

Spring 2010 Real Estate Investment Outlook

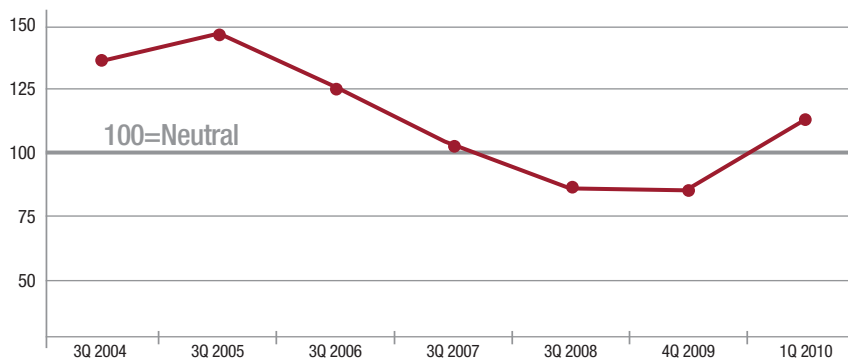
Recovery on the Doorstep

With the U.S. economy improving, investors plan to increase their stakes in commercial real estate.

Commercial Real Estate Investor Sentiment Turns Positive: Will It Last?

For the first time since 2005, investor sentiment is on an upward trajectory. According to the *National Real Estate Investor* (NREI)/Marcus & Millichap Investor Outlook Study for the first quarter of 2010, respondents started to show signs of being increasingly positive about the commercial real estate market.

[Figure 1] Investor Sentiment Index Turns Bullish



The index takes into account expected changes in property values for various real estate sectors, as well as plans to increase or decrease total real estate holdings. With a baseline of 100 indicating neutral sentiment for the industry, investor sentiment can be traced from its high in 2005 to a trough that began in 2008, but which is now back on the rise.

Methodology: In mid-March, NREI's research unit and Marcus & Millichap e-mailed invitations to participate in an online survey to public and private investors and developers of commercial real estate. Specifically studied were Marcus & Millichap clients and subscribers of *National Real Estate Investor* and *Retail Traffic* selected from commercial real estate investor, pension fund, and developer business subscribers who provided their e-mail addresses. The majority of respondents are private investors (36%); private partnerships (19%) or developers (16%) with an average of \$35.8 million invested in commercial real estate. Real estate investment trusts and institutional investors represent 6% of all respondents.

It may be too soon to pop the champagne corks, but investor sentiment is improving as economic news turns positive and a bottom nears for commercial real estate markets. Sixty percent of respondents indicate they plan to increase their commercial real estate holdings over the next year.

That is a more bullish sentiment compared with the 51% who voiced the same opinion in the fourth quarter of 2008 when property values were dropping rapidly amid the credit crisis. Respondents who do plan to acquire property in the next 12 months say they expect to boost their portfolios by an average of 25%.

For each of the major property types, at least 40% of current investors see now as the time to buy. Among investors currently invested in multifamily properties, the pent-up demand is especially high with 70% indicating now is the time to buy apartments [Figure 2]. The survey of 720 investors was conducted in late March.

“The survey results really point to the fact that investors believe in the economic recovery, and that’s the first domino that we



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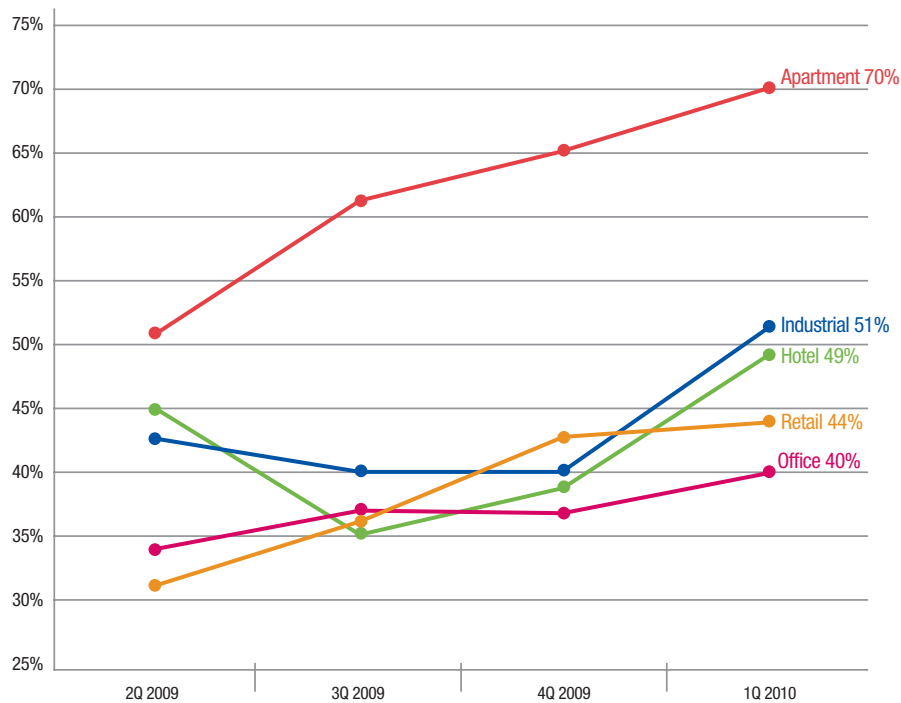


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[Figure 2] A Growing Percentage of Investors in Each Property Type Say Now is the Time to Buy



need to ignite a recovery in commercial real estate,” says Hessam Nadji, senior vice president and managing director at Encino, Calif.-based Marcus & Millichap.

Investors are gaining more confidence on the heels of positive economic news. The gross domestic product (GDP) in the United States expanded at an annualized rate of 2.2% in the third quarter of 2009, 5.6% in the fourth quarter and 3.2% in the first quarter of 2010. Economists are predicting lower, but positive growth in 2010. Some estimates are for GDP to grow 3.5% for the year.

Valuations still falling

With the exception of apartments, investors

are far from optimistic on the outlook for property values. Yet most agree that the worst of the fallout is over. Roughly one-third of respondents believe that valuations in the office, industrial and retail sectors will be lower a year from now, but most believe that prices have nearly bottomed out.

That outlook marks a stark contrast from a year ago when investors were expecting significant price corrections across the board. Investors expect retail property values to decrease just 1.9% over the next 12 months, the biggest drop among all commercial real estate sectors.

Survey respondents anticipate industrial properties to fall 0.8% in value and office

building valuations to drop 0.3%. Perhaps the biggest sea change is that investors expect apartment values to rise 3% over the next year [Figure 3].

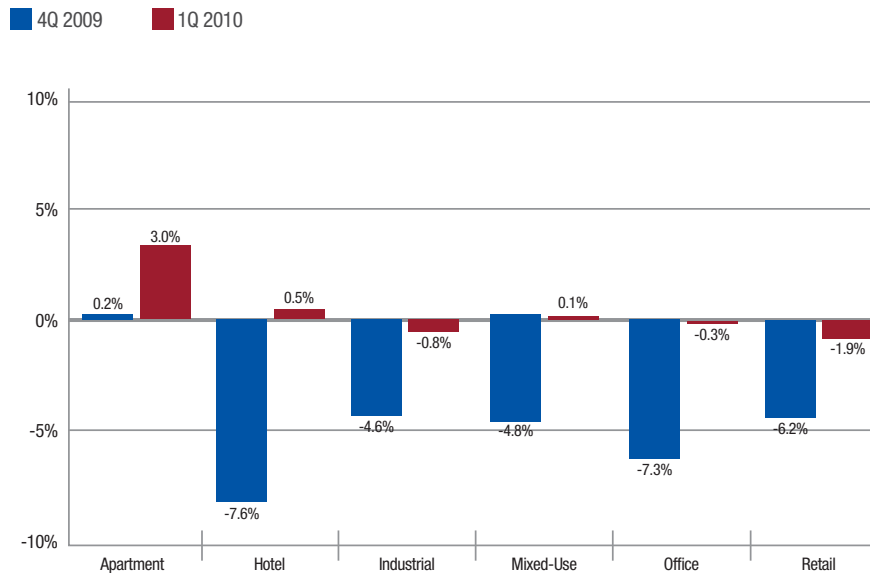
Both institutional and private investors project higher prices and lower capitalization rates for the upper end of the market across all property types. Statistics show this trend has already begun to materialize. Conversely, further price declines for lower-quality assets, especially in secondary and tertiary locations are likely, albeit at a less precipitous drop than the past year.

Respondents believe that the apartment sector will be the first to recover. Some 41% of apartment investors expect an uptick in valuations in the coming year. Another 42% expect apartment values to remain the same, while 15% anticipate a drop in valuations. Again, the consensus among respondents is that apartment values will rise 3% over the next year.

Challenges and opportunities

Clearly the investment market for commercial real estate faces obstacles that hinder activity. Chief among them is a shortage of quality properties on the selling block. Few owners are inclined to sell into a market where prices are falling and reinvestment opportunities are scarce. In fact, only 9% of respondents indicate they plan to decrease their holdings in the coming year.

Meanwhile, investors continue to accumulate capital in anticipation of buying opportunities in the coming year. Slightly more than two-thirds of respondents (68%)

[Figure 3] Expected Changes in Property Values Over the Next Year

indicate they are currently amassing capital with an average of \$14.4 million ready for acquisitions. Much of that capital is flowing to low-risk investments.

Consequently, the investment market remains bifurcated. While there is strong demand and compressed capitalization rates for top-tier properties, there is far less demand and higher cap rates for lower-quality Class “B” and “C” buildings in secondary and tertiary markets. “Any quality properties that we are bringing to market, Class B or better, are fetching 20 to 30 offers,” Nadji says.

In fact, it is that intense competition for quality properties that may explain a slight pullback in investor buying strategies. The 60% who reported that they plan to increase commercial real estate holdings over the

next 12 months is down from 66% who held the same view in the survey taken in the fourth quarter of 2009.

That decline may be a reflection of caution in the marketplace, as well as investors’ discouragement over not being able to get their hands on what they want to buy, Nadji notes. “The inventory of less risky, high-quality product is quite thin, which is why you’re getting these high numbers of multiple bids,” he adds.

Apartments are in favor because that sector tends to track more closely with the economy due to the short-term nature of its leases. Apartment vacancies are expected to peak at 8% this year, while retail and office vacancies are projected to reach 10.6% and 18% respectively, according to Marcus & Millichap.

Slow rebound ahead

Investors remain hesitant in what is shaping up to be a slow economic recovery. Based on a five-point scale—with 1 representing a very cautious approach and 5 being very aggressive—more than half of investors (54%) rate their acquisition strategy for the next 12 months as either a 1 or 2. Only 18% rate their investment strategy as a 4 or 5.

That caution reflects the laundry list of concerns that investors have related to everything from inflation and continued lending constraints to mounting foreclosures and weak real estate fundamentals. “There is a lack of quality jobs. Unemployment is too high, and there is a lack of spending and confidence among consumers,” writes one respondent.

“I feel there may be a very long and slow recovery,” writes another respondent. “Investors will start placing money based on inflation hedge and lack of return in other investments. Therefore, core or stabilized Class-A locations will actually increase in value by 2011 in comparison to today.”

However, with signs pointing to the fact that the commercial real estate sector is at or very near the bottom, the big question is what’s next? The answer is likely to be a gradual recovery in the economy and the commercial real estate industry with investors continuing to target low-risk, quality properties.

“We can’t declare that we are out of the woods yet by any stretch of the imagination,” says Nadji of Marcus & Millichap. “Yet the survey shows that the economy has bottomed and the worst is over.” ■