

Business Opportunities

Real Estate Trends Encouraging

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Investor Survey Foresees Favorable Trends and Few Setbacks for the Rest of 2006

Steady declines in vacancy rates in downtown and suburban office markets across the country, a leveling-off of overall capitalization rates, and a continued deluge of equity and debt capital into real estate are combining to keep investors' hopes soaring into 2006.

This is according to the PricewaterhouseCoopers fourth quarter 2005 Korpacz Real Estate Investor Survey, which was released in late January.

"Last year, 75% of central business district (CBD) markets posted year-over-year declines in overall vacancy, compared to only 25% recording such declines between 2002 and 2003," said Peter Korpacz, director, PricewaterhouseCoopers' Global Strategic Real Estate Research Practice.

"At the same time, in suburban office markets, 80% of CBD markets saw year-over-year declines last year, as compared with only 29% between 2002 and 2003."

"As vacancy rates continue to edge down in each sector of the industry and with alternative investment options still being viewed dubiously by investors, capital continues to flow into each sector of the real estate industry from a range of sources—private, public, institutional and especially foreign investors," Korpacz said.

The quarterly survey of professionals involved with the real estate industry, including institutional investors, REITs, pension funds, mortgage bankers, developers and insurance companies, identifies trends across key real estate industry sectors.

Other notable findings include:

- In spite of higher energy prices, consumer spending in the retail sector has continued strong in recent months, with many regional mall tenants experiencing impressive year-over-year gains in retail sales.
- High home prices, soaring construction costs and rising mortgage rates have combined to spur increasing demand for apartments in recent months.
- As the U.S. economy continues to expand, and industry fundamentals remain on a positive track, many developers are looking closely at opportunities for new land development in each of the commercial property sectors.

One key beneficiary of the continued improvement in real estate fundamentals has been the self-storage industry, according to Charles Ray Wilson, chief economist at Self Storage Data Services, Inc., whose commentary on the sector is featured in the new edition of the Korpacz Survey.

But while capital has continued to flow into this segment, some potential problems have begun to arise. Chief among these is the concern that pricing is ahead of, and not supported by current underlying fundamentals.

As a result, overall capitalization rates may have reached a plateau, as more and more self-storage investors are beginning to realize the magnitude by which net incomes must increase in order to achieve anticipated

yields, Wilson writes.

In addition to pricing concerns, many self-storage investors need to pay more attention to what drives demand instead of simply looking for new deals to do, he noted. Also, investors who continue to purchase new assets need to better recognize and quantify the differences in the location and quality of a self-storage asset as they relate to the risk and value of the investment.

In addition, investors need to be aware of a growing trend among taxing authorities nationwide to focus on reassessing self-storage properties upon the transfer of ownership. Sudden, unforeseen tax increases can have a devastating impact on yields, according to Wilson.

Retail Picture Bright

In spite of higher energy prices, consumer spending in the retail sector has continued strong in recent months. Even so, some survey participants expressed concern that rising heating costs could dampen their overall performance results.

As many regional malls continue to perform well, investment demand has remained strong, and has helped bring a slight decrease in the average overall capitalization rate (OAR) for many mall classifications.

The national power center market continues to attract active interest from investors, thanks in part to impressive year-over-year retail sales performances by a number of big-box retailers and discount merchants.

Still, investors need to exercise caution in which power center assets they choose to pursue, as a number of major retailers posted strong gains in September 2005, including Costco, Wal-mart and Target, while a number of other large discount retailers announced plans to close significant numbers of stores.

Tough competition and aggressive pricing in the national strip shopping center market has led to a tail-off in transaction growth, although many investors still express significant interest in grocery-anchored strip centers.

At the same time, a lack of quality offerings and a growing desire to build new centers—rather than buying existing ones—is encouraging new development.

In fact, neighborhood/community shopping centers placed first in terms of development potential, scoring a 6.22 on a scale of 0 (abysmal) to 10 (outstanding) in the recently released *Emerging Trends in Real Estate 2006* survey published by PricewaterhouseCoopers and the Urban Land Institute.

Office Market Improves

The national commercial business district office market continues to improve, with this sector's overall vacancy rate falling from 13.7% to 13.1% between the second and third quarters of 2005.

By way of comparison, this sector's overall vacancy rate was 14.8% in the third quarter of 2004 and 15.5% in the third quarter of 2003.

According to the report, the three top-performing CBD office markets over the past year are all located in California: San Francisco, Oakland and Orange County, where overall vacancy rates fell an average of 360 basis points between the third quarters of 2004 and 2005.

Another CBD market that continues to perform well is Phoenix, which posted an overall vacancy rate of 15.4% in the third quarter of 2005, a decline of 230 basis points from the third quarter of 2004.

In the *Emerging Trends* survey, Phoenix scored a 6.27 on a scale of 0 (abysmal) to 10 (outstanding) in terms of investment potential, the same as New York City. For development potential, Phoenix scored a 6.28 among *Emerging Trends* respondents.

In the national suburban office market, declining speculative new construction—due in part to high construction costs—and an improving job market are helping to fuel a continuing recovery. A total of 5.27 million square feet of speculative office space was under construction in 40 suburban office markets during the first nine months of 2005.

By way of comparison, for the first nine months of 2003, this total was 8.44 million, and for the first nine months of 2004, the total was 6.41 million.

But even though overall vacancy rates continue to fall, few investors express confidence that now is the best time to buy suburban office assets. In fact, the *Emerging Trends* survey found that 20.4% of respondents believe that 2006 will be the best time to buy suburban office assets.

At the same time, 35.6% of respondents said that 2006 will present the best time to "hold" suburban office properties, while the remainder (43.9%) said that 2006 will be the best time to "sell" suburban office assets.

Warehouses and Condos

Overall, most investors tend to view flex/research and development acquisitions as "opportunistic" and involving greater risk, particularly compared to traditional warehouse investments.

Even so, steadily improving fundamentals and the anticipation of higher returns are drawing some investors to this category. In fact, R&D industrial assets are likely to give investors one of the highest unleveraged returns in 2006, according to *Emerging Trends in Real Estate*.

One market singled out in the Korpacz survey was Philadelphia, where the vacancy rate in flex/R&D fell to 12.8% in the third quarter of 2005, marking a decline of 170 basis points from the prior quarter.

Another flex/R&D market singled out is Portland, where the vacancy rate fell to 10.4% in the third quarter of 2005. Other cities where buyers of flex properties have been especially active during 2005 include San Jose, San Diego and Los Angeles.

Steady returns and strengthening fundamentals are also leading many investors to seek opportunities in the national warehouse market. Sales activity has been described as extremely brisk in the western region of the U.S., where a total of 349 warehouse assets were reported sold during the first 10 months of 2005.

Approximately 30% (105) of these warehouse properties were located in Los Angeles. Seattle, with a total of 44 assets sold, had the second highest number of warehouse transactions on the West Coast.

Other regional warehouse markets identified as performing well include Chicago, where a total of 102 warehouse properties sold during the first 10 months of 2005, and Northern New Jersey, where industrial vacancies amounted to a low 7.7% in the third quarter of 2005.

The market for apartments has seen increased demand in recent months. The overall vacancy rate in the third quarter of 2005 amounted to 5.8%—down from 6.4% in the prior quarter and 6.6% a year earlier.

Part of the reason for the decline can be traced to an increase in renter demand, as well as a steady increase in the rate of condo-conversions. In the third quarter of 2005 alone, approximately 33,600 apartments were converted to condominiums, with a total of 84,000 condo-conversions occurring at the time the Korpacz survey was completed.

By comparison, 2004 saw a total of approximately 66,000 conversions, the researchers pointed out.

The high level of competition among "condo converters" has caused prices to remain elevated and led to further declines in overall capitalization rates in many areas. Key markets where condo-conversions have been especially hot include Orlando, Tampa, Broward County and Phoenix.

Overall, condo-conversions made up 43.0% of the total apartment sales in the third quarter of 2005, the survey found.

Bidding Wars Erupt

In the national net a reduction in the number of properties being offered for sale has led to bidding wars on the best quality assets being offered.

And while sales activity has continued to occur in each segment of the net lease market—sale-leaseback, 1031 exchange, and triple-net-leased properties—high real estate prices and the ability to access equity have helped spur a growing number of sale-leaseback transactions.

Overall, the number of net lease offerings nationwide declined in the third quarter of 2005, when 6,898 worth a combined value in excess of \$23.1 billion were up for sale.

This compares to a total of 9,324 available properties, with a combined value of over \$27.9 million only one quarter earlier. This represents a 27.0% drop in the number of available properties and a 17.2% decrease in their cumulative value in only three months time.

Top-rated states for net lease property investments have remained fairly consistent over the past quarter, with states offering the greatest number of properties for sale as compared to state population. These states include Texas, Florida, California, Arkansas and Georgia, which altogether totaled 45.3% of the total net leased property offerings in the third quarter of 2005.

Positive economic factors are prompting developers to look closely at opportunities for new land development in each of the commercial property sectors.

According to the survey, some of the most attractive opportunities over the near term include infill housing and mixed-use projects, age-restricted communities, and resort/second-home building.

The survey goes on to list the top 10 markets offering the best prospects for commercial/multifamily development for the coming year. Listed one to 10, they are: Washington, DC, San Diego, Northern Virginia, Orange County, Los Angeles County, Riverside/San Bernardino, New York City, Maryland suburbs, Phoenix, and Fort Lauderdale/West Palm Beach.

While development land opportunities are opening up across all segments in the real estate industry, caution is still an important watchword, the survey warns. "Even in niche real estate markets, such as self-storage, medical and student housing, fundamentals can be easily imbalanced if too much product gets built too quickly."