

2010 Real Estate Investment Outlook

Will more buyers result in more sales?

Financing, pricing gap and wait for distressed sales are blocking the path for investors.

After a quiet year of investment sales, buyers are preparing to forge ahead with acquisitions in 2010. Two-thirds of investors (65%) who responded to the 6th Annual Investment Survey plan to boost their investment in commercial real estate over the next 12 months. That figure is up from 56% in the third quarter and 51% a year ago. The exclusive survey is produced jointly by *National Real Estate Investor* and Marcus & Millichap.

The fact that buyers are once again returning to the table is a huge vote of

confidence for a commercial real estate industry that has been slammed in the past year by falling property values, occupancies and rents. Respondents to the annual survey who do plan to expand existing portfolios anticipate an average increase of 26%, up from 24% in the third quarter and 22% a year earlier [Figure 1].

Yet there may be a significant disconnect between what investors hope to achieve, and what will be feasible in a market that remains fraught with challenges. The survey, which polled

506 respondents between Oct. 9 and Nov. 5, shows that investors are well aware of the obstacles that lie ahead.

Chief among those impediments are the continued lack of financing, a narrower but still sizable gap between buyer and seller price expectations, and uncertainty related to the volume of distressed properties coming to market.

“We have seen buyer traffic pick up substantially over the last two to three months. The logjam is largely created by extremely conservative financing and underwriting that has

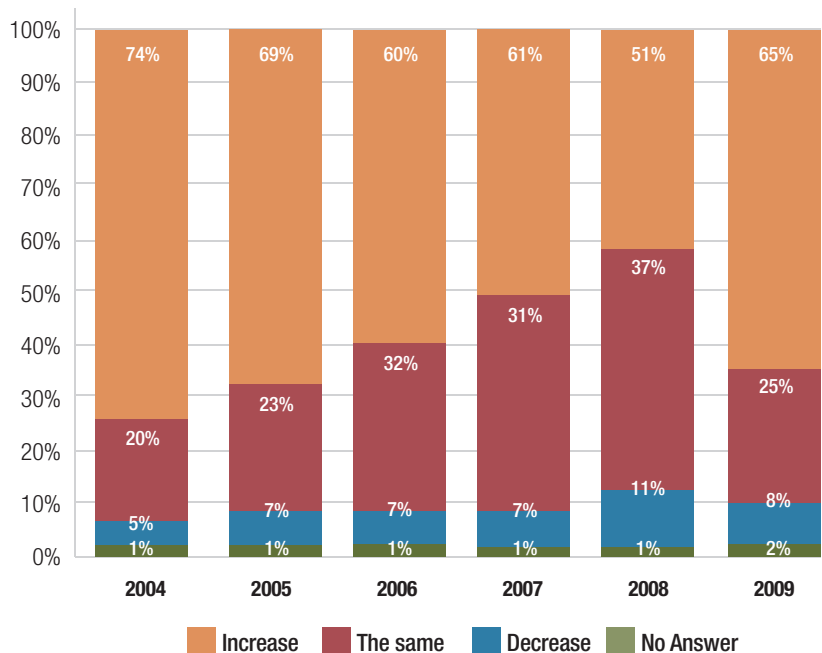
Survey Methodology

Penton Research collected data for the Annual Investment Outlook from Oct. 9 through Nov. 5. The e-mail survey yielded 506 responses. The purpose of the survey was threefold:

1. to examine current real estate investments among clients of Marcus & Millichap Real Estate Investment Services and subscribers of *National Real Estate Investor* and *Retail Traffic* magazines;
2. to determine which property investment markets are strongest and will be most attractive to investors in the future;
3. to investigate respondents' opinions regarding trends in the industry and compare results to those captured over the past six years.

FIGURE 1. PLANNED CHANGE IN COMMERCIAL REAL ESTATE INVESTMENTS

Do you plan to increase or decrease your commercial real estate investment in the next 12 months?



Base: all respondents to the 2009 (506), 2008 (1,129), 2007 (1,004) 2006 (1,042), 2005 (1,167) and 2004 (648) surveys.

swung too far to the other extreme from the market peak,” says Harvey Green, president and CEO of Encino, Calif.-based Marcus & Millichap.

Even access to capital is no guarantee that acquisition strategies will find success in the current market. The combination of stiff competition, a limited supply of properties for sale and high prices has sidelined well-capitalized investors such as Camden Property Trust.

The Houston-based apartment REIT did not acquire any properties in 2009. However, Camden is continuing to scout for deals and is hoping that more opportunities will materialize in the latter half of 2010.

“We have an acquisition appetite of \$1 billion-plus. The question will be whether we can find the right transactions,” says Richard J. Campo, Camden’s chairman and chief executive officer.

Finding good buying opportunities is more difficult as investors adopt conservative strategies to fit the current volatile climate. On a five-point scale, with 1 being very cautious and 5 being very aggressive, more than half of respondents (53%) rate their acquisition strategy as a 1 or 2.

Although that is a slight improvement from the third-quarter results when 66% of respondents held the same conservative strategy, it reflects the continued aversion to risk and uncertainty that remain in the marketplace.

Timing the market

It’s clear that investors want to pursue new acquisitions. Overall, 72% of respondents indicate that they are currently amassing capital in preparation for buying opportunities.

The majority of investors expect to execute more transactions. More than one in four respondents (28%) say they have already started adding to their portfolios, while an additional 41% say they plan to begin acquiring property

FIGURE 2. CAP RATES NEEDED FOR AGGRESSIVE BUYING

Based on in-place net operating income (NOI), what do cap rates need to be before you become an aggressive buyer of each of the listed property types and levels?

Property type:	Top-tier properties	Mid-tier properties	Low-tier properties
Apartment	8.2%	9.3%	11.0%
Hotel	10.2%	11.5%	13.6%
Industrial	9.0%	10.2%	12.2%
Mixed-use	9.1%	10.0%	11.4%
Office – downtown	9.0%	10.0%	11.6%
Office – suburban	9.6%	10.6%	12.2%
Retail – mall	10.0%	10.8%	12.7%
Retail – Grocery/drug-anchored center	9.1%	10.2%	11.7%
Retail – lifestyle/power center	9.6%	10.5%	12.0%
Retail – single tenant	9.3%	10.3%	12.0%

over the next six months.

Although 2009 was an unusually slow year for investment sales, investors appear to be more optimistic that investment sales will pick up in 2010. Property sales year-to-date through September totaled \$12.4 billion, which is a fraction of the \$110.6 billion notched during the same period in 2007, according to Real Capital Analytics, a New York-based research firm that tracks office, industrial, retail, apartment and hotel transactions above \$5 million.

Miami-based LNR Property Corp. is looking at opportunities in office, industrial, retail and apartment markets in 2010, as well as indirect investment in underperforming real estate debt and potential operating platforms.

“This past year the fundamentals have been too uncertain, and it has been too early in the cycle, while next year should have more volume of higher-quality assets coming to market,” predicts Eric Paulsen, a vice president at LNR Property.

One hurdle for buyers remains pricing. Many buyers are waiting for bigger price discounts before they jump into the market. The minimum cap rates respondents say would be necessary to spark

aggressive buying in a particular property type range from an average low of 8.2% for top-tier apartment properties to an average high of 13.6% for low-tier hotels [Figure 2].

“The degree of cap rate movement needed for buyers to become aggressive in this market really points to a lingering pricing expectation gap,” says Hessam Nadji, senior vice president and managing director at Marcus & Millichap.

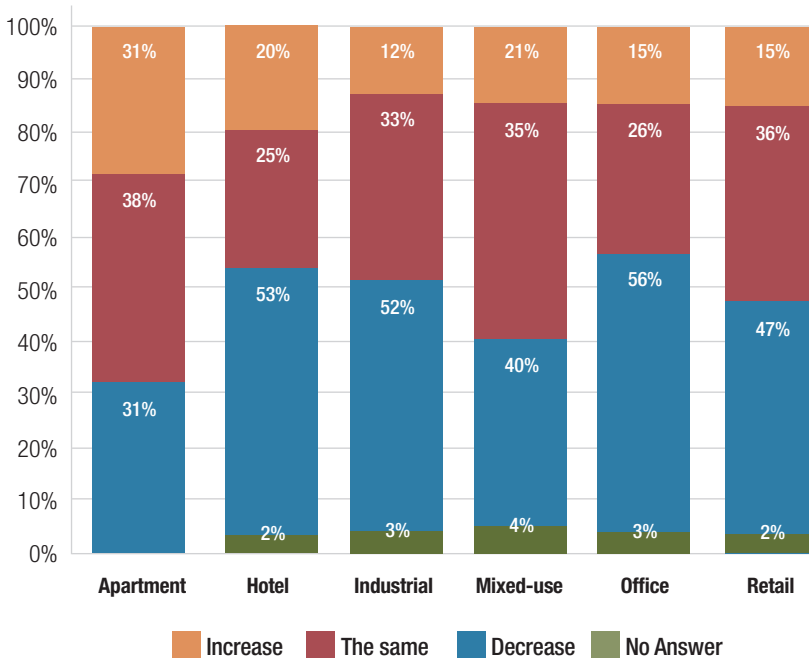
“For example, the expectation that investors would require an 8.2% cap rate to spark aggressive buying of top-tier apartments seems unrealistic considering the fact that those ‘A-quality’ apartment properties are still trading in the range of 6.25% to 7%. Continued investor appetite for top-tier properties will likely prevent cap rates from rising dramatically. On the other side of the spectrum, investors may be right to expect higher cap rates on lower-tier properties and/or markets given the added risk,” Nadji adds.

Waiting on distress

Uncertainty regarding the volume and pricing of distressed properties that will eventually find their way to the selling block is creating hesitancy among

FIGURE 3. PROPERTY VALUES

Considering only the property currently in your real estate portfolio, do you expect the value to increase, decrease or remain the same twelve months from now?



Only respondents invested in the property type are included in the columns for that property type.

investors. Three out of four investors (78%) expect that a moderate to large volume of distressed properties will hit the market during the next 12 months.

Slightly more than half of respondents (51%) believe that distress will be most widespread in the suburban office sector, followed by hotels (50%), retail mall properties (45%) and undeveloped land (44%).

Stiff competition and a limited supply of distressed properties on the market have combined to keep opportunistic buyers such as LNR Property from making any new investments during 2009. The firm is targeting potential acquisitions that deliver returns in the high teens.

“We believe there will be greater potential for investment opportunities next year, but we may need some kind of government mandate that forces the issue, otherwise it will continue to be a slow trickle of properties to the

market,” says Paulsen of LNR.

Although the flow of distressed assets to the sale market has been limited to date, the build-up of distressed properties among lenders is clearly on the rise. The total delinquency rate among bank commercial mortgages that are 90-plus days past due reached an estimated 4.7% in the third quarter, according to Foresight Analytics. The delinquency rate on CMBS loans climbed to 3.9% in September on loans that are either already real estate owned or 30+ days delinquent, according to Realpoint Research.

The complexity of unraveling securitized and off-balance sheet loans, coupled with banks’ need to postpone further losses, is largely to blame for the delay in the discounting and sale of distressed assets.

However, impatient investors are more inclined to believe that government solutions aimed at addressing

toxic assets are only contributing to that hold-up. Nearly one in six respondents (59%) believe that the government solutions are creating a delay in the discounting and sale of commercial real estate assets, compared with 51% who held the same view in the third quarter and 45% in the second quarter.

Investors tread carefully

Investor demand appears to be rebounding even as buyers brace for a slow economic recovery. More than half of respondents (57%) believe that net job growth is a year or more away, while nearly two-thirds of respondents (62%) do not expect real estate values to return to their peak values for six years or longer.

Apartment investors are the most optimistic, with opinions evenly split at 31% among those who expect valuations to increase or decrease during the next year. Another 38% who believe values will remain the same. In comparison, more than half (56%) of office owners are bracing for a decline in values, while 26% believe values will remain the same and 15% anticipate an increase [Figure 3].

The apartment sector is the only property type where owners expect values to hold up with an expected increase over the next year of a slight 0.2%. Investors in other property types anticipate further declines in valuations in the coming year with hotels faring the worst. Respondents project a 7.6% drop in hotel valuations, followed by office at 7.3% and retail at 6.2%.

Only a fraction of investors expect effective rents will rise in the coming year, while the majority of investors expect additional deterioration. Office investors appear to be most concerned about falling rents. Among those respondents invested in office properties, 62% believe effective rents will fall further, while 25% anticipate rents will

remain the same, and 9% are optimistic that rents will rise [Figure 4].

Respondents believe that retail will suffer the biggest drop in rents at 7.6%, followed by office properties (7.5%) and hotels (5.7%). Even apartments are not expected to be immune from market challenges. Investors anticipate a 1.4% decline in effective rents.

Expectations regarding effective rents are a key concern for investors who are relying more on cash flow and less on property appreciation when it comes to underwriting deals today.

“When we’re underwriting today, we’re building in declines in cash flow between now and the end of 2010 and early 2011, but then we think there is going to be a substantial uptick in cash flow because of the lack of new supply,” says Campo of Camden Property Trust. Camden’s target returns are for an unleveraged IRR of 10% to 11%.

Financing hurdle lingers

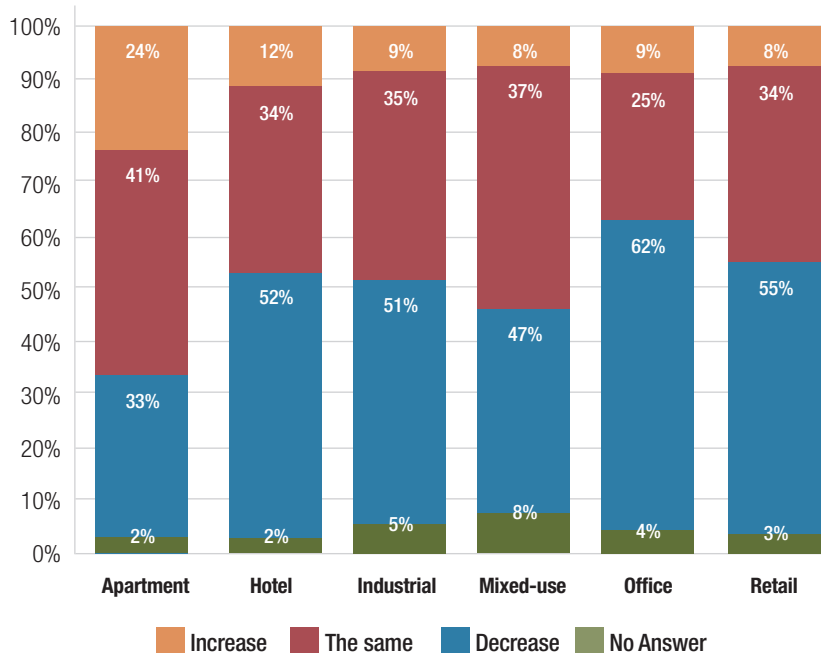
Lack of available financing continues to be one of the biggest impediments for returning investors, and respondents are not anticipating much improvement for the coming year.

Investor expectations regarding the availability of financing have remained consistent throughout 2009. The majority of respondents (77%) expect that the availability of capital will remain the same or increase in the coming year with 36% who say there will be an increase, 41% believe availability will remain the same, and another 22% who expect a decrease.

In comparison, 64% expect that the cost of financing will increase next year, while 32% believe it will

FIGURE 4. EFFECTIVE RENTS

Considering only the property currently in your real estate portfolio, do you expect the effective rents to increase, decrease or remain the same 12 months from now?



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stay the same and 4% believe financing costs will decrease.

“Unfortunately, there is no quick fix to getting the banking system on solid footing again,” Nadji says. Further improvements in their capital position and profitability are necessary before their tolerance for commercial real estate loans increases, and that will take more time—particularly since there are still some waves of home foreclosures in the pipeline.

There are some encouraging signs emerging as life insurance companies are increasing their allocation, Freddie and Fannie are expected to remain active in the apartment sector, and at least a moderate thawing of the CMBS

market should materialize in the next year, adds Nadji.

“The full impact of the stimuli will also materialize in 2010, but it will take time for government solutions to normalize credit markets,” Nadji emphasizes.

On a positive note, evidence is emerging that both buyers and sellers are returning to the table, and there has been some narrowing of the pricing gap.

“Quality assets are coming to market at reasonable prices that are generating as many as 20 offers because those buyers aren’t trying to time the bottom,” explains Green. “They see the long-term value of the real estate.” ■