

Real Estate Capital Markets Update, Settling into the Transitional Economic Environment

by James R. DeLisle, PhD

Commentary

As we predicted last fall, the United States economy has continued to slow. Indeed, the shift has been so dramatic that it has resulted in widespread use of the "R" word as fears of recession have replaced concerns about inflation. A number of factors have contributed to this slowdown, ranging from plummeting consumer confidence to continued volatility in the stock market, especially within the technology sector. In some respects, the decline is a self-fulfilling prophecy, with consumers finally listening to the post-election rhetoric as the president-elect sought to lower economic expectations.

As we sail through 2001, we expect this uncertainty to continue. Although the prospects for meaningful tax cuts and other economic stimuli may provide some relief in the second half of the year, the downside risk will remain greater than it has been for some time. As such, consumers and businesses alike will remain skittish with the gnawing feeling that the good times are finally over.

Much has been written in recent years about the "old" versus "new" economies. Many observers who have followed those debates have alternated between one or the other side of the issue as the pendulum has swung back and forth. This fluctuation is certainly understandable, especially after the dot.com shakeout pulled the rug from under the revolutionists. In our opinion, the economic environment should not be debated as a binary event (e.g., old economy versus new economy). Rather, we believe it is more appropriate simply to label it a "transitional" economy. Still, some observers will no doubt draw on their experiences in sailing through past business storms and anticipate that the economy will do a "come-about" and inevitably return to the old way of doing business, albeit with some new virtual bells and whistles to make the sailing a little

smoother. Others will continue to argue that the technologically enabled changes will relentlessly continue as we stay the course toward a more "net-centric" future.

In our transitional outlook, we recognize that the economy will continue to meander, giving false hopes and miscues to those who long for the past and have been quick to overreact to the recent plight of the technology sector. From our perspective, the shakeout among technology companies was somewhat foreseeable. Indeed, it is reminiscent of the early boom period of the real estate investment trust (REIT) resurgence, in which the market discounted double-digit growth rates and priced them as growth stocks despite the fact that REITs are fundamentally income vehicles. When reality finally set in, REITs went through a difficult adjustment period as they were repriced to reflect their true nature.

In a similar vein, the frenetic pace of technological change outstripped the moderate pace at which changes in business and consumer behavior can be absorbed. Granted, some companies and consumers led the revolution, and others were caught up in the initial vacuum. For most, however, the sheer pace of new innovation created an insurmountable barrier; it was too widespread to merely navigate around and proved too high to sail over easily. The dot.coms themselves were faced with a similar obstacle, but failed to realize it was not some virtual artifact. Those who threw caution to the wind were yanked down to reality because their ships were not built on the foundation of solid business propositions, nor manned with the skill to make the trip without catastrophic results.

While the plight of many of the high-flying dot.com companies might have created some solace for those who want the world to return to its former bricks-and-mortar base, we believe there is no going

back. Rather than merely throwing money at technology and embracing other e-business initiatives, businesses will have to apply much greater discipline to ensure that their investments build on a solid business proposition and add value to the bottom line. In effect, other companies will go through the same rationalization that the dot.coms have recently experienced, though in a more gradual and guarded manner. We expect renewed interest among companies in seasoned employees and recent graduates who can act as technology transfer agents and build a bridge of communication between traditional functional business areas and technology champions.

As we have discussed in previous issues, the real estate industry has developed a much better feel for the impact of the convergence of the capital market and the real estate market. While this understanding must continue to evolve, the "transitional" economy in which we operate and the continuing emergence of technological innovations suggest that real estate professionals shift their attention to more fundamental real estate issues. Several considerations bolster this argument.

First, we are entering the final stages of the recovery that started in the mid-'90s; indeed, in some sectors and markets we have passed into the next stage of the cycle. As such, successful operation in most property sectors and markets depends on returning to an understanding of fundamental drivers versus cyclical drivers. This transition leaves few degrees of freedom for those who misread or fail to focus on market fundamentals of supply and demand. Unfortunately, some investors continue to have unrealistic expectations for performance and will not be as sensitive to risk; efforts to increase their understanding might go unappreciated, at least in the near term.

Second, as we move through this transitional economic phase, we are undergoing a structural shift that will change real estate market dynamics and amplify the inherent risk in taking long positions in real estate. In the economic environment that will ultimately emerge, real estate consumption, production, management, and investment will fundamentally change. We are rapidly moving toward an "inflection point" that will render invalid traditional cycle theories and models that are based on trend lines of evolutionary change. As a result, those who plot markets and property types along some constant wave or around a fixed clock will find themselves out of sync with the "new" real estate market.

To determine how this new market will operate and to identify the key drivers and relationships, real estate professionals will have to pay special attention to the subtle, somewhat inconsistent cues that emerge. We believe that "behavioral" research focused on a better understanding of space producers, space users, and facilitators will be critical in anticipating when the next inflection points will occur. To address these fundamental questions, it is useful to review the overall economic environment, and then to explore new business trends and the integration of technological innovations that will affect business demand.

The Economic Environment

Economic Growth

Last fall, we shared the consensus opinion that the "soft landing" for the economy would continue, with GDP growth moderating somewhat, though exhibiting some upside potential for higher near-term growth. During the fourth quarter, revised numbers for the first part of the year came in above expectations and set the stage for stronger economic growth than anticipated. Despite this momentum, however, fourth quarter results fell off, declining to the slowest pace of growth in five years. In our opinion, this decline can be attributed to several phenomena.

First, economic fundamentals were mixed to negative. Second, the post-election posturing out of Washington finally trickled down to the attitudes of businesses and consumers. The rhetoric raised a warning flag that ultimately rippled across the economy, creating even more uncertainty as to where we were in the business cycle. As of late, an increasing number of economic forecasts with cautionary titles alluding to impending problems (e.g., "Gathering Storm," "Economy Folds," and "Hopes Dashed") have emerged. In light of these signals, the resultant economic slowdown is understandable.

Although tremendous uncertainty and fear of a recession continue to cloud the economic outlook, the general expectation is for moderate but positive economic growth. This outlook faces a number of storm clouds, however, with more downside than upside risk. Of particular note is the fact that the technology sector, which insulated us from several earlier downturns, remains weak. Needless to say, both the financial and equity markets and consumers will watch the economy very carefully. Despite high levels of anxiety, many interested parties will be seeking signs

that the recession fears have been overblown and that we have sailed into a safe harbor.

On a positive note, all parties are aware of the tenuous nature of the economy and the need to carefully nurture it through this transition period. To some extent, the negative talk has served to grease the skids of proposed tax cuts and has raised pressure to pass other legislation to help avoid recession. To the extent that such legislation is passed, economic growth could begin to respond in the second half of the year, but it may take some time to ripple through the economy unless the government action is both retroactive and has an immediate impact on net take-home pay. Otherwise, it will still bring relief, but as a lagged boost that will operate more subtly by raising consumer expectations. Regardless of the timing of such actions, policy changes alone are unlikely to cause a rebound that would catapult economic growth to the unsustainable levels of the recent past. This is especially true as businesses struggle to find the appropriate balance of old and new economic principles. Unfortunately, these "new" principles have not yet been written and will undergo a number of revisions before a final draft is ready.

Inflation and Interest Rates

If we need any more evidence of how quickly things can change in this transition economy, we only have to look to Fed actions on the interest rate front. In the fourth quarter, it appeared that the economy was cooling sufficiently to allow the Fed to hold off on any further interest rate increases. Then, in mid-December, the Fed began to shift its position, exploring the need for stimulus to ward off recession. This led the Fed to cut interest rates unexpectedly by 50 basis points in early January, followed by a similar reduction at the end of the month. While some expected additional rounds of cuts, Fed Chairman Alan Greenspan, in his closely watched testimony in mid-February, presented an upbeat message, creating even more uncertainty about the level and timing of any future declines in interest rates. Nonetheless, the future market discounted additional declines in the range of 25-50 basis points by the end of the second quarter. The potential for future reductions is bolstered by the fact that, with the exception of energy prices that are clearly out of control, inflation remains in check.

Whether these additional interest rate cuts actually materialize depends on a number of undeter-

mined factors. We have learned that the Fed is poised to move more quickly and decisively in trying to keep the economy on course. While this action orientation has some appeal, it also suggests that the volatility that we have experienced recently will continue. The inflation outlook remains guarded, though energy prices will continue to make news for the next several months. Similarly, although the temporary rise in the Producer Price Index appears to be an anomaly, the Fed will be watching both fronts warily as it tries to nurture a recovery.

Business Indicators

During December, businesses worked off some of their excess inventory in response to a slowing demand that caught many companies off guard. These efforts took a number of forms, including layoffs, shift reductions, and deep discounts. Going into the first quarter, the correction of 2000 should take pressure off of 2001, reducing pressure on companies to make further adjustments. However, the inventory/sales ratio remains above par, suggesting that surplus capacity may continue to dampen new business activity. Leading economic indicators continued to fall in December, translating to three consecutive monthly declines, and raising the specter of further economic declines. Productivity growth also slowed during the fourth quarter, despite maintaining a record pace for the year.

Productivity should remain strong, due to the structural improvements of the past several years. Factory orders surged during December, though such expansion was likely temporary and could lead to further setbacks as the economy adjusts to a slower pace. Purchasing was off dramatically during the fourth quarter, with even greater declines early in 2001. Although durable goods orders increased surprisingly in December, reversing the slippage that had occurred over the six months prior, manufacturing activity should remain soft during the first half of the year, with some upside potential for the second half if the economy regains its lost momentum.

Stock Market

The ebb and flow of economic change during 2000 was driven by the combination of a rapidly maturing technology sector, eroding economic news, growing business, and consumer angst. Toward the end of the year, the only constants were political uncertainty, political posturing, dramatic stock market

fluctuations, and mixed economic signals. During the first quarter of 2001, little has changed in terms of market fundamentals, but confusion continues to reign as the Fed chief presented upbeat testimony in February after earlier rate cuts: retail sales running unexpectedly strong, inventories coming into alignment, unemployment leveling off, and import prices declining. Despite these positive signs, a number of trouble areas continue to undermine the stock market, warding off any major upward movement, especially in the technology-laden NASDAQ Index.

Corporate America seems to be saying that 2001 will be a period of belt-tightening, with little opportunity to pass on price increases. In this environment, market watchers are expected to keep one eye on the Fed and the other on the news wire, focusing on individual earnings reports or other upbeat news. Therefore, the year should continue to challenge prognosticators, creating a tenuous market environment. In addition to hitting investors and companies, a flat-to-declining stock market will have significant spillover effects on tax coffers by materially dampening the recent surge in capital gains taxes. To understand the magnitude of the contribution of capital gains to tax revenues and consumer spending, it should be noted that realized capital gains surged at an average annual rate of 34% yearly during the second half of the 1990s.

Consumer Confidence

In the fall of 2000, we noted that consumer confidence had slipped in August after an upward revision in July, signaling growing uncertainty among consumers. After a brief increase in September, consumer confidence began to taper toward year's end, and then plummeted in January of 2001. Indeed, the consumer confidence index has fallen off dramatically from its peak in mid-2000, and is now at its lowest point in four years. The most dramatic decline, and the most telling, was in the "personal expectations" component, revealing the growing angst among consumers over how they might fare in the future. Similarly, their expectations regarding business conditions and employment prospects flipped, shifting toward the pessimistic side of the equation. This uncertainty among consumers is a major concern for the overall economy, since retail sales are such an important component of the overall economic picture. While the Fed's recent move toward lower interest rates might provide some so-

lace to consumers, the almost constant barrage of layoffs and cutbacks among both dot.coms and more traditional companies will continue to weigh heavily on their expectations.

It should also be noted that before the stock market turmoil, realized capital gains had catapulted to around 8% of disposable income, attesting to the greater alignment of consumer and business interests. As with the stock market, there is no convincing evidence on the horizon that suggests consumer confidence will rebound in the near term. The U.S. economy will have to look to other sectors, or, more likely, to a confluence of events to power us out of a downturn.

Retail Sales

The pattern of retail sales during 2000 reflected the volatility in the stock market and the overall economy. The year began with an early burst in sales driven by autos, only to fall off toward the end of the first quarter. Despite some strengthening in the second quarter, the figures bounced around in the third quarter and then dropped off toward the end of the year, falling moderately for two consecutive months. In January 2001, overall retail sales rose above expectations. The good news on the retail sales front is that the improved performance was broad-based, including both durable and non-durable items. Chain store sales also improved, providing welcome relief for these merchants after only moderate growth in the second half of 2000 and a poor showing in December.

Despite this rebound, there is little to suggest that the economy is in for a new round of consumer spending, as recent increases can be attributed to favorable weather and heavy retail promotions with merchants using deep discounts to clear merchandise left over from the disappointing holiday season. The dramatic decline in consumer confidence—especially on the expectations front, which provides a leading indication of anticipated consumer expenditures—is reason for caution. It is also noteworthy that growth in consumer credit fell significantly in the fourth quarter, extending into both revolving and nonrevolving credit. While breaks in the weather and seasonal promotions might pique consumer interest, the outlook for retail sales is guarded to moderate. Although the average consumer will continue to buy, and may exhibit further spurts of activity, a major resurgence will depend on some real evidence

that the good times are back, and that they'll stick around a while.

On the Internet frontier, e-commerce sales surged in the fourth quarter, rising by almost a third over the third quarter, and by two-thirds over the year before. As expected, online sales declined in January, but this drop-off was more cyclical than suggestive of any shift in channel preferences. On the other hand, when compared to the stellar growth rates of recent years, the data suggests, that the sector is maturing, with market-capture ratios beginning to flatten out. Strong e-commerce results in the fourth quarter were particularly noteworthy compared to the dismal performance of the overall retail sector. Despite this increase, e-commerce still logged in at slightly above 1% of total sales for the quarter, and slightly below that level for the year. To continue to grow in terms of market share, it is becoming clear that the e-commerce channel must deliver on the bottom line, suggesting that the free ride is over for both e-tailers and consumers.

A positive note on the e-commerce front is the movement in Washington to extend the Internet sales tax moratorium for another five years. Even more notably, traditional retailers continue to grow their Internet activities, offsetting some of the setbacks among the pure "click" retailers. Although "clicks" are not taking business from "bricks" as some predicted, and despite all the turmoil and attention focused on fallout in the sector, e-commerce is continuing to emerge as a viable distribution channel for retailers.

The Overall Business Environment Overview

At this point, we have explored the macroeconomic conditions and the general economic environment in which the real estate market will operate. Before we turn to a discussion of the real estate market in general, and the various property sectors in particular, it is useful to step back and look at some of the emerging issues, challenges, and opportunities that businesses will face in the near term. These can be collapsed into several categories, including resource issues and constraints, a new wave of business rationalization and belt-tightening, and technology integration.

Resource Issues and Other Externalities

The California energy crunch, watched eagerly by many malcontents outside of Silicon Valley, is nevertheless troublesome on a number of fronts. First,

it could have a ripple effect across the national scene due to the significant role the state plays in the U.S. economy and its key role in exports. Second, and perhaps even more enduring, the resource constraints faced in California may portend impending resource problems in other regions. Much of the energy problem in California can be attributed to the surge in natural gas prices. In turn, this increase can in turn be explained by a combination of low inventories, an unusually cold winter, and an inelastic supply chain that has had an impact on other regions, creating hardship for businesses and consumers alike. In some markets, these circumstances have come on the heels of deregulation which, combined with heightened environmental sensitivity, calls into question the effectiveness of market-based solutions. Access to an adequate and affordable supply of energy is likely to become more important to both consumers and businesses, creating a competitive advantage for areas able to promise this package.

In addition to energy woes, water problems continue to fester in a number of regions, especially in the bull-market Southeast. On a different front, air pollution and traffic congestion are reaching a point in a number of fast-growing markets that could take some of the steam out of growth rates. In a number of these markets, many located in the sunbelt, infrastructure has simply been unable to keep up with the dramatic economic and population growth associated with the boom economy of the '90s. This added "urban friction" comes at a time of increasing awareness of the linkages among employee health, happiness, productivity, and personal stress. This awareness has opened the eyes of some employers who take a more holistic view of their operations, especially those that are seeking the new breed of knowledge workers. These workers, who are in demand by both technology companies and—perhaps more importantly in a transitional economy—by traditional companies that are trying to rationalize their technology investments, are especially sensitive to the new worklife issues. While the dot.com shakeout has put some of these workers on the street, thus easing the burden of hiring, this condition will be short-lived, as the demand for technology workers still far outstrips the supply. To compete for such enlightened workers, companies will have to consider new "externalities" in selecting urban markets and sites.

Another issue looming over the economic environment is the troubled health care industry. The current problems in health care stem from several

factors, including chronic labor shortages and dramatic increases in drug and hospital costs. While rising drug costs and restricted coverage have received the most attention, the labor issue might prove to be an even more significant constraint on the sector. This is especially true in the nursing profession, where workers are no longer willing to move into a profession in which altruistic social concern is assumed to compensate for low wages and limited institutional respect. In addition to increased workloads brought on by chronic labor shortages, stress in this profession is increasing due to the higher "sickness" profile of patients. That is, as a result of the pressure for higher throughput (i.e., shorter inpatient stays), hospital beds now tend to be occupied by patients with more acute needs. The resulting pressure on the price, quantity, and quality of health care has created new drains on the system. Managed care has not proven to be the panacea that some hoped, leaving many employees scrambling to understand the rationale behind a net decline in benefits and a shift in prices. Although the extent of the health care crisis varies from state to state and company to company, there are no obvious solutions, suggesting that the situation will get worse before it gets better. This is especially true in light of the slower pace of the overall economy, which leaves less slack for companies to subsidize or enhance employee benefits at the expense of the bottom line.

Business Trends: Consolidation, Divestiture, and Rationalization

Three corporate trends—consolidation, divestiture, and job rationalization—cloud the outlook for the overall economy and for employees alike. With respect to consolidation, the trend is bifurcated, as the large get supersized and the small get upsized. The former tendency is characterized by the Time Warner/AOL merger, along with talks among several of the major airlines and players in the telecommunications industry. On a less dramatic note, financial services and health care companies continue to purchase existing companies or divisions, seeking to expand their full-service capabilities or to grow market share. The news about smaller companies is dominated by the dot.coms and pure e-tailers, as the "survivors" scramble to find their niche, or at least a kindred spirit with whom they can form a viable ongoing enterprise. This type of corporate match-making will become more critical to survival

due to the fall-off in venture capital and the general tightening of capital flows to this sector.

While mergers and acquisitions will continue as companies seek to achieve further economies of scale, we are also in for a wave of divestitures as companies seek to shed unprofitable or non-core operations. This trend will not abate in the near term, as companies use the cloud of the economic slowdown as an excuse to make some of the difficult decisions they had been able to defer in a stronger economic environment. On a complementary note, corporate America continues yet another round of cutbacks, responding to the slowing economy in an attempt to firm up the bottom line. This latest round of contractions is noteworthy because few sectors have been spared. Not surprisingly, the dot.coms lead the pack, though a number of "old economy" companies are once again tightening their belts to respond to the slowing economy. In the retail arena, which has been subject to capacity excesses, companies are going through a new round of store closings, with operators choosing to cull underperforming assets as they shift from a market share model to one of unit profitability. This business rationalization will extend to companies that have migrated to hybrid operations blending the "old" and "new." After making significant speculative investments in new technology and exploring new frontiers, we expect these companies to begin placing more emphasis on rationalizing their existing technology investments and e-business initiatives.

Technology Integration

It should be noted that the effective integration and management of technological innovation has proven to be an elusive goal for many companies. Thus, the effort to marry technology to e-business initiatives will continue through 2001 as companies fine-tune their operations. With the specter of a recession lurking, companies can be expected to err on the conservative side. This conservative bent will have a number of direct and indirect impacts on the business cycle, business indicators, and consumer confidence. Analogous to their labor force rationalization, companies can be expected to cast a critical eye over the economic viability and value-added components of their technology investments. This scrutiny will be particularly important to companies that have gotten caught up in all the rhetoric surrounding the technological revolution and, feeling competitive

pressure, have invested in innovations without taking the time to critically evaluate the underlying economics. In fairness to those companies, it should be noted that the business landscape was changing so fast that many were pressured to eschew traditional decision-making models to fast-track technology solutions. Toward the end of the boom, but before the dot.com shakeout began, this practice became even more common as companies who had initially rejected technological innovations tried to play catch-up under the scrutiny of their investors and business partners.

In the current economic environment, and in the wake of the shakeout among technology companies, we expect corporate America to become much more introspective about technology. Indeed, most companies will be asking the hard bottom-line questions regarding technology investments that they have not had the time nor expertise to explore. Although these deliberations are likely to evoke strong feelings between traditionalists and technological revolutionists within firms, we think such turf struggles will be relatively short-lived as companies quickly realize that there is simply no turning back to the "Way We Were." We believe they will find that while technology is no panacea, it is clearly an enabler and a competitive tool that must be mastered to survive and flourish in the transitional economy. We further anticipate that some companies will bolster their internal technology skills during this process, rather than continue to rely on outside assistance.

To gain insight about how these deliberations might eventually impact the real estate market, it is useful first to look at some of the key integration concepts and trends, as well as the key issues and transition technologies that most enlightened businesses are exploring. The key technology-enhanced business initiatives can be divided into two categories: internal applications and external applications.

Examples of internal applications of technology integration include:

- **Knowledge Management.** The Internet and other technological innovations have made it possible to implement true knowledge management programs as an integral part of creating learning organizations. At the same time, the field of knowledge management has made significant progress in creating the infrastructure
- and management models to accommodate such goals. In addition to strong support from the various business entities and divisions, this approach requires the use of a number of data management, data mining and data analysis tools to turn warehouse data into knowledge—information that can be used to achieve corporate missions, goals, and objectives. This information is both internal and external to the firm, with sources of data ranging from field operations to outsource providers and strategic partners.
- **Enterprise Application Integration (EAI).** EAI refers to the business practice of integrating information technology systems within a firm to ensure that infrastructure investments are deployed in an efficient, effective manner despite the fact that they comprise different systems and solutions. EAI focuses on the integration of systems across platforms, software, and business units to develop a corporate-wide architectural solution. One of the key goals of EAI is to develop an infrastructure environment that is flexible and can accommodate changing business needs and processes.
- **Enterprise Resource Planning (ERP).** ERP refers to integrated, multiple-module application software packages that are designed to serve and support a full range of business functions. ERP systems can include such diverse applications as software for manufacturing, order entry, accounts receivable and payable, general ledger, purchasing, warehousing, transportation, and human resources. One of the key differentiators of ERP is the use of packaged software rather than proprietary software written by or for one customer. A successful ERP integration is one in which modules can interface with an organization's own proprietary software and support with moderate effort on the part of end-users. Such systems are also portable and supportable via the use of common programming languages and industry-standard specifications.
- **Data Mining.** Technological advances and dramatic growth of e-business on both the business-to-business (B2B) and business-to-consumer (B2C) fronts has created an explosion in data regarding customers, competitors, suppliers, and strategic partners. Unless managed carefully and in an efficient, cost-effective manner,

this data can be relegated to meaningless bits and bytes. Data mining can help make this information the basis for more proactive, customer-oriented, competitive decision-support. A growing number of companies have turned their attention to data mining in an effort to better understand their existing clientele and operational efficiencies, as well as to identify new initiatives and niches that will firm up their competitive advantage and open up new frontiers.

Internal technology integration efforts such as these will focus on helping companies operate more efficiently, enabling them to exploit a largely untapped base of knowledge, experience, and insight. These efforts will be focused on a combination of advanced business communications and organizational models. On a parallel plane, companies are extending similar initiatives to better deal with the outside world under the auspices of Customer Relationship Management (CRM) and Supply Chain Management (SCM), which focuses on paying closer attention to strategic partners and business processes. In brief:

- **Customer Relationship Management (CRM).**

The CRM concept has arisen in response to renewed awareness of the need to regain focus on customer satisfaction for long-term success, as well as to take advantage of new technologies in managing such relationships. During the early stages of the e-commerce and e-business movements, many companies focused on technology rather than on their basic business proposition. One of the major weaknesses of many business plans was the lack of attention paid to the customer and what it would take to satisfy their needs for goods and services, and how they could best be reached and served. While CRM is founded on well-established marketing concepts, the emergence of new tools and technological innovations makes it possible to take the practice to new levels of service and nurture greater loyalty and customer support.

- **Supply Chain Management (SCM).** This refers to the integration of the procurement, production, pricing, logistics, and other business functions associated with the provision of goods and services. The field incorporates such sub-areas as: Advanced Planning/Scheduling, Distribution Planning/Deployment, Inventory Management, Material Handling Systems, Outbound/Fulfill-

ment, Trading Partners, Transportation Management, and Warehouse Management. Advances in two sub-areas of SCM are particularly noteworthy to real estate observers: logistics and procurement. The field of logistics management is an important subset of the broader area of supply chain management. As a result of technological innovations, the field has undergone dramatic changes triggered by e-business, the Internet, and the technological revolution. In the future, a growing number of companies are expected to seek to establish networks, join consortia, and foster other means of expediting and improving the acquisition function.

A serious concern about the integration of technology is the management of technology by firms. Given the explosion of technological innovation and the development of an entirely new business vernacular, many companies have turned to the new breed of Application Service Providers (ASPs) to direct their efforts. No doubt, many of these ASPs have provided companies and agencies with a wide variety of specialized, high-level support systems that have met their needs. While this service sector will continue to play an important role in the diffusion of innovation, we believe that an increasing number of companies will begin to internalize this support and/or grow it organically by retraining and retooling existing employees. This is not to say that most companies will attempt to provide the full array of vision and tactical operations internally. Indeed, we believe the need for specialized external technology support will increase. However, we also believe companies are deciding that they cannot rely solely on external service providers who have varying degrees of understanding of—and alignment with—their firms' proprietary strategic plans and business initiatives. In order to understand, anticipate, and support the changes in real estate requirements that these trends will trigger, real estate professionals must develop greater empathy with space users as well as an adequate understanding of technology to provide needed support.

Real Estate and Capital Markets

Real Estate Capital Markets

During the fourth quarter of 2000, the real estate capital markets remained on the same general course as in the first three quarters, though concern over the slowing economy in general, and problems in

the technology sector in specific, dampened some of the activity. As one might expect, this tightening was most pronounced in the the office sectors of technology-oriented cities that had been the greatest beneficiaries of the boom.

Despite a moderate slowdown as the capital markets and real estate began to digest the impact of a slowing U.S. economy, the domestic real estate market remains relatively healthy going into the second quarter of 2001. The decline in interest rates early in the year, coupled with curtailed construction, should keep capital and demand in moderate balance. The good news is that while further interest rate declines are anticipated during the year, we anticipate no massive influx of capital. While projects with solid fundamentals and significant pre-leasing by viable, high-credit tenants will continue to move forward, the spigot will remain dry for speculative projects. This will create consternation among developers and eternal optimists who were poised to move forward before all the negative noise started rippling through the economy. The atmosphere will, however, be positive overall, reflecting the continued alignment of the real estate and capital markets.

Construction Activity

During 2000, construction spending reflected the overall economic picture, showing a series of peaks and valleys. After a strong start, construction spending fell off in the summer of 2000 and then experienced a slight rebound in the early fall. By late fall, however, construction spending once again contracted due in large part to a weather-related drop in remodeling activity. On the other hand, homebuilding, commercial, and public construction all increased moderately through the end of the year. The commercial activity was led by office completions, a sector that is traditionally slow to respond to an economic downturn due to the long production process and "lumpy" nature of large-scale projects. Toward the end of the year, the high pace of office starts launched in 1999 began to burn off, with slower starts suggesting a moderate decline in completions during 2001.

Retail construction activity picked up somewhat, although the range of store closings and belt-tightening among retailers, coupled with growing concern over consumer spending, should slow that pace during the first half of 2001. On the industrial front, activity should also taper due to softness in the manu-

facturing sector, especially among technology companies. However, changes emanating from advances being made in new Supply Chain Management models could stimulate demand and create opportunities for new industrial product, especially once the economy gets back on track. Apartment construction should remain healthy, fueled by anticipation of new household formations, economic uncertainty, and declining consumer confidence stalling homeownership for some households.

Private Equity Market

As in the first half of 2000, the private real estate market remained active through the end of the year, with institutional capital continuing to focus on core-type investments. In particular, domestic pension funds remained interested players, drawn by the combination of allocation pressures due to the run-up of the stock market and growing fears of a downturn that could drag down equity performance. To an increasing extent, domestic equity real estate will be seen as a "safe harbor," assuming that the industry can avoid major fallout from the retrenchment of the dot.coms and the overall tightening of corporate coffers. In terms of investment performance, institutional returns continued to be strong, with the NCREIF Index containing unleveraged and deleveraged returns eking out a 12%-plus year, and the classic NCREIF unleveraged index racking up almost 13% total returns. These figures are higher than our forecasts, suggesting continued strength of capital flows to the private market. This is evidenced by the 3.3% value component on top of 8.5% income returns. Unfortunately, the strong results were not as pervasive as in the past, with the West leading with 15.6% returns, followed by the East with 12.7% returns and the South and Midwest lagging (8.6% and 8.4%, respectively).

Going forward, we expect continued downward pressure on institutional returns due to the combination of a slowing economy and expanded business rationalization. The California energy crisis should dampen returns in the West, creating an additional drag on dependent economies. Despite these caveats, we believe that institutional returns will remain competitive with other asset classes, especially on a risk-adjusted basis. Fortunately, with the exception of a few markets that got caught up in the "exuberance" of the dot.com mania, excess capacity is not a widespread issue.

Public Equity Market

The public REIT market had a relatively strong first half during 2000, with overall six-month returns for the NAREIT Index coming in at a stellar 18.6%. These returns compared favorably to all other asset classes, and on top of a strong economy and uncertainty in the equity market set the stage for a strong year-end. As the annual returns came in, the NAREIT Index performed on par, with total returns of 29% for the year. Similarly, real estate funds outperformed most other funds, with returns slightly lagging the overall NAREIT Index. Several factors were credited in this strong performance, including stabilization in earnings growth, a fairly solid overall real estate market, a relatively good value in terms of price/earnings ratios, and uncertainty in other markets which made REITs an attractive sector on a risk-adjusted basis. Going forward, the slowing of the economy and the moderation of real estate conditions overall should take some of the steam off the public real estate market, although there are no major warnings signs other than the economic uncertainty to affect all asset classes. Due to overall conditions, industry analysts are projecting returns to fall in the 10% to 15% range, off the 2000 pace but still more optimistic than expectations for the overall equities market. Such returns would be on or around the annual average returns posted over the past decade, including the peaks of the REIT resurgence.

Commercial Mortgage Market

During 2000, the commercial mortgage market unfolded as expected, with fairly solid results and an active pipeline. Capital remained available for new projects with solid fundamentals, but tightened significantly for speculative projects. Lenders remained disciplined in their underwriting, and became somewhat more selective in the second half of the year, especially as the economy began to show signs of cooling off. The solid performance in the commercial mortgage market is evidenced by the performance of the Mortgage REITs, for whom one-year returns exceeded the strong numbers of their equity counterparts. This gap widened during the first two months of 2001, suggesting a tight but healthy mortgage market with adequate, but not excess, capital to support growth, especially as it moderates in response to the overall economy. On the Commercial Mortgage-Backed Securities (CMBS) front, the year 2000 was soft through the first part of the year,

with volume off about one-quarter from 1999. Some of this loss was made up at year-end, moderating the year-to-year declines. CMBS defaults remained low, which, along with a stable real estate environment, should help boost volume during 2001. Retail contractions and exposure to the technology sector will be closely watched by investors, nevertheless.

Foreign Investment

During 2000, foreign investment activity remained strong, with investors continuing to seek U.S. real estate. The rationale for the continued appeal of domestic real estate for foreign investors parallels that of domestic investors: solid performance and competitive returns, especially on a risk-adjusted basis relative to other asset classes. In terms of capital attractiveness, the stable—albeit slowing—U.S. economy is also a draw, with investors receiving much solace in the Fed's willingness to step in and act decisively to thwart a prolonged economic downturn. Similarly, foreign investors continue to pay close attention to the discipline of the capital markets and real estate, especially as construction activity stays in line with sustainable market conditions. The bulk of foreign direct investment in the United States continues to come from Europe, with members of the European Union accounting for the bulk of those capital inflows. Given the recent pace of inflows and economic issues on various home fronts, there might be some near-term dampening of foreign capital flows. However, nothing on the horizon indicates a major shift in the source of foreign capital flows, suggesting that pricing and investment models will remain stable. Coupled with continued discipline on the domestic front, the stability of capital flows continues to bode well for the asset class.

Real Estate Outlook

As we noted last fall, the overall U.S. real estate market should continue in a mature, steady phase of the business cycle. We maintain, however, that the market will experience more divergence in performance within the asset class as market conditions soften and the cushion afforded real estate with weaker fundamentals erodes. Our analysis of the separate market sectors follows.

Office Market

During 2000, the overall domestic office market remained balanced, with vacancy rates in the single-

digit range and down from 1999. The downtown sector continued its strong performance, once again edging out the suburbs in terms of occupancy. Through mid-year, high-tech centers remained the hot spots of the office sector, though the dot.com shakeout was a sobering experience for many players who had forgotten about the cyclical nature of real estate. Despite some readjustment, the overall outlook remains solid, though specific markets and submarkets will succumb to the excesses of the peers. Fortunately, these setbacks will be relatively brief and mainly due to the curtailment of capital flows and construction activity, especially for speculative developments. This will create new lessons for investors who have forgotten what the other side of a bull market looks like. During 2000, institutional office returns were very strong, coming in at 13.75% for the year, slightly below that of the industrial sector. These figures came on solid income of 8.5% and even stronger capital gains of almost 5%, attesting to the appeal of the sector to investors.

On the public market front, the experience was comparable, with office REITs beating out their industrial counterparts with returns slightly over 30% for the year. While such returns will moderate as the market falls back in line with long-term figures, office returns should continue to be strong in the near term. We are, however, concerned about the lack of discipline that characterizes some of the office development of recent years, especially in submarket locations, and as traffic and other problems erode the appeal of the amorphous areas that surround many cities. As the cycle plays out, such projects will fall on hard times, with buildings that are more employee- and customer-friendly moving ahead of the pack.

Retail Market

After several years of uncertainty caused by the e-commerce revolution, the retail sector returned to a more balanced state during the first half of 2000. Unfortunately, the sector softened in the second half of the year, dragged down by a slowing economy and disappointing sales, especially in the fourth quarter. Not surprisingly, these conditions led to another round of retail cutbacks, with a variety of players using the softness as a rationale to thin out their portfolios. Exacerbating the problem is continued concern over the fate of traditional retailers in their struggle with the "e-tailers." The battle is shifting in favor of those who have it all—the retailers who cre-

ate the optimal mix of Internet and in-store shopping. We expect that during 2001, retailers will spend much more time on fundamentals, using technological innovations described earlier to focus on understanding their customers better. This added attention could benefit the sector, though the economic environment remains cloudy. According to the NCREIF Index, the private front of the retail sector lagged behind the other major property types in 2000, with income returns at 8.3% and negative appreciation dragging total returns down to 7.7%. Fortunately, for institutional investors with a preference for smaller investments, the figures were not as dismal for smaller retail, with neighborhood returns coming in at a respectable 10.8%. On the public market front, the retail picture was quite different, with regional malls racking up 25.6% returns, compared to the shopping center category, including smaller retail, which slipped just below 20%. The performance discrepancy between large and small retail, as well as between the private and public sector, might be suggestive of an adverse selection process. That is, it might lead credence to the argument that the better malls have wound up in the hands of the public markets. Furthermore, it might suggest that investors with significant portfolios of malls can better exploit potential economies of scale (e.g., working with national tenants) than smaller operators with more limited holdings. Despite such issues, it should be understood that even in the public arena, retail performance also lagged behind other major property sectors. Going forward, retail behind performance should continue to lag due to a combination of endemic considerations (e.g., oversupply, weak consumer confidence) and the continued apprehension of some investors.

Industrial/Warehouse Market

The strong economy and changing production and distribution models set the stage for a dynamic industrial market in 2000. This condition held up through the end of the year, with market fundamentals remaining relatively healthy overall. Despite a moderating economy, the overall industrial sector is expected to remain stable, with shifting logistical preferences associated with the continued reconfiguration of supply chains creating demand for space even in a soft economic environment. During 2000, industrial returns were especially strong in the higher-risk flex and R&D sectors, though warehouses showed a

very respectable 12.6% return. On the public market front, industrial returns were also strong, logging in at around 27% for the year. Going forward, returns should moderate, but the continuation of strong investor demand, slowing construction, and changing logistical models should stimulate performance.

Apartment Market

As we discussed in the fall, the housing market remained relatively strong during 2000, though new and existing home sales growth tapered toward the end of the year. The decline in home purchasing could be attributed to a number of factors, including the fall-off in consumer confidence, especially with regard to future expectations. On the multifamily front, the housing market remained robust throughout 2000. Private market returns were somewhat off the pace of the favored office and industrial sectors, although the 12.8% return overall was respectable in light of historical performance and far outpaced the depressed retail sector. These figures were bolstered by returns for high-rise properties, which exceeded 20% on the year. On the public market front, however, apartment returns outpaced all other property sectors, with total returns exceeding 33% for the year. Looking forward, the apartment market continues to have solid fundamentals, and should receive additional short-term boost at least until the economy begins to pick up steam and increased consumer confidence creates a new wave of homeownership.

Conclusion

The overall outlook for the domestic real estate market remains solid. While the cloud hanging over the economy is certainly a cause for concern, the generally balanced state of supply and demand, tempered by added discipline on the supply side, bodes well for the asset class. Although investors should be aware of a number of externalities that will skew tenant demand, thoughtful investing strategies based on solid fundamentals and careful portfolio construction should provide the sector some insulation. Capital flows to the real estate asset class should remain solid, with strong interest from the private and public arenas, as well as domestic and foreign investors.

James R. DeLisle, PhD, is director of the Real Estate Research Center at Georgia State University, Atlanta. In addition to his experience within the academic community, he has worked on the industry side of the real estate business. Dr. DeLisle has been a guest speaker at numerous industry conferences and has published his work in various journals. He is also the president-elect of the American Real Estate Society. He received his BBA in real estate, MS in market research, and PhD in real estate and urban economics from the University of Wisconsin.