centers and mountain bike trails, incubate small- and mid-cap companies, "which always seem to get bought up." Boulder's fractured high-tech market regains momentum as a hub for defense and homeland security. Employment growth remains solid, "but unspectacular." Office hobbles along in oversupply. The multifaceted downtown LoDo market stands out as the exception. Bursting with new residential and street life, this expanding 24-hour district boasts low vacancies. It's also Denver's light-rail hub—people increasingly look to mass transit alternatives to avoid choked commuter highways. "The closer you're invested to LoDo, the better you're doing." Multifamily improves and retail is decent, but "the market is not taking off like a rocket ship."



Chicago

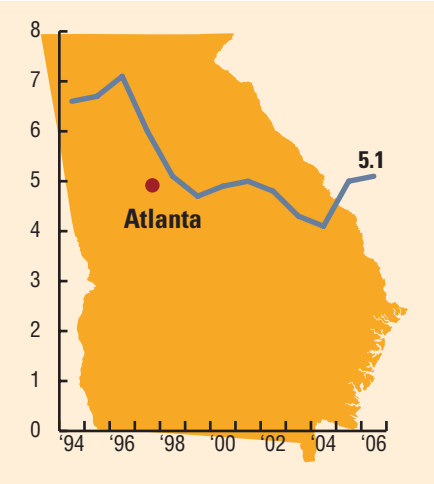
This solid 24-hour city stumbles as other markets resuscitate. Office development has continued despite "poor job growth and weak demand." Tenants take advantage and expand into new space at bargain rates, leaving older buildings on the ropes. It's a testament to what could happen in other markets if new construction ramps up unnecessarily. "Local government is too development friendly and downtown has too many parking lot sites." Corporate consolidations also hurt—the city no longer has a money-center bank headquarters. "Office rates are about where they were in the eighties." Investors "overpay" for Loop and near Northside towers. Suburban office markets are "scary" too. "Once dead, they are now just in critical condition." Housing looks "overpriced" and condominium development gets way ahead of "move-back-in" trends." Some for-sale luxury units turn into rental pumpkins. But multifamily firms and landlords begin to raise rents in the dependable industrial market around O'Hare.



Atlanta

Go-go growth days may be over. Like Dallas, "this older Sunbelt city could be surpassed by the next generation—Phoenix." The local economy flounders, at least temporarily. See what happens when sprawl and congestion strangle appeal for corporate relocations. Unemployment actually increased during part of 2005, office absorption trails national trends, and Delta Airlines' precarious state hits a low note. What's worse—cranes start appearing. "Forget it. Too much land, too many sites." "A developer lines up on every corner." "Tenants play musical chairs with owners." Infrastructure costs rise to fix past planning mistakes for new roads and sewers. Resulting tax bill hikes make the area less cost competitive. Despite market softness (office vacancies in the high teens), investors pour in to make deals at

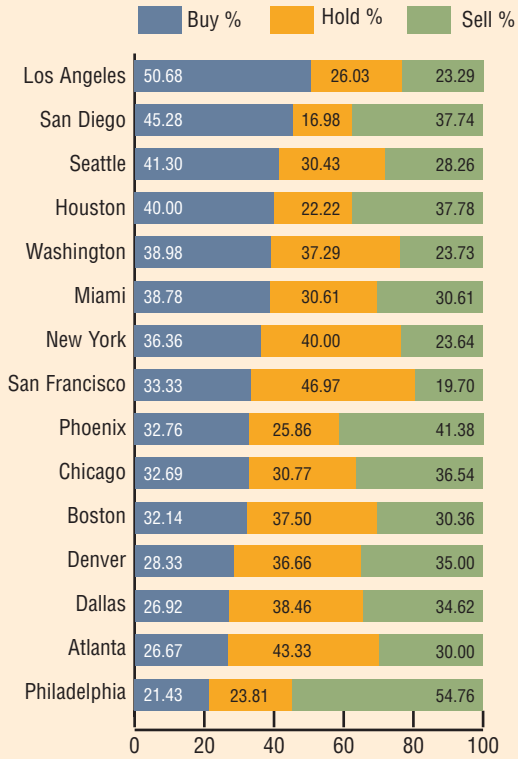
core-styled cap rates, feeding nascent development fires. The best commercial markets center in Midtown and Buckhead, both urbanizing areas with 24-hour characteristics and high-quality residential neighborhoods, including condominium towers and apartments. MARTA subway access also helps these districts: "People are willing to pay for extra convenience." Demographic shifts continue to favor the South, and Atlanta remains strategically positioned to benefit, especially with its crossroads location and world-class airport. But the market needs to fashion more multifaceted urban districts like the new Atlantic Station development, and find a way to expand mass transit. For now, investors can't get excited.



Houston

New Orleans's pain will be Houston's gain, at least in the short term. This energy-industry city has never approached equilibrium since its early-1980s construction binge. But now Mother Nature shifts fortunes. Refugee businesses and population from the Katrina catastrophe will help eat into chronic oversupply in office and apartments. The hurricane accelerates a long-term trend—Houston's coaxing energy-related companies from the Crescent City. Warehouse markets also capture redirected port traffic from New Orleans and other damaged Gulf Coast harbors. Houston is a top "buy" market for warehouses (see Exhibit 3-6). But, like Atlanta and Dallas, the city has had trouble igniting enough employment growth to keep up with never-ending development.

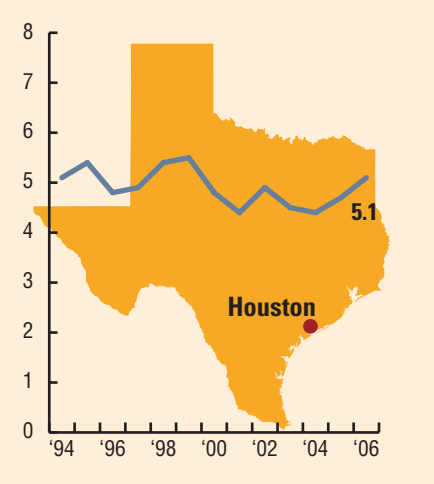
Exhibit 3-6 Warehouse Property Buy/Hold/Sell Recommendations by Metro Area

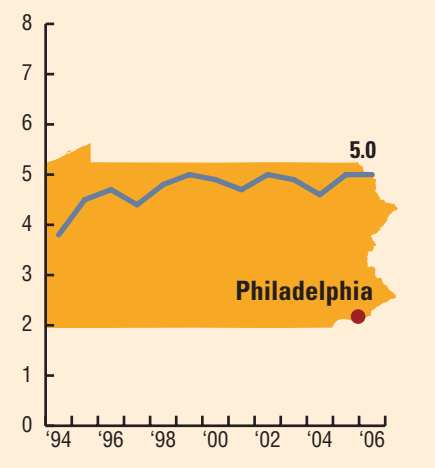


Source: Emerging Trends in Real Estate 2006 *survey.*

Philadelphia

"Limps along." Two new office towers add 2 million square feet in and around Center City, pirating tenants out of existing space. Watch vacancy ratchet up in

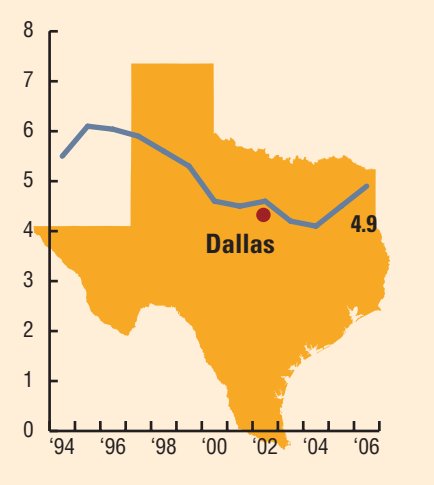




this low-growth market, hurt by recent pharmaceutical company cutbacks. Tax abatements encourage new residential development and conversions in Center City, a key to a possible market renewal. Cheap real estate attracts some new residents and businesses hit by sticker shock in Northeast metropolitan areas.

Dallas

"Despite 25 percent vacancy, they can't quit building." "Investors need to learn that too much new construction kills value harder and faster than any slowdown in demand." Locals argue that much of empty downtown space is so obsolete "it shouldn't be counted." "Class A downtown towers lease much better" and most of the new building is confined to perimeter areas. Job growth has revived to moderate levels, as national companies take advantage of significant air freight, cargo, and logistics capacity at the Metroplex's superior airports. UPS, Fluor, and Celanese announce the basing of new local operations. Home prices stay well below the national average. Ample housing alternatives and new development cap appreciation potential.

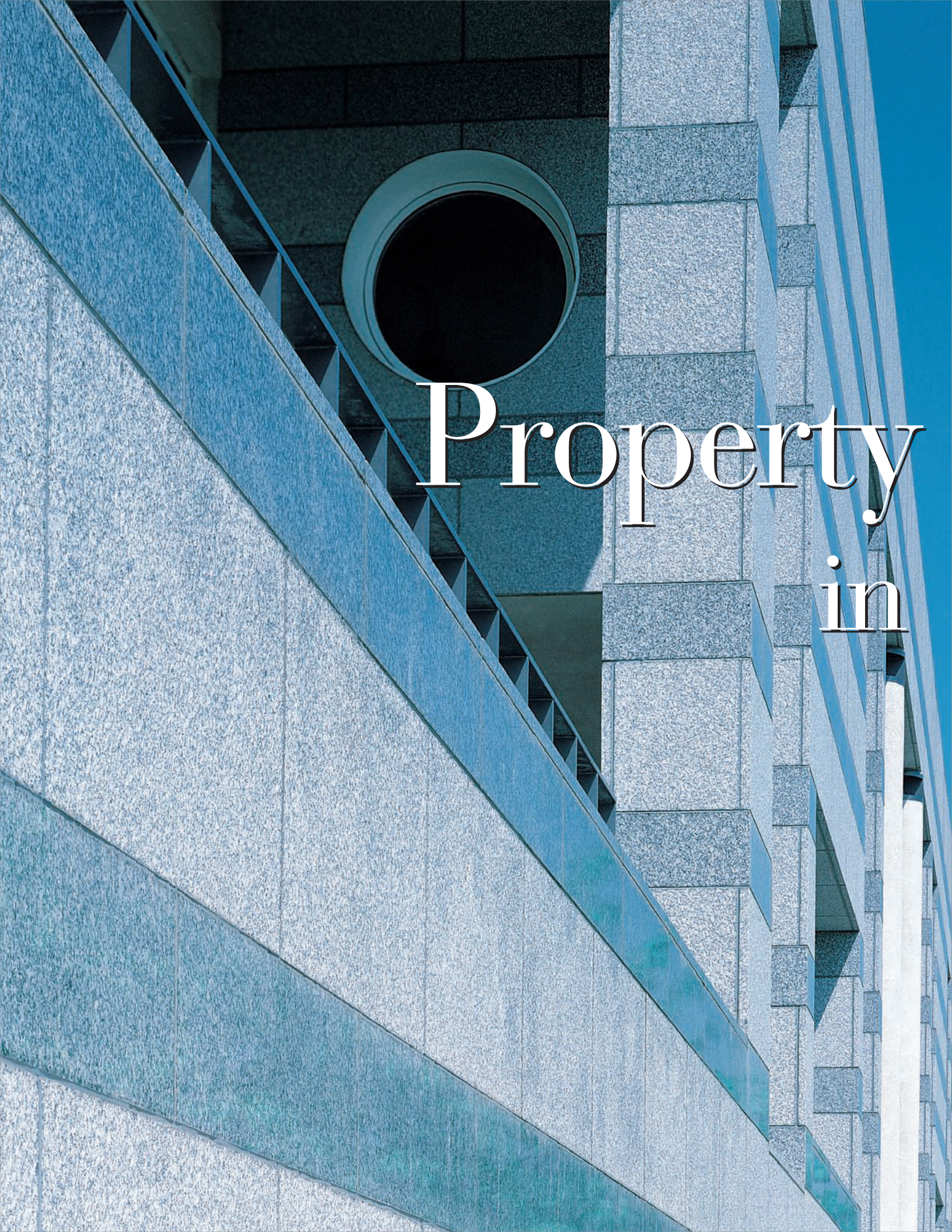


Smaller Market Prospects

Most interviewees remain skeptical about the risks/rewards for investing in secondary and tertiary markets. "Avoid—they have no employment growth, no immigration, no in-migration, and no clear exit strategies." Value-add investors, shut out of opportunities in larger markets, see reasonable risk: "You'll be OK if you buy at a low-enough basis and figure a local buyer will eventually take you out." But more investors, pushed along by competition for product amid swells of capital, "fail to differentiate yields between primary and secondary markets." "Trophy-looking buildings now trade in Minneapolis, St. Louis, and Cleveland at premiums, because they take pretty pictures."

Sacramento retains sturdy state capital appeal—lots of government jobs and government-related employment, serving a veritable nation-state—and a strong housing market with more moderate home prices than nearby San Francisco doesn't hurt. Las Vegas booms off California out-migration and tourism

in everybody's favorite glitzy sin city. Escalating house prices are still a fraction of those in Orange or San Diego County, but condo-mania may be overplayed. Most new arrivals can't afford some of the high-end product. Also, the local economy is a one-trick pony susceptible to a quick downturn, especially if consumer hands turn cold. Will high energy costs curtail weekend jaunts from points east and west to the dice tables and Celine Dion shows? Honolulu benefits from improving hotel, travel, and resort industry prospects. Austin easily outranks other Texas markets—it's a university town as well as a state capital with a vibrant tech-oriented economy. But this increasingly influential city is not a commercial crossroads like Dallas. San Jose revives from recent tech-wreck troubles as Silicon Valley company prospects improve. Orlando and Tampa have lower-grade condominium conversion fever than south Florida markets. Without Miami-like barriers to entry, these expanding cities behave more like traditional high-growth Sunbelt markets. Tourism, retirement, and health care provide resilient underpinnings. Jacksonville's port becomes more strategic. Although cooler than other Florida markets, the city lies directly in the prime population growth path headed to the palm coasts. Attractive Portland (Oregon), a smaller 24-hour market, is slightly off the beaten track. Carolina corridor cities—Raleigh and Charlotte—continue to percolate with incoming retirees and relocating Snowbelters attracted to cheap housing and a temperate climate. Colleges and universities support the Research Triangle, while two of the nation's largest banks call Charlotte home. Even without Katrina, New Orleans ranks near the survey bottom. Rebuilding efforts will funnel a lot of capital into the city, but the losses are staggering. While the city's unique convention destination aura may be restored around the distinctive French Quarter, some Poydras Street corporate operations may never return. . . and you know the Midwest story by now!



Property in

"Aside from hotels, *property sector value increases have derived from* cap rate *compression, not operations."*

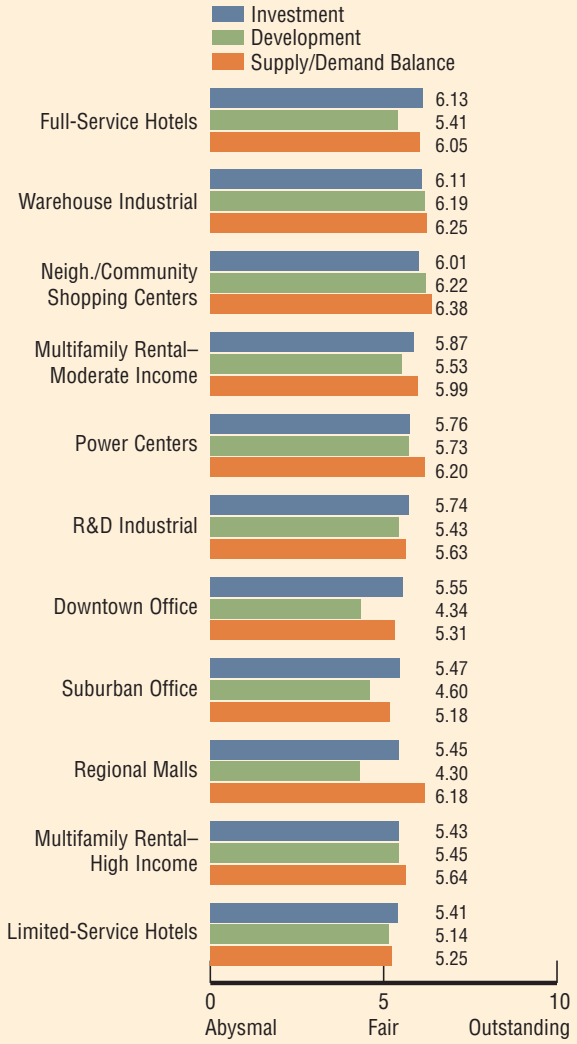
Types Perspective

For 2006, *Emerging Trends* interviewees predict that investment prospects will improve slightly over last year's survey across all major property sectors and generally remain "fair" to "modestly good" (see Exhibit 4-1). The spread between the leading and trailing categories narrowed to 0.7—hardly a significant difference. In the 2003 survey, a 2.4 top-to-bottom spread existed. Last year, the spread was nearly 1.0. All sectors will remain in or reach relatively good supply/demand balance, reinforcing views that markets will tighten and help increase property cash flows. Interviewee ratings (on a scale of zero [abysmal] to ten [outstanding]) register only small improvements from last year for the favorite income-generating core sectors: warehouse (6.1), neighborhood shopping centers (6.0), and moderate-income apartments (5.9). Full-service hotels (6.1) make the biggest leap, jumping to the survey's top spot, while limited-service hotels returned to familiar territory, ranking last. Lack of recent development insulates the full-service category, while limited-service hotels are more vulnerable to overbuilding. Downtown (5.5) and suburban (5.4) office also score relatively solid gains, but remain settled in the rankings' lower rungs. All three retail sectors dropped in the investment rankings, indicating an expected falloff in value gains.

Hotels, Warehouses, and Niche Sectors on Top

Full-service hotels' primacy marks the first time the category has led *Emerging Trends* rankings. Investors hungry for alpha upside predict more revenue growth from upscale lodging categories than any other property sector. Multifamily yields will be compromised by extremely low cap rates, while office and industrial rents recover slowly. Retail sectors never experienced any softness after 9/11 or the "tech wreck" and appear to have

Exhibit 4-1 **Prospects for Major Property Types in 2006**



Source: Emerging Trends in Real Estate 2006 *survey.*

Exhibit 4-2 **Total Expected Unleveraged Returns 2006**

	Percent
Land	10.87
Hotels–Limited Service	8.54
Hotels–Full Service	8.53
R&D Industrial	7.86
Suburban Office	7.70
Neighborhood/Community Centers	7.69
Power Centers	7.64
Warehouse Industrial	7.54
Apartments–Moderate Income	7.53
Downtown Office	7.47
Apartments–High Income	7.24
Regional Malls	7.05

Source: Emerging Trends in Real Estate 2006 *survey.*

Exhibit 4-3 **Capitalization Rate Characteristics in 2005**

	Bid	Ask	Spread (Basis Points)	Deal
Apartments–High Income	6.5	6.0	50.0	6.0
Regional Malls	6.5	6.0	50.0	6.5
Apartments–Moderate Income	7.0	6.0	100.0	6.5
Neighborhood/Community Centers	7.0	6.5	50.0	7.0
Downtown Office	7.5	6.5	100.0	7.0
Power Centers	7.5	7.0	50.0	7.0
Warehouse Industrial	7.5	7.0	50.0	7.3
R&D Industrial	8.0	7.5	50.0	8.0
Suburban Office	8.0	7.0	100.0	8.0
Hotels–Full Service	8.4	8.0	40.0	8.0
Hotels–Limited Service	9.0	8.5	50.0	9.0

Source: Emerging Trends in Real Estate 2006 *survey; median responses.*

exhausted most of their appreciation potential after several sensational years of performance (see Exhibit 4-2).

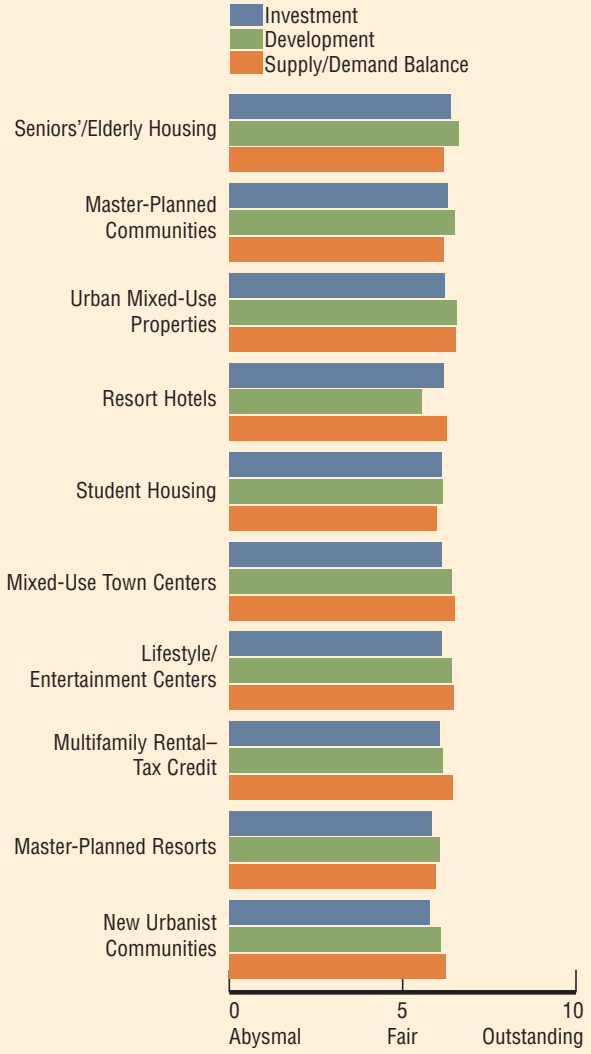
Given capital demand for product, cap rates have declined across all property sectors since last year's survey—apartments and regional malls register the lowest deal rates, while hotels score the highest (see Exhibit 4-3).

Interviewees appear uniformly uninspired about buy opportunities in primary property categories. Land, full-service hotels, warehouses, and moderate-income apartments entertain passing interest, but investors put checkbooks away after that. Pricing is too rich for most appetites. Sell signals proliferate, especially in the office, retail, and high-income apartment sectors.

In markets like southern California, Phoenix, and even the Manhattan financial district, investors view condominium conversion and development opportunities as higher and better land uses than either office or retail. "In housing-constrained markets, retail rents can no longer keep up with housing."

Many niche properties—seniors' housing, master-planned communities, urban mixed use, and resort hotels—score higher investment ratings than the major property sectors (see Exhibit

Exhibit 4-4 **Prospects for Niche and Mixed-Use Property Types in 2006**



Source: Emerging Trends in Real Estate 2006 *survey.*

4-4). Generally, interviewees hope these property types can skirt the capital wave and offer better investment values. But niche sectors tend to offer shallow selection and fewer opportunities. Outsized investor interest has already bid up pricing, and only underscores the lack of attractive deals in the traditional property categories.

Development Gearing Up

Development prospects also advance across all sectors, led by warehouse (6.2) and neighborhood centers (6.2). These scores edge ahead of sector investment ratings—pricing for existing properties in these two categories stands well above replacement cost, enticing builders. But any new construction may be premature in many markets. Except in leading southern California and northern New Jersey markets, industrial vacancy rates decline slowly and may stay above average, while consolidation among supermarket chains shadows grocery-anchored retail. Moderate-income apartments could be poised for new development, too, if a combination of interest rate advances and high housing costs push more renters into the market. Relatively soft office markets argue against building new product almost everywhere. Most developers long ago gave up on planning new regional malls. Securing anchors and entitling large tracts becomes increasingly difficult. Given rising occupancies and strong revenue gains, new full-service hotel construction almost certainly will get on track in 2006.

Infill and intown housing again score the highest development prospects. Traffic congestion, gasoline costs, and the growing inconvenience of suburban lifestyles propel many people back toward urban and subcity cores. The empty nester and "bright lights" echo boomer syndromes also help fuel this trend, which shows no signs of abating.

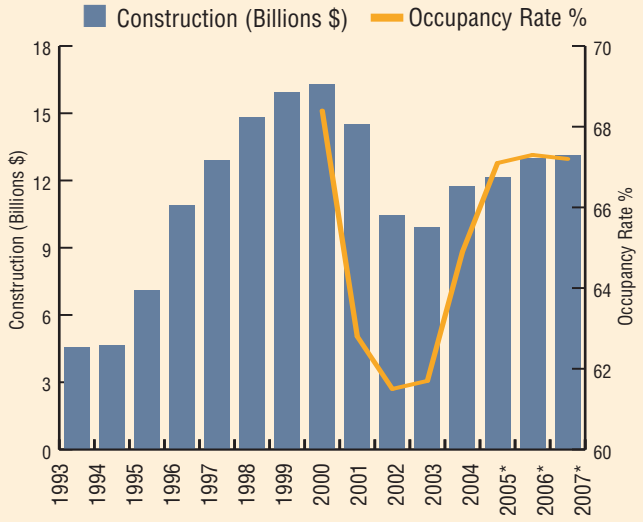
Traditional single-family home development will continue apace. For all the move-back-in activity, cheaper housing is located in suburban and exurban areas, where the majority of Americans still want to live. But rising mortgage rates could dampen activity overall and gas pump costs may temper demand in perimeter areas when buyers calculate driving expenses and time lost in commuting. Rising construction-related costs and expected construction material shortages could short-circuit some homebuilding activity. Second and leisure homes should maintain buyer momentum from growing numbers of baby boomers, entering prime wealth accumulation years and eyeing retirement.

Hotels

Strengths

Hotels make a "roaring comeback," boosting all segments. "We're knocking out the lights." Occupancies race toward 70 percent, well above (55 percent) break-even levels. Lenders had redlined most new construction, allowing full-service markets to firm and now revenues to catch fire. Condominium conversions also helped constrict supply in some major markets—owners cash out of luxury lodging and convert into opulent living. Corporate travel heads back to a pre-9/11 pace and the weak dollar entices foreign tourists. "It's hard to find rooms again," especially in full-service central business district hotels. At luxury hotels in major markets, $300–$400 room tabs are back, not including pricey extras for room service and breakfast coffee. "Sir, here is your [$20] basket of fresh-baked muffins and English breakfast tea." Creative surcharges generate healthy revenues for everything from restocking minibars to bed turndowns and gym use. "That towel at the pool will cost you extra!" But at these prices, does it really matter to guests paying the tab? Even limited-service properties show impressive gains.

Exhibit 4-5 **Hotel Construction and Occupancy Rates**



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

Weaknesses

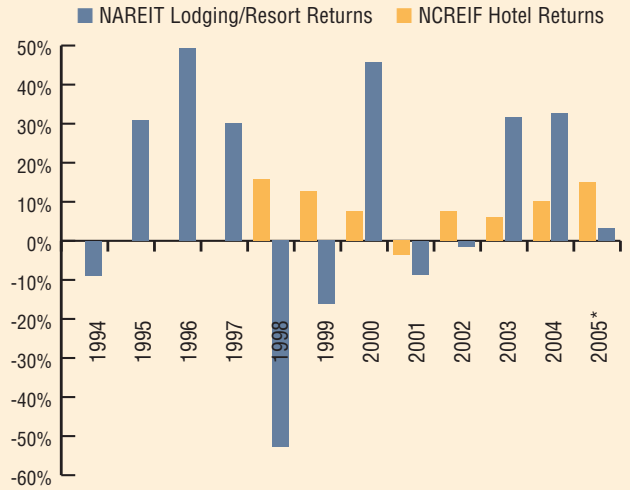
Energy prices deliver a wild card, potentially affecting lodging demand. Higher airfares and gas prices could curtail some business and tourist travel or at least decelerate growth trends. An avian flu outbreak could also chill the sector. No surprise, ravenous capital bids up property pricing—bargain hunters are left wanting. During the 9/11 downturn, many owners deferred maintenance and capital projects. Some properties need costly makeovers, which require increased investment and slash revenues when rooms temporarily go out of inventory.

Best Bets

Resorts and destination cities show the most punch. The luxury sector benefits from long development lead times. Existing properties have significant current pricing power, which portends excellent cash flow growth. Some major cities appear supply constrained, particularly New York and Los Angeles. Boston and San Francisco should improve. Warm weather destinations in Florida and Hawaii also excel.

Sell limited-service hotels into strong buyer demand. These properties are too easy to build. If development gears up as expected, new competition will eat into occupancies, revenues, and eventually values.

Exhibit 4-6 **Hotel/Lodging Total Returns**



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

**2005 NCREIF data annualized from second-quarter 2005. 2005 NAREIT data year-to-date as of September 30.*

Avoid

Limited-service product in second-tier cities and suburban markets typically play a weak hand. Interviewees consistently urge caution. Most institutional investors avoid altogether. Many properties have deferred maintenance issues and need capital infusions. "Watch for hidden costs." Over time, demand will be spotty and pricing power is more difficult to sustain.

Hotel investors need to create alignment of interests with managers, often through joint ventures. This specialized sector requires reservation flow and operations economies, but investor/operator relationships have never been easy. Turnover in flags confuses travelers and can disrupt service. Inexperienced capital would be wise to spend elsewhere.

Development

Lenders get more comfortable—development financing is available again. New construction will begin to add supply by year-end 2006 and into 2007. By 2008, everybody will bemoan development excess, especially in limited-service segments. Owners in luxury and resort segments will continue to convert some rooms to residential as long as the market for extravagant pieds-à-terre and getaways holds up. Adjacent land tracts are ripe for leisure home development. Buyers will pay extra to avail themselves of resort amenities.

Exhibit 4-7 Prospects for Full-Service Hotels in 2006

	Prospects	Rating	Ranking
Investment	Modestly Good	6.13	1st
Development	Fair	5.41	7th
Supply/Demand Balance	Modestly Good	6.05	5th
Expected Unleveraged Returns 2006		8.0%	
Deal Cap Rate 2005		8.0%	

Buy	Hold	Sell
35.15%	38.41%	27.44%

Source: Emerging Trends in Real Estate 2006 *survey.*

Exhibit 4-8 Prospects for Limited-Service Hotels in 2006

	Prospects	Rating	Ranking
Investment	Fair	5.41	11th
Development	Fair	5.14	8th
Supply/Demand Balance	Fair	5.25	10th
Expected Unleveraged Returns 2006		8.6%	
Deal Cap Rate 2005		9.0%	

Buy	Hold	Sell
22.0%	28.9%	49.1%

Source: Emerging Trends in Real Estate 2006 *survey.*

Outlook

Hotels have legs as long as the economy expands. "It will be another two years before a new round of development kicks up room supplies" and slows revenue growth. Terrorism hangs in the background as an ongoing risk, but all forecasts need to concentrate on the direction of fuel prices. Hotels are the most sensitive and volatile property segment. Any souring in demand drivers will hit bottom lines immediately.

Industrial

Strengths

"Good, steady, and boring," warehouses are sound "low beta" investments. "Rents don't move much," but exceptional institutional appetites for this classic core sector ensure ready exit strategies and excellent liquidity. Economic growth spurs recent vacancy declines and rents should increase "modestly" in 2006—the sector is "clearly in recovery mode" after national occupancy levels had fallen to historic, though manageable, sub–90 percent lows.

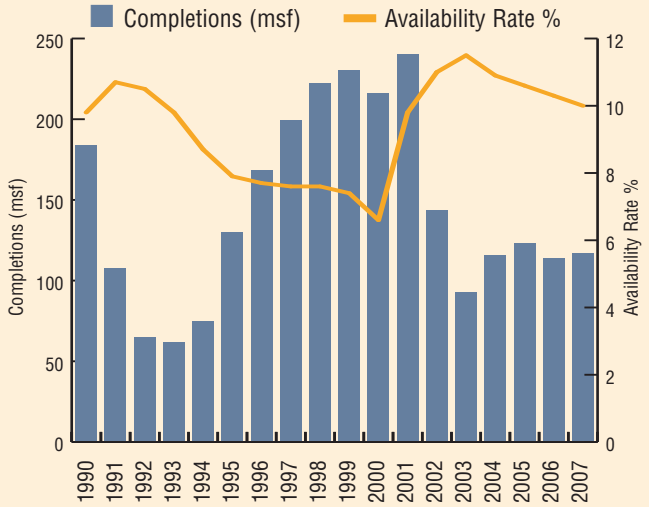
Weaknesses

Cap rate compression has pushed pricing well above replacement cost, especially in supply-constrained California markets, where Pacific ports gorge on imports from China and the rest

If you're flummoxed about whether to buy existing properties or develop warehouses today,

of Asia. In some major industrial hubs, developers step up construction of higher-quality, more flexible, big-box distribution facilities. They can offer lower rents, undercutting existing product that may be at a competitive disadvantage, if configurations cannot accommodate rapidly evolving shipping technologies and tactics. Just-in-time manufacturing continues to reduce demand growth and control inventories. Changing shipping logistics strategies make it more difficult to keep up with tenant needs. Property management becomes more specialized, especially in the prime international transport centers. Big box performs better, but bears greater risk from the large single tenants they attract—bailouts can sink returns. Small deal size makes for inefficient investing. Acquisition packages can build portfolios more quickly, but sellers often take advantage, mixing in "cats and dogs" with premier properties. For many investors, the opportunity to buy a good asset outweighs reluctance about weaker sisters.

Exhibit 4-9 Industrial Completions and Availability Rates



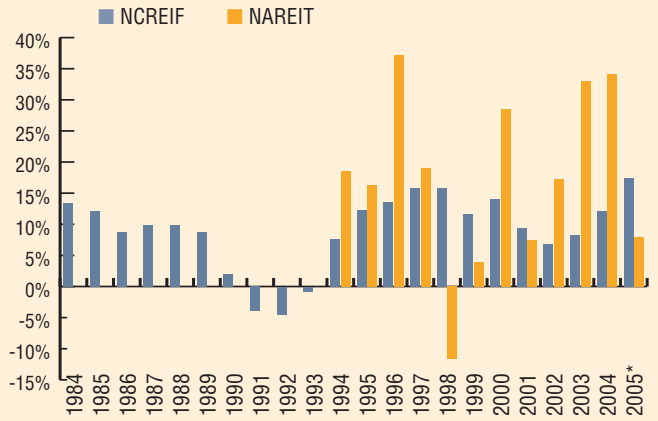
Source: Torto Wheaton Research.

**Forecasts.*

Best Bets

Most interviewees sing a familiar tune: own big-box warehouse in the small number of airport and seaport markets serving the global transport routes. The "same old list" includes northern New Jersey (Newark Airport, turnpike, New York ports), Los Angeles–Inland Empire, San Francisco, Seattle, and Miami. Core buyers pay premiums in these places for highly predictable cash flows. The volume of imports inundating major West Coast ports helps expand warehouse demand at secondary harbor destinations including San Diego, Houston, Washington/Baltimore, Charleston, and Jacksonville. Houston also gains from New Orleans's travail.

Exhibit 4-10 Industrial Property Total Returns



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

**2005 NCREIF data annualized from second-quarter 2005. 2005 NAREIT data year-to-date as of September 30.*

Avoid

Atlanta and Dallas, key airport/interstate nexuses remain oversupplied—"it's too easy to build." Other interior secondary and tertiary markets get removed from distribution chains. "It's a tale of the two coasts." Even Chicago "isn't on as many buyer lists," although it holds onto a top rating thanks to O'Hare. While lower-ceiling traditional storage-style warehouse space "can work" in smaller regional markets, owners can't compete effectively in the major hubs. There, major shippers use facilities as well-oiled redistribution points driven by complex logis-

Exhibit 4-11 Prospects for Warehouse Industrial in 2006

	Prospects	Rating	Ranking
Investment	Modestly Good	6.11	2nd
Development	Modestly Good	6.19	2nd
Supply/Demand Balance	Modestly Good	6.25	2nd
Expected Unleveraged Returns 2006		7.5%	
Deal Cap Rate 2005		7.0%	

Buy	Hold	Sell
32.2%	37.7%	30.0%

Source: Emerging Trends in Real Estate 2006 *survey.*

Exhibit 4-12 Prospects for R&D Industrial in 2006

	Prospects	Rating	Ranking
Investment	Modestly Good	5.74	6th
Development	Fair	5.43	6th
Supply/Demand Balance	Modestly Good	5.63	8th
Expected Unleveraged Returns 2006		7.9%	
Deal Cap Rate 2005		8.0%	

Buy	Hold	Sell
27.1%	34.4%	38.5%

Source: Emerging Trends in Real Estate 2006 *survey.*

tics technologies now including computer chips embedded in shipment palates, which can be tracked by satellites and redirected at a moment's notice. Properties need large turning areas for supersized tractor trailer trucks and large open spaces to accommodate movement of goods quickly from incoming transport to outgoing.

Development

If you're flummoxed about whether to buy existing properties or develop warehouses today, new construction or redevelopment strategies get the nod given high pricing and low yields on premium existing space. Developers can build for less and profitably flip to institutional buyers. Finding suitable tracts at reasonable prices can be difficult in the leading markets unless at fringe locations. But port and traffic congestion in these areas lead many shippers to institute "just-in-case" strategies in the event "just-in-time" cannot deliver. They store product in satellite locations outside the central market hubbub in the event of any shortfalls from delays. Understanding and meeting these tenant needs can determine project success. Warehouse supply/demand never gets too "out of whack," because of short project completion time frames. Developers can pull back quickly, if markets appear to overheat or tenant demand suddenly diminishes.

Warehouse Outlook

The industrial warehouse sector should "plug along as usual," tracking expected economic expansion. Expect steady improvement across most markets, helping stabilize values at or near rich levels. Development will temper the rate of vacancy declines in some areas and may undercut opportunities for rent hikes. Buyer demand never seems to let up. These bond-plus investments may act more like bonds in the medium term.

R&D Outlook

Off most investor shopping lists, the historically volatile research and development/technology sector offers a more opportunistic risk/return profile than the more staid warehouse category. Core players typically steer clear—exit strategies are more limited and the sector is less liquid. "Whom do you sell to?" Tenants are specialized and quirky, often with atypical layout requirements. Typically credit-risk startup enterprises, they may transform suddenly into a Google or more likely just collapse. High vacancies from the 2000–2001 tech industry meltdown continue to plague most R&D markets, but turnarounds can be abrupt. The vanguard Silicon Valley shows signs of life and if computer firms, chip makers, and biotech companies finally rebound, demand in other markets could sharply increase. "It will happen. It's just a matter of when." Even in R&D, good buys will be hard to uncover given capital interest. Still, this sector has more upside than most. Just be prepared to sell holdings before the new Bill Gates, who signed that big lease, turns out to be just another John Smith.

Apartments

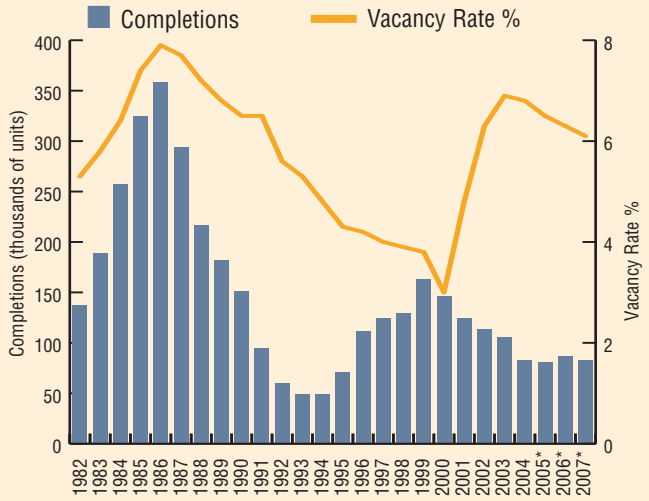
Strengths

Many "bullish" interviewees point to a convergence of market forces set to boost occupancies and rents throughout the year and into 2007. These include stratospheric home prices, higher homebuilding costs, rising mortgage rates, satisfactory job growth, an incoming demographic tide of echo boomer renters, and condominium converters continuing to take product off the market. "More people can't afford to own and will have to rent." Investors concede daunting cap rate declines, "which defy fundamentals" but embrace the sector's lack of volatility from steady rent flows and liquidity from unquenchable buyer demand. Concessions abate in most markets.

Weaknesses

Although some interviewees suggest a soft-landing "wind down" to the recent spate of condominium conversions and development, most express greater concern. "The condo craze" could come back to haunt some high-end apartment markets where speculators—buying multiple units to flip in a rising market—have dominated recent buyer demand and incited "insane" investor and builder activity. Some converters buy multifamily properties for premiums 20 to 30 percent above apartment investors. "I love condo converters," says a value-add portfolio manager, who has been selling out of apartments. "It would take an idiot not to see what will happen in south Florida." But converters and developers also steam up other markets. Many "babes-in-the-woods" speculators—individual investors jumping on the real estate bandwagon—will get stretched on carrying costs if their units do not resell quickly.

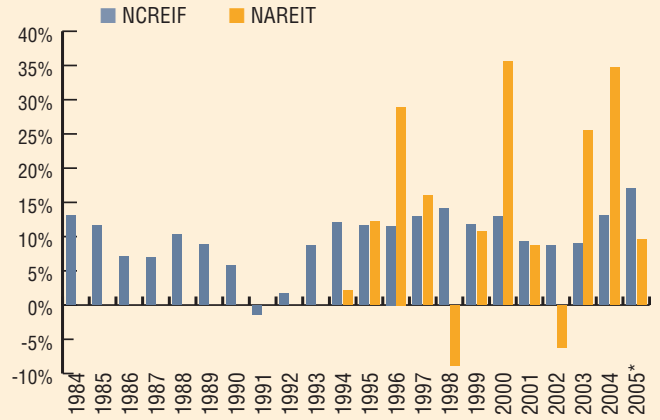
Exhibit 4-13 Apartment Completions and Vacancy Rates



Source: REIS (Includes Top 50 U.S. Markets).

**Forecasts.*

Exhibit 4-14 Apartment Property Total Returns



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

**2005 NCREIF data annualized from second-quarter 2005. 2005 NAREIT data year-to-date as of September 30.*

The domino effect kicks in when new condominium product fails to move and bad press about speculator remorse unnerves other buyers. Units then get turned back to rentals, softening apartment supply just as affected markets should tighten toward equilibrium from increased demand. Low-end condominium projects could turn sideways too when "starter-home" buyers get stretched on rising mortgage payments—lenders have been lax on financing terms with all sorts of condominium-borrower-friendly gimmicks that reduce initial payments but have various costly balloon features. Low cap rates, driven down

Exhibit 4-15 Prospects for Moderate-Income Apartments in 2006

	Prospects	Rating	Ranking
Investment	Modestly Good	5.87	4th
Development	Modestly Good	5.53	4th
Supply/Demand Balance	Modestly Good	5.99	6th
Expected Unleveraged Returns 2006		7.0%	
Deal Cap Rate 2005		6.5%	

Buy	Hold	Sell
31.7%	26.4%	41.4%

Source: Emerging Trends in Real Estate 2006 *survey.*

Exhibit 4-16 Prospects for High-Income Apartments in 2006

	Prospects	Rating	Ranking
Investment	Fair	5.43	10th
Development	Fair	5.45	5th
Supply/Demand Balance	Modestly Good	5.64	7th
Expected Unleveraged Returns 2006		6.5%	
Deal Cap Rate 2005		6.0%	

Buy	Hold	Sell
15.5%	30.4%	53.6%

Source: Emerging Trends in Real Estate 2006 *survey.*

by converters, mean recent apartment acquisitions "have no risk premium" built into underwriting. At these prices, "forget about appreciation over a five- to seven-year holding period."

Best Bets

Dispose of weaker holdings, selling into the continuing buyer wave for as long as it lasts. Meanwhile, consider "rifle shot" investments for value-add gains. Look for B or B-minus units that can "be dressed" up inexpensively into B-plus apartments: "slap on a fresh coat of paint, plant new landscaping, and retile the swimming pool." Northeast barrier-to-entry markets remain most compelling and resistant to any cap rate decompression—building new product is difficult and premium housing costs sustain consistently strong renter demand. Hold some powder and "buy busted-up condo deals."

Avoid

Late-in-the-game condominium conversions and development could end badly in certain markets. South Florida and Las Vegas "may be disasters waiting to happen." Southern California looks ripe for a lesser correction—"prices are unsustainable"—and projects in Phoenix and Chicago could be vulnerable—overbuilding may drop values. New York and Boston suffer from excessive capitalization, "but don't look like bubbles." Apartment investors need to stay away from markets susceptible to condo-rental reversions.

Development

For now, returns on new multifamily product generally pencil out ahead of dearly priced acquisitions. Most "low hanging" condominium conversions have been completed successfully and some developers join the party just as housing market demand starts to brake. "It's out of control." The optimistic view suggests that new units may "take longer to sell." Apartment builders need to exercise greater caution—improving renter demand may not support construction where conversions tumble back into inventory.

Outlook

For 2006, multifamily will be the bellwether for other sectors. If development imbalances can be controlled, increased numbers of renters should bolster occupancies and augment cash flows, creating a full-blown landlord's market. These improved supply/demand fundamentals will shore up values as interest rates increase. At least in some markets, condominium excesses cloud prospects for a strong recovery. Anyway you cut it, yields look slim. Sellers should do better than buyers.

Office

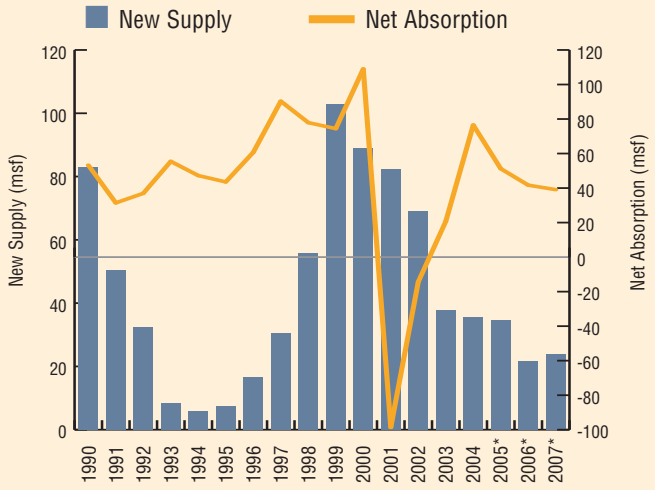
Strengths

Recovery gains momentum . . . finally! Vacancies will continue to decline nationally and rental increases will extend beyond New York, Washington, D.C., and southern California markets. Tenant concession packages also become more economical. Vacancy suddenly looks like an asset for writing up values in markets with decent job growth. Development activity bears watching—new construction has been restrained.

Weaknesses

Although office "looks better than it has for a long time," the sector is "no house of fire." As five-year leases inked at market highs roll over, property cash flows take a hit. At least, owners can anticipate marking up rates from leases executed in ensuing weaker years . . . . Landlords curse corporate productivity gains, which just keep advancing. Technology, alternative workplace strategies, and outsourcing to freelancers as well as cheap overseas workers dampen office demand growth, slowing rebounds in occupancies and lease rates. Only market timers scored really well in office over the last cycle—"rents and vacancies don't look much different from ten years ago." Bank and financial company consolidations hurt two stalwart markets—Chicago and Boston. Investors "need to accept stabilized vacancy at about 10 percent. Five percent to 7 percent is too low given job losses, rightsizing, downsizing, and outsourcing."

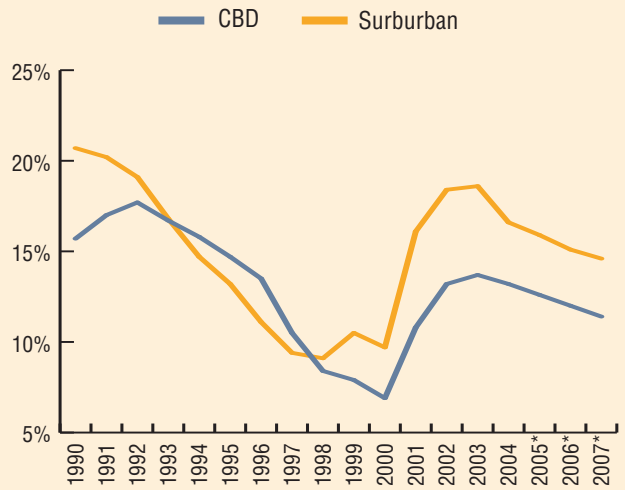
Exhibit 4-17 Office New Supply and Net Absorption



Source: Torto Wheaton Research.

**Forecasts.*

Exhibit 4-18 Office Vacancy Rates



Source: Torto Wheaton Research.

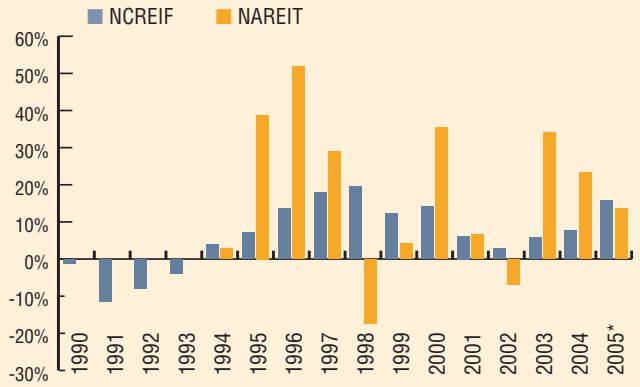
**Forecasts.*

Best Bets

Voracious capital demand eliminates most chances to buy low and ride recovery to a cyclical zenith. Current pricing already anticipates peak rents in many markets. Selling nonstabilized assets makes more sense (cents), especially when buyers bet the farm on resounding future performance. Why take a chance that tenant demand disappoints? Well-located, prime assets should make decent holds. Coveted properties feature more flexible floor plates to accommodate changing tenant requirements and tech needs. Best hold markets boast good jobs creation—Washington, D.C., New York, southern California, and south Florida—and/or are supply-constrained—San Francisco and Boston.

comparatively fragile tenant demand.

Exhibit 4-19 Office Property Total Returns



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

**2005 NCREIF data annualized from second-quarter 2005. 2005 NAREIT data year-to-date as of September 30.*

Avoid

Rents may not catch up to support the low cap rates many investors seem willing to pay, especially in markets more prone to competition from new development. Watch out for tenant musical chairs—moving out of older space into newer buildings and locking in the lowest possible rents before markets have a chance to tighten further. Older space loses.

Development

Construction material bills shoot up, widening the gap between replacement cost and current market rents. Investors gain greater confidence that development can be contained to help sustain the ongoing market convalescence. But cap rate compression encourages developers to put some projects back on the drawing boards. If development gets stoked too soon, office markets would backslide given comparatively fragile tenant demand. Chicago and Philadelphia built through the soft patch and will suffer.

Exhibit 4-20 Prospects for Downtown Office in 2006

	Prospects	Rating	Ranking
Investment	Modestly Good	5.55	7th
Development	Modestly Poor	4.34	10th
Supply/Demand Balance	Fair	5.31	9th
Expected Unleveraged Returns 2006		7.0%	
Deal Cap Rate 2005		7.0%	

Buy	Hold	Sell
22.6%	31.7%	45.7%

Source: Emerging Trends in Real Estate 2006 *survey.*

Exhibit 4-21 Prospects for Suburban Office in 2006

	Prospects	Rating	Ranking
Investment	Fair	5.47	8th
Development	Fair	4.60	9th
Supply/Demand Balance	Fair	5.18	11th
Expected Unleveraged Returns 2006		8.0%	
Deal Cap Rate 2005		8.0%	

Buy	Hold	Sell
20.4%	35.6%	43.9%

Source: Emerging Trends in Real Estate 2006 *survey.*

Outlook

Office looks risky compared with other traditional core investment categories—apartments, industrial, and retail. "Investors should have higher yield expectations" unless they are buying trophy office properties in barrier-to-entry 24-hour markets with good jobs and growth prospects. Then buyers should just back up the Brinks truck at the closing.

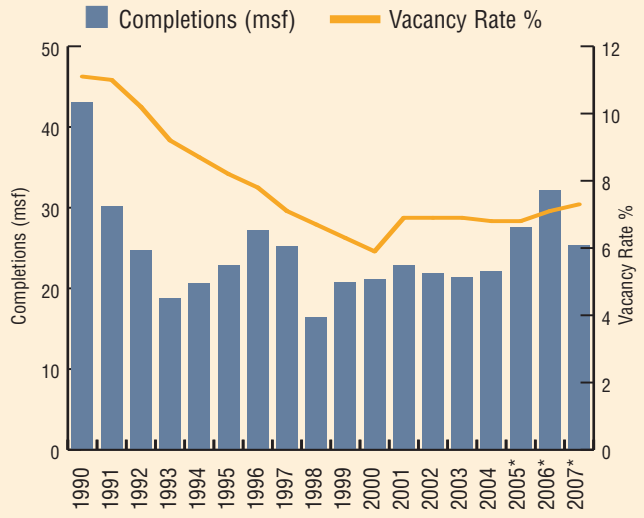
*The **retail** sector "must come down to earth."*

Retail

Strengths

Retail property performance "cannot get any better." As long as consumers keep spending, properties will generate cash flow. "Americans love to shop, we all know that, but how long can they keep it up?" Investors, meanwhile, "love the income"—that's good, because appreciation will be hard to come by at current pricing levels. . . . Fortress malls and infill neighborhood centers in upscale suburban markets look unassailable. REITs continue to corner the market on the top-grossing regional centers. Most other capital turns to grocery-anchored retail, where transaction activity has been frenzied. Buyers need to focus on centers with a number-one or number-two supermarket chain to buffer inroads from discount giants. Urban retail, usually part of mixed-use projects in prime 24-hour districts, also appears sound. Downtown shoppers either walk or take mass transportation—they don't fret as much over gas station prices before heading to the store.

Exhibit 4-22 Retail Completions and Vacancy Rates



Source: REIS.

Note: For top 50 markets.

**Forecast.*

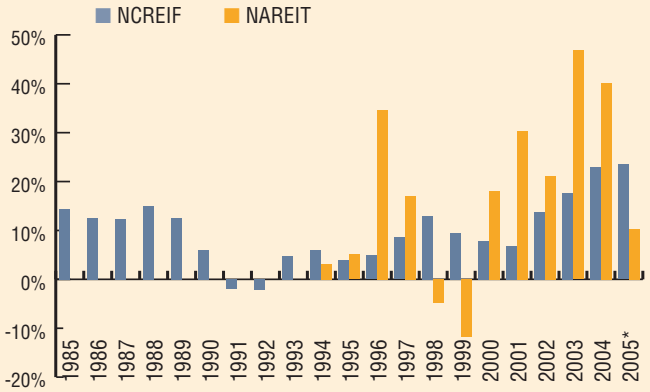
Weaknesses

The retail sector "must come down to earth." Rising energy costs; higher local property taxes; interest rate hikes on credit cards, car payments, and mortgages; and increasing medical expenses start to impinge on consumer spendthrifts. Gas pump prices worry retailers the most, not only cutting into shopping budgets, but also discouraging extra car trips to malls and power centers. Unless wage rates accelerate, people will have fewer choices—they must focus more on necessity buying (food and groceries) than wish-list items (everything else). Federal tax cuts and mortgage refinancings have begun to run their course, and consumer debt levels remain worrisome. "People have borrowed money they don't have to buy what they don't need." For investors, "cap rate compression is over . . . period." Grocery-anchored retail is "priced to absolute perfection. Buyers can no longer have any appreciation expectations. They're buying a long bond in a rising interest rate environment."

Best Bets

Emerging Trends interviewees send unmistakable sell signals for all retail categories: malls, grocery-anchored retail, and especially power centers. After a run of spectacular 20 percent–plus annualized returns, retail properties have hit their cyclical highs. Given capital demand, owners have an excellent opportunity to winnow

Exhibit 4-23 Retail Property Total Returns



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

**2005 NCREIF data annualized from second-quarter 2005. 2005 NAREIT data year-to-date as of September 30.*

Exhibit 4-24 **Prospects for Neighborhood/Community Shopping Centers in 2006**

	Prospects	Rating	Ranking
Investment	Modestly Good	6.01	3rd
Development	Modestly Good	6.22	1st
Supply/Demand Balance	Modestly Good	6.38	1st
Expected Unleveraged Returns 2006		7.0%	
Deal Cap Rate 2005		7.0%	

Buy	Hold	Sell
20.8%	32.2%	47.0%

Source: Emerging Trends in Real Estate 2006 *survey.*

Exhibit 4-25 **Prospects for Power Centers in 2006**

	Prospects	Rating	Ranking
Investment	Modestly Good	5.76	5th
Development	Modestly Good	5.73	3rd
Supply/Demand Balance	Modestly Good	6.20	3rd
Expected Unleveraged Returns 2006		7.6%	
Deal Cap Rate 2005		7.3%	

Buy	Hold	Sell
14.3%	28.2%	57.6%

Source: Emerging Trends in Real Estate 2006 *survey.*

portfolios, holding their best infill properties. Buyers beware: "Market pricing is nuts," says a major mall owner. "It's more cyclical than secular. We're holding powder dry for the next phase."

Avoid

Steer clear of weaker regional centers and neighborhood center outliers. If consumers turn parsimonious, B/C malls with second-rate anchors and minor league tenant lineups will feel the pinch first. The ghost mall syndrome will be alive and well. Buyers need to discriminate more carefully about anchors, credit risk, and locations. Wal-Mart and Target remain a threat to regional centers anchored by dog-eared, "mid-price-point department stores." The merger between Federated and May guarantees anchor closings in some second-tier centers. Power centers depending on movie multiplexes wobble—Hollywood flicks look as good on flat screens at home without the stale popcorn smells. Large discounters make significant inroads into grocer market shares. Again, shopping centers leasing to C-team supermarket chains and drugstores will be extremely vulnerable. Their anchors only can lose to the discounter giants on pricing for consumer staples. Some chains won't survive.

Development

Sky-high pricing on existing neighborhood retail goads developers into breaking ground—they can build more cheaply than buy and sell profitably into the demand curve. "Discipline slips" in some markets. The trend to consolidation among retailers, dominated by discounters (Wal-Mart, Target, Marshalls, Kohls) and a few major category killers (Home Depot, Lowes, Bed Bath & Beyond) may help constrain development. Builders need one or more of these major tenants to justify a new large-scale project. Spec neighborhood center developers need to be careful, too. Smaller regional grocers start disappearing—they can't go head to head against Wal-Mart or Target. The pool of available tenants dissipates.

Exhibit 4-26 **Prospects for Regional Malls in 2006**

	Prospects	Rating	Ranking
Investment	Fair	5.45	9th
Development	Modestly Poor	4.30	11th
Supply/Demand Balance	Modestly Good	6.18	4th
Expected Unleveraged Returns 2006		7.0%	
Deal Cap Rate 2005		6.5%	

Buy	Hold	Sell
10.3%	40.0%	49.7%

Source: Emerging Trends in Real Estate 2006 *survey.*

Shopping centers need to reinvent themselves constantly to stay competitive and meet the needs of retailers' ever-changing marketing strategies—whatever lures customers. New power centers may combine big-box, lifestyle, and Main Street elements, including restaurants, supermarkets, and even department stores. Malls and neighborhood centers will also add lifestyle components to blunt competitors. Starbucks locates next to Safeway. "Expect more high-end merchants and discounters at the same property. Owners may attempt to extract additional "hidden value" on large mall tracts, adding mixed-use components—apartments, hotels, even office.

Outlook

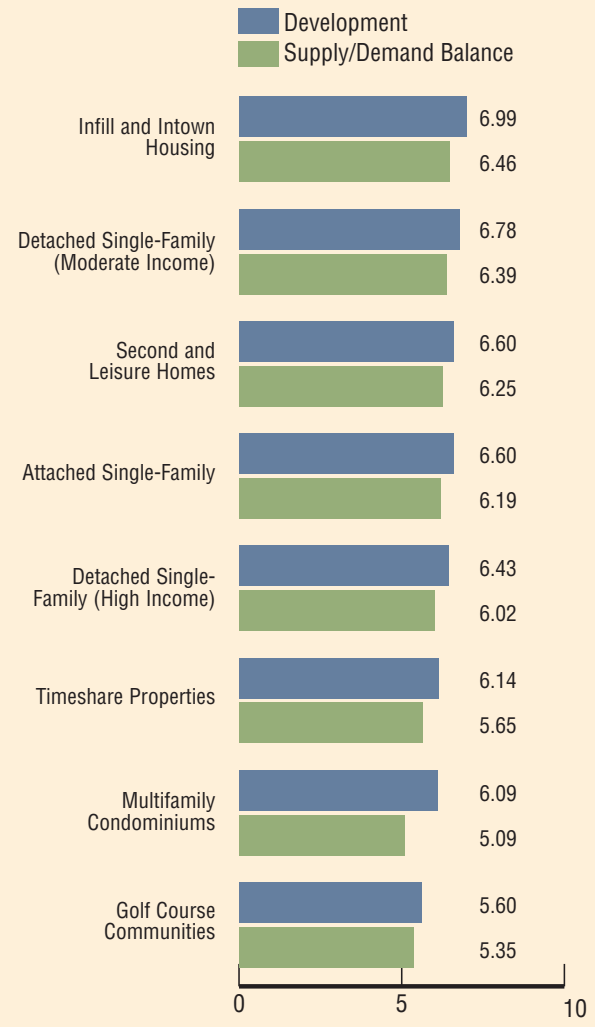
Temperamental energy prices hold the key. Sustained high costs—car fuel, heating, and electricity—could finally break consumers' backs. If oil markets relax and the economy produces more high-paying jobs, shoppers get another life. The market for properties will begin to bifurcate as buyers become more discriminating, distancing themselves from centers with more questionable tenant rosters. Development picks up to catch the tail end of the capital wave. Under any circumstances, retail property performance scales back in an inevitable reversion to the mean.

Housing

Strengths

Low interest rates have been the bulwark of the nation's unprecedented housing boom. As long as mortgage rates stay low and lenders pursue "forgiving" credit standards, buyer demand can be sustained among many people who otherwise couldn't afford steep price tags. The recent buying binge has been extraordinary—nearly 70 percent of the country now owns homes and multiple homeownership has increased significantly. "Does everyone have three houses in America?" Fear of bubbles "is overblown." Any corrections should be confined to local areas. "Housing markets are not centralized like stocks and bonds; supply/demand and pricing are very market-by-market specific."

Exhibit 4-27 Prospects for For-Sale Housing in 2006



Source: Emerging Trends in Real Estate 2006 *survey.*

Weaknesses

Housing values are "too frothy" and "unsustainable." Middling wage hikes promise to "put a lid on prices." "If home prices increase by 20 percent a year and incomes rise by less than 5 percent, then a disconnect eventually occurs in affordability." In some product-constrained areas like southern California and

certain Northeast metropolitan areas, 20 percent or less of the local population can afford median home prices. Something has to give. "Markets have been almost totally finance driven," and now mortgage rates edge up. Over 30 percent of recent loans are interest only, and by some estimates speculators purchased more than 20 percent of homes in 2004. Floating-rate debt could become a problem soon when buyers can't make higher payments. Surging property values have hiked property assessments and tax bills in many areas, adding to carrying costs. A "ton of for-sale signs" begins to appear on lawns in some places as owners try to cash out at perceived peaks. Recent home affordability "has sucked demand forward" and may result in lower future demand. Twenty-something buyers usually must wait until they accumulate enough wealth. But adjustable-rate mortgages, negative amortization, tiny downpayments, and other financing exotica grease the skids for eager purchasers. "Lenders and borrowers have been stretching to within an inch of their lives to make deals work."

Best Bets

Baby boomer demand for second homes in resort and retiree areas will build, regardless of the interest rate picture. The 50- to 60-year-old cohort wants waterfront locations, chalets with mountain vistas, beach retreats, and championship golf course villas. At their peak earning and cash accumulation years, many boomers can afford to buy even if mortgage rates increase.

Single-family building activity should remain above average in high-growth regions, primarily in the South and Southwest, where population inexorably shifts. Top states: Florida, Texas, North Carolina, Georgia, Arizona, and California. The Gulf Coast will undergo a mammoth resurrection in the wake of Katrina and Rita.

Infill and urban townhouse, condominium, and coop projects will gain increasing favor from the move-back-in crowd.

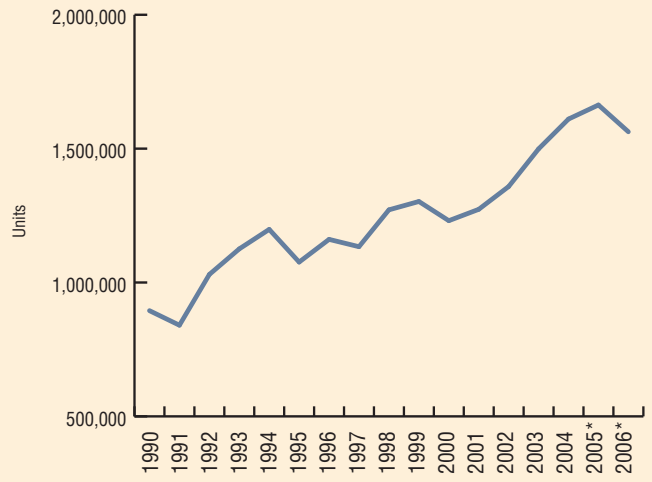
Avoid

Speculators need to back off. Buy-and-flip schemes to make fortunes will fall out of favor like Internet stock picks circa 2000. Tune out those infomercials. Buyers should bypass neighborhoods and projects where speculators have been active until prices settle or bottom out. Carrying costs and defaults should force product back on the market. Then look out for some bargains.

Development

Greenfield homebuilders hope oil prices nosedive back to reasonable levels. Otherwise anticipate newspaper and TV reports about nosebleed winter heating bills for all those owners of new exurban McMansions with cathedral ceilings. Insulation and solar panels make a comeback. High-flying homebuilder stocks could correct as buyer fervor ebbs and construction material costs increase. Margins may get squeezed. Everybody takes their tools to the Gulf Coast.

Exhibit 5-28 Single-Family Housing Starts



Sources: U.S. Census Bureau, National Association of Home Builders (NAHB).

**Figures from 2005 and 2006 are NAHB forecasts.*

Outlook

Mortgage rate movements may not shock most markets, but "a leveling off in appreciation is inevitable." Prices will flatten in most areas during 2006–2007, with outright declines in certain overheated markets where speculators have been active. Property values could stagnate for several years. Over time, homeownership will endure as a solid investment for users, but late-in-game investor-only buyers will fare poorly. The spate of low mortgage rate–driven homebuying will be over soon.

Lenders and investors become more comfortable with **mixed use**.

Niches

Resorts/Resort Hotels

Second homes in resort areas relish a growing market—affluent baby boomers look toward comfortable retirements and for legacy properties to pass on to children. Developers should include home offices in high-end projects. Satellite/cable/high-speed Internet technology enables executives to spend more time working away from headquarters in their cozy retreats. Hotel owners add condominium units to attract buyers who want extra services and amenities.

Mixed Use

Lenders and investors become more comfortable with mixed use, embracing the need for sophisticated infill development that meets increasing demand from people looking for greater lifestyle convenience. "It's more mainstream" and "in vogue." "Demographics, city planning, commuter preferences favor the trend" and diversified income streams from a single property can be attractive. Most projects center around residential components, office is less crucial. "Small [site] and tall" high-rise residential combined with low-rise retail becomes more common, especially in urbanizing districts. Apartments with supermarkets "are a strong infill amenity." Projects near transit stops have the greatest allure—"street cars, light rail, street grids, and residential woven around retail and office." "Leasing is much stronger in buildings where you can walk to restaurants or stores." "Problems endure in underwriting multiple uses in a single property," and many developers lack expertise in delivering all property types. "There always seems to be a dog element." Urban mixed use requires greater density to pay for infrastructure costs. Sites are still difficult to assemble and entitle. "Fewer opportunities exist than city planners would like to recognize."

Public Storage

These rentable warehouse units have investment profiles "resembling multifamily" with short-term leases that can quickly adjust to economic conditions. Storage rents typically run higher than apartments on a square-footage basis, operating expenses are far less, and tenant problems are minimal. The dusty old couch under the drop cloth doesn't call the super. But let's face it—this is a thin market. Institutional investors have been buyers, driving down cap rates, only because traditional property sectors have become too expensive for their fiduciary tastes. Developers often have trouble getting zoning approvals; public storage creates few jobs and little commerce. But otherwise few barriers to entry exist for these easy-to-build facilities.

Seniors' Housing

Investors continue to itch to get into seniors' housing, figuring the country's aging demographics will propel demand. They may be right eventually, but the graying baby boomer tidal wave is still probably 15 years away from clamoring for various forms of assisted care living. Supply tends to track ahead of the market. "Beware of ramped-up development pipelines." Active adult communities are a better bet for now.

Student Housing, Medical Office

State budget shortfalls force many public universities to rely on private developers to meet student housing needs. Old dorms—built to accommodate the baby boom influx in the late 1960s and 1970s—need renovation or redevelopment. Echo boom students demand upgrades and many colleges realize they need to retool to stay competitive . . . . Medical office buildings near hospitals can attract steady and reliable tenancy from physicians and their staffs. Increasing numbers of older people translate into more sickness and care and will require more doctors and hospitals.

Interviewees

The Ackman-Ziff Real Estate Group, LLC
Gerald S. Cohen
Patrick Hanlon
Russell Schildraut
Simon Ziff

Advance Realty Group
Gregory N. Senkevich

AEW Capital Management, LP
Douglas J. Poutasse

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Michael Bluhm

Alaska Permanent Fund Corporation
David Stuart

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John T. Meyer
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American Realty Advisors
Kirk V. Helgeson
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BNP Residential Properties Trust, Inc.
Philip S. Payne

Broadway Real Estate Partners
Brian Zila

Burnham Real Estate
Greg Bisconti
Stath Karras
D. Mickey Morera
Jim Munson
Robert Prendergast
Thomas W. van Betten
Jonathan A. Walz

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Bowen H. "Buzz" McCoy

CalPERS
Albert E. Grijalva
Michael B. McCook

CalSTRS
James J. Hurley
Michael J. Thompson

CB Richard Ellis Investors
Douglas Herzbrun
William C. Yowell III

Champion Partners
Jeff Swope

Charter Properties Inc.
Dean R. DeVillers

Childress Klein Properties
Landon R. Wyatt III

Citigroup Property Investors
Joseph F. Azrack

Citistates Group
Peter Katz

Colony Capital, LLC
Richard B. Saltzman

Column Financial, Inc.
Kieran Quinn

Commercial Mortgage Alert
Paul Fiorilla

Commercial Mortgage Securities Association
Dorothy Cunningham

The Concord Group
John R. Shumway

Continental Development Corporation
Alex J. Rose

Cornerstone Real Estate Advisers
Marc Louargand

Crescent Real Estate Equities, Inc.
Jeanette Rice

Crescent Resources LLC
Henry C. Lomax, Jr.

Crosland Inc.
Edward F. Long
Todd W. Mansfield

Cushman & Wakefield, Inc.
Timothy Welch

Deutsche Bank/RREEF
Charles B. Leitner

Dewberry Capital
Lara O. Hodgson

East West Partners–Western Division
Harry H. Frampton III

Ernst & Young
Dale Anne Reiss

First Fidelity Mortgage Corporation
Lance Patterson

Florida State Board of Administration
Douglas W. Bennett

Forest City Enterprises
James A. Ratner

Fremont Realty Capital
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Claude J. Zinngrabe, Jr.

GE Commercial Finance Real Estate
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General Electric Capital Corporation
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Glenborough Realty Trust Inc.
Alan Shapiro

GLL Partners
Dietmar Georg

GMAC Commercial Mortgage
Thomas MacManus

GMAC Institutional Advisors
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Oliver Fleener

GVA Lat Purser & Associates, Inc.
Lat W. Purser III

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Richard Kateley

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Geoffrey Dohrmann

INVESCO
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The Irvine Company
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Rick Fromm
Craig Jones
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The John Buck Company
Charles Beaver

John Burns Real Estate Consulting
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Kennedy Associates Real Estate Counsel, Inc.
David P. Lindahl
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LaSalle Investment Management, Inc.
William J. Maher
Lynn Thurber

Lazard Freres Real Estate Investors, LLC
Robert C. Larson

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MDH Partners, LLC
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Monday Properties LLC
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Morgan Stanley
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Owen D. Thomas

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New Plan Excel
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New York State Common Retirement Fund
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ULI–the Urban Land Institute
1025 Thomas Jefferson Street, N.W.
Suite 500 West
Washington, D.C. 20007
202-624-7000
www.uli.org

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Real Estate Leadership Team

Patrick R. Leardo
Global Real Estate Business Advisory Services
New York, New York
646-471-2666

Robert K. Ruggles III
Real Estate Valuation Advisory Services
New York, New York
201-689-3101

Peter F. Korpacz
Real Estate Business Advisory Services
Baltimore, Maryland
301-829-3770

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