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Real Estate and the Capital Markets: A Transitional Period of Spatial Market/Capital Market Convergence
by James R. DeLisle, PhD

Commentary
An uncertain economy was in transition going into 2002. Consumers, businesses, and investors were adjusting to the recession and gradual, but consistent, erosion in real estate market fundamentals. The prospects of an economic recovery loomed on the horizon, with an increasing number of indicators suggesting the economy would turn the corner in the second half of the year. Unfortunately, much uncertainty remains over the recovery, especially with the threat of terrorism still nagging Americans. To understand how the real estate market will move to its next state in this environment, it is important to keep an eye on macroeconomics, capital markets, and underlying real estate fundamentals. Despite the prospects for additional setbacks and some difficult situations, the path seems to point to a moderate recovery. No proven paths exist to ensure capturing the benefits of a recovery. Real estate investors, space users, and facilitators should proceed cautiously with their transition game to allow adjustments to unexpected events or new discoveries that might indicate a more prudent path.

The Economic Environment
Economic Growth
The economy sputtered in the fourth quarter, losing the struggle to eke out moderate growth for the year. Some fourth quarter economic problems were undoubtedly related to September 11, 2001, and its aftermath, but the underlying causes were widespread and insidious. Despite the tragedy and concerns over a major recession looming in the aftermath of unknown events, the economy showed positive signs. In spite of downward revisions to the third- and fourth-quarter estimates, and a weak start for 2002, the general expectation is for a mid-year recovery. If the economy stays on track and major shocks can be avoided, this pattern might well reflect the V recession many forecasted for the recession late last fall. A number of clouds hang over the economy that could change that outlook, ranging from additional terrorist attacks on U.S. soil, to more Enron-type eruptions. In its current tenuous shape, the economy can ill afford either or both phenomena.

Assuming the recovery remains on track, economic growth should pick up as the year unfolds. The outlook is for a moderate recovery rather than a major growth spurt. This gradual recovery may have actually started in the fourth quarter, when GDP turned in a slightly positive growth, once again riding on consumer and government expenditures. The activity suggests positive economic growth in 2002, beginning on a modest note in the first half of the year followed by an activity pick-up in the second half. This prognosis was reinforced by positive signs in the fourth quarter, including improved retail sales, and reductions in the international trade gap and inventory burn-off. Prospects for an early recovery were welcomed by most, but the tempered outlook disappointed those banking on a strong, deep V-recovery scenario. The flat economic indicators should continue to provide pressure to support tax cuts for individuals and companies, but the recovery might be sufficient to thwart efforts to reconcile economic-incentive differences between state platforms.

Employment
Recent unemployment and the outlook for future employment are major concerns for the economy. The good news at year-end was that the decline in
job growth eased, continuing the slowdown that occurred in the last two months of the year. In terms of job categories, the manufacturing sector reflected the overall pattern of slowing job losses, while the service sector reported a moderate increase in jobs. The exception was in the retail sector where service employment continued to decline but, once again, at a slowing rate. Unemployment improved modestly in January, 2002, although the cloud has not lifted. With respect to the costs of labor, increases were slightly off the pace of the prior year because of the soft employment situation. Health care continues to be a major concern with businesses, and many are asking employees to pay more of the rising premiums. The unemployed ranks have shifted in this phase of the downturn with younger workers hit harder than the more visible technology workers and other darlings of the New Economy who have received the most attention. This situation is even worse for high-school graduates because more skilled workers have been forced into lower paying jobs. The employment outlook should improve somewhat as the economy recovers, although the bottom end of the labor pool will continue to struggle. On a positive note for the unemployed, it appears that there will be some relief out of Washington in the form of extension of the 26-week period of unemployment benefits.

**Inflation and Interest Rates**

As throughout 2001, inflation is expected to continue at a low pace in early 2002. The threat of renewed inflation is receiving more attention, with a moderate increase possible as the economy recovers in the second half of the year. This summer, the government will unveil a new inflation measure to address the criticism that the current measure overstates inflation. Although not supplanting the current Consumer Price Index, the new index will be published as a separate series. The new index is intended to more accurately measure consumer prices by incorporating substitution effects in which some consumers switch to cheaper brands or substitutes in the face of price spikes for certain goods or services. It is anticipated that the new measure will indicate lower inflation rates and could receive significant attention as a way to reduce inflation-based cost-of-living adjustments for Social Security and other federal benefits as well as private benefit and payment programs.

In its January meeting, the Fed’s left interest rates alone, describing the outlook for the U.S. economy as promising. In its comments, the Fed’s noted that weakness in demand was softening and there were increasing signs that the economy was picking up. An outlook for continued productivity increases and favorable monetary policy underpinned Alan Greenspan’s comments. These rather upbeat comments by the Fed’s Chairman caught many off guard, especially in light of the somber economic picture he had painted in a recent speech. Interestingly, Greenspan seemed somewhat surprised that his earlier comments had been interpreted as negative. He worked to eliminate the confusion by changing his rhetoric away from caution. It appears that for the balance of 2002, expectations regarding interest rate moves will shift away from the prospects of more decreases to the question of when and how much rates might rise as the economy picks up steam. No major movement in rates is on the horizon as of early 2002, especially in light of the Fed’s transitional state of mind.

**Business Indicators**

As noted previously, the general perception that the economy will experience a near-term recovery is gaining momentum, benefiting from a number of positive business indicators. One major upbeat economic story was the record-breaking burnoff of business inventories in the fourth quarter that dropped inventory-sales ratios to near-record levels. While inventory reduction placed a drag on current growth, it has helped set the stage for added momentum when the economy began to pick up speed. Some of this potential growth will be dampened on the plant and equipment front, with capacity utilization continuing to fall in early 2002 to the lowest level in more than 20 years. As with many indicators, the rate of decline is slowing, suggesting a bottoming out may be at hand.

The global recession has led to widespread deflationary pressures in prices. Although these pressures are abating for both producer and import prices, they are in negative territory and creating an additional drag on profits. On an increasingly familiar note, with respect to business investment, there was also good news as the rate of decline slowed to the lowest level since late 2000. On the manufacturing front, which suffered the most in the recent recession, some signs indicate the sector is finally
emerging with fairly widespread gains and an increase in new orders. Despite the recession that carried through most of 2001, productivity continued to grow with an exceptionally strong fourth quarter. Gains in productivity are expected to continue as business activity picks up and firms increase investment activity.

Stock Market
Going into 2002, the stock market has been on a roller coaster. Although investors seem to be looking for good news, the tenuous nature of the recovery continued to plague the market. The Enron collapse added to this turmoil, creating angst and suffering for employees and investors alike. Although the direct impacts of the implosion of Enron have been priced into the market, the ripple effects have proven to be rather far-reaching. Many investors fear that there are more Enron-like cases that could explode, creating a need for greater scrutiny of financial disclosures and fringe accounting treatments. This cloud has eroded investor confidence and suppressed the market's ability to jump on the good news buried in the economic indicators. Some sectors should begin to pick up as the economy strengthens in the second half of the year, but the stock market will continue to oscillate, leaving investors struggling with interim strategies during this transition. In this environment of business and economic uncertainty, a return to the good times for the market will likely depend on improved market fundamentals rather than investor expectations. Business and consumer sentiment will be carefully scrutinized, as investors remain anxious to recover from recent setbacks. In this environment, old economy stocks will receive the most attention as investors seek to dampen market volatility by favoring companies with proven strategies that exhibit staying power and the ability to position themselves for the future regardless of economic times.

Consumer Confidence
During much of 2001, the U.S. economy owed a depth of gratitude to consumers who seemed to eschew signs of economic weakness and view life through rose-colored glasses. During the latter part of the year, and especially in the period immediately following the terrorist activities, consumer confidence fell as consumers reacted to the combination of weakening economic signals and concerns over home-front security. After a brief period of decline, consumer confidence turned around at year-end and increased with the overall index rising to the pre-September 11 levels and carrying into early 2002. Despite this improvement in the overall index, it should be noted that the increase was because of the expectations of future prospects rather than current situations. This reversal from the third quarter suggests that consumers anticipate an early end to the recession. While welcomed by all, this increase caught many economists off-guard, bearing the consensus outlook and adding to the ranks of those who feel consumers will once again help the economy out of its doldrums. However, consumer sentiment is expected to vacillate, with high debt levels nagging at the consumer psyche.

Retail Sales
Late in 2001, consumer spending was expected to lose steam as consumers struggled with the aftermath of the terrorist activity, a soft employment market, and generally weak economic conditions. Despite these expectations, consumers once again rose to the occasion, turning in solid retail sales gains for the fourth quarter. Retailers earned these gains by turning to early, deep and sustained promotions to lure shoppers to the stores. While successful in terms of total sales, profits were dampened by widespread discounting and a strong interest in bargains and value. Going into 2002, retail sales were expected to lose some of this momentum as retailers moved slim inventories and geared up for the aftermath of a wave of Enron-related revelations. Once again, consumers seem to believe traditional logic, bolstered by expectations of a strengthening economy and putting some of the terrorist fears behind them. Going forward, consumer strength will be a vital component to a recovery because consumers account for two-thirds of U.S. economic activity.

Lingering concerns that consumers cannot continue unabated spending hang over the outlook for retail sales, despite early increases. The rise in consumer confidence and optimism may carry through early 2002. But, unless there is evidence that the economy is indeed on the road to a sustained recovery, consumer spending should drop off in the second half of the year. However, if modest improvements on the employment front continue and business indicators maintain their pattern of reversal, consumer spending may help set the stage for a solid
second half of the year. Such gains will have to overcome the lagged effects of widespread year-end 2001 promotions, especially in the automobile sector, which enjoyed record sales as a result of its zero-interest and low-interest financing programs. Going into 2002, consumers are expected to remain fairly active on the purchasing front, with value still driving their decisions until economic times and the job front stabilizes. The nature of consumer demand will also depend on the war on terrorism, with consumers accumulating a pent-up demand for travel and pre-September 11 consumption preferences. The travel industry (e.g., air, hotel, and rental car) will cross its collective fingers, hoping consumers will return to more normal leisure activities and spending patterns.

As for Internet sales, consumer preferences mirrored that of traditional in-store retailers, with the highest year-over increases racked up by value-oriented sites. A number of forecasts suggested that terrorism would cause consumers to shift from traditional stores to Internet merchants, but surveys of consumer buying habits and expectations suggest that it played a moderate role in changing consumer behavior. It is likely that the solid double-digit gains in year-over retail sales can be attributed to more enduring factors and a sign that the B2C sector has found a niche in the total retail picture. Although e-commerce sales pale compared to total retail sales, market share has been stable to positive, despite the widespread turmoil that has rippled across the “new economy” frontier.

Housing Market
In the fourth quarter of 2001, the housing market remained one of the bright spots on the economic horizon, although producers remained concerned over the sustainability of consumer demand and began to slow the pace of building permits. Most sectors continued to struggle in early 2002, but the housing market exhibited signs of a widespread recovery, both for new and existing home sales. The early reports suggest that home sales might set a record for a January period. This unexpected surge can be attributed to mild weather, signs of an economic recovery, rising consumer confidence, a history of proven housing appreciation rates over the near term compared to other investments, and signs that the decline in interest rates might be over with more upside risk than downside opportunity. Picking up on these signals, builders remained active, with construction starts rising above year-end figures. Starts were slightly off the pace of the prior year before the recession officially began, suggesting that builders would be quick to ramp up toward capacity setting the stage for robust starts. Completions were down from the revised year-end figures, but once again above the prior year.

The surprising strength in the housing market was not spread evenly across the U.S. The high-growth South led, followed by the Northeast, which benefited from pent-up demand. In addition to solid demand built on consumer expectations, the housing market continues to benefit from low interest rates, which made housing more affordable. The outlook remains positive but modest, tempered by the potential for moderate interest rate increases to outpace any future increases in household income as the economy recovers. However, consumers may once again rally the sector. For the whole year, the housing market is expected to moderate as the year unfolds, although housing investment should come in above last year’s totals. With the exception of the potential for rising interest rates, housing will do its part to sustain the recovery and will benefit from it. But it will not be one of the driving forces that propels the economic recovery.

Real Estate and Capital Markets
Real Estate Capital Markets
In late fall, the real estate market seemed to recover from the immediate after-shocks from the terrorist attacks, and continued to fall in line with the overall economy. Capital markets operated as expected, paying close attention to real estate market conditions and their relationship to the broader economy. The Enron-scandal had a chilling impact on investors, both those who owned properties occupied by effected tenants, as well as those by other high-profile, high-flying tenants whose occupancy had instilled a sense of confidence in landlords. The ripple effects of the incident and concerns, if similar practices were widespread, forced many investors to revisit their risk management programs and the notion of credit tenants.

The growing public fervor surrounding the collapse of Enron because of the domino effect of highly leveraged invisible partnership arrangements may place an ominous cloud over other sectors that use such generally accepted accounting procedures. The real estate industry might come under scrutiny as
reporting and disclosure rules are tightened to provide more complete exposure of effective leverage that might not appear on balance sheets. The prevalent use of joint ventures and partnerships by Wall Street sponsored “Opportunity Funds,” known for the ability to use financial engineering to enhance returns and mitigate risk, could come under special scrutiny. This issue could be particularly troublesome in the international arena where joint ventures have been the rule in structuring development ventures in an attempt to access local expertise and manage market and country-level risk. Public REITs in which debt levels are used to compare and contrast company styles and inherent risk levels, and engage in various special-purpose partnerships, may also have to revisit disclosure requirements. Private investors may begin taking a closer look at the “implicit” leverage levels of commingled funds, which under current practices do not have to include partnership debt in calculating fund-level debt. Finally, fall-out from Enron’s use of synthetic leases to keep real estate costs off its balance sheets and lower its operating expenses may result in the elimination of this option. Since the use of synthetic leases is a fairly widespread practice among U.S. companies, such a change may create a new wave of investor angst as the market discovers the existence of countless here-tofore “hidden” assets and struggles with the appropriate pricing adjustments to account for such liabilities.

Despite concerns surrounding the financial stability of tenants and investment vehicles, and the somewhat tenuous nature of the economic recovery, the capital markets continued to approach real estate in a deliberate manner appropriate with the times. Investors and other capital market players are expected to operate in this mindset through 2002, and resist the urge to get caught up in the wave of optimism that might begin to percolate in other sectors as the economy begins to improve. Attention has appeared to shift away from concerns of additional terrorist strikes targeted at real estate, but memories lurk in the minds of investors and tenants, suggesting that investment preferences and capital flows will continue to be shifted away from high-profile investments. In this environment, the added scrutiny of real estate conditions caused by the public markets will help keep capital flows in check, albeit with a dampening tendency that will keep supply of capital in line with market fundamentals.

Construction Activity
During the second half of 2002, commercial construction activity appeared to be headed into a downward cycle associated with general economic weakness. The terrorist events in September created an immediate, but short-lived shock to this cycle pattern, although construction activity picked up some lost steam in the fourth quarter. Despite the recession, the value of construction put in place for the year was up over the prior year, with total construction activity levels hovering in record territory. At an aggregate level, some of the gains in nonresidential construction were because of the prolonged production period and lagged delivery times for major facilities. Much of these gains in nonresidential construction were because of broad-based increases in public expenditures. The recent drain on public coffers associated with economic malaise could dampen some of this spending, especially at the state and local levels. But pressure will remain to fund planned projects deemed critical to the economic recovery. With respect to property types, the retail and office sectors lead the pack in 2001, although office levels tapered off consistently through the year as the lagged effects of the dot-com bust in 2000 and the softening economy factored into the market.

In terms of total nonresidential construction, activity for 2002 should be off somewhat, with the prospects for a moderate pickup in 2003. That prognosis will depend on the rate of more business contractions associated with additional belt-tightening of tenants, along with the strength and speed of the economic recovery. Unfortunately, low utilization of existing plants in the manufacturing sector, which was hit the hardest by the downturn, will dampen construction levels. The extent will be amplified in this cyclical recovery because of the close scrutiny placed on real estate market fundamentals associated with public investment activity, both on the CMBS and REIT-sides of the market. The good news is that pressure on Washington to fund new infrastructure and stimulate investments in both plant and equipment may well offset any private sector turbulence in the overall construction sector, which remains a vital component of the broader economy.

Private Equity Market
The impact of terrorist-related turmoil and the economic recession in the private equity market was somewhat mitigated because private investors had
already been scaling back expectations for real estate returns. This sense of moderation was attributable in part to the greater transparency in market conditions associated with the emergence of the public markets, as well as to the recognition that institutional real estate is more of a value asset over the long haul than is an opportunistic investment. That is, once a market enters the inflexion point of a cycle, on either the upside or the downside, excess returns and short-term profit takings are squeezed out of the asset class in favor of more sustainable, income-oriented returns. For investors who doubt the validity of this long-term market phenomenon, one only has to point to the experience of REITs when the sector was repriced from an unsustainable growth vehicle to a more realistic income-oriented investment.

In addition to moderating returns that have tempered capital flows to real estate, the denominator effect also has dampened institutional investment demand, especially among pension funds. Briefly, the denominator effect refers to the fact that pension fund investment-to-allocation levels can shift to an over-investment stage through two sides: the actual investment of additional funds or the numerator effect; or, the decline in the total size of the pie, the denominator effect. Because of losses in the stock market and slowing organic growth associated with a softening economy and tempered business growth, many of the more aggressive real estate funds which have historically pushed investment levels toward allocations have found themselves over-allocated and out of the market.

Indeed, most pension funds that have real estate initiatives are pushing their allocations. Thus, many pension funds that would normally be the usual suspects during this phase of the market might be forced to remain on the sidelines. On the other hand, the opportunity funds that raised significant capital during the latter 1990s are flush with cash and under pressure to acquire equity real estate. This is especially true since the funds that had been earmarked for Europe when opportunities were declining in the U.S. have not been able to capture sufficient returns that will satisfy investor expectations. Unfortunately for these sponsors, market conditions in the U.S. are not sufficient to warrant massive dumping of assets at opportunistic returns, creating a wide bid-ask spread between available capital and existing deals.

The bottom line on the private equity side of the market is that demand remains relatively stable to slightly negative, placing upward pressure on cap rates for new acquisitions. As noted, this situation was anticipated and has been factored in market activity levels. For example, over the past three years, the private equity index published by the National Council of Real Estate Investment Fiduciaries (NCREIF) has declined rather consistently, falling to its lowest quarterly and annualized returns since the prior real estate recession in 1994. During the fourth quarter, the Index declined even more dramatically, due in part to the fourth quarter effect that we discussed (i.e., a much higher proportion of properties in the Index were being reappraised in a generally down environment). Indeed, during the fourth quarter the index was -1.34%, causing the total return to plummet to the lowest quarterly level since the fourth quarter of 1993, the last negative total return. On an annualized basis, total institutional returns were around 7%, approaching long-term levels for core institutional real estate. While there is little danger of NCREIF-like returns dipping into the negative realm, the declining values that have been reported for institutional real estate over the past several quarters have placed downward pressure on implicit cap rates of held real estate. The yields that investors have accepted to this point for existing, owned assets has actually declined, creating a gap between hold and buy rates. Despite these caveats, institutional returns should remain competitive with other asset classes, especially on a risk-adjusted basis. Institutional demand and returns are expected to stay relatively flat in a steady as she goes pattern.

**Public Equity Market**

The Real Estate Investment Trust (REIT) industry came through 2001 with competitive returns in the mid-teens, outperforming all major investment classes, which, with few exceptions, reported negative returns for the year. The strong annualized performance benefited from a fourth quarter rebound that offset declines that beset the industry in the two months following the September 11 terrorist activities. Their strong returns were attributable to solid income returns that, although down somewhat from 2001, constituted more than half of the total returns and were on par with three-year moving averages. In terms of market cap, the composite REIT Index stood at some $152 billion at year-end, with an implied market cap of $161 billion. With respect to composition, the retail, office, and apartment sectors each accounted for some 20% of the market, followed by industrial
and diversified REITs, which split the balance with other subgroups (e.g., lodging/resorts, health care, mortgage, self storage, and others). For the second straight year, there weren’t any public REIT IPOs, although secondary offerings of REITs increased threefold, with common share issuances dominating the activity. Despite this increase, secondary offerings were behind the record levels of the hey-dey period that came to an abrupt end three years earlier. On a similar note, unsecured debt issuances increased dramatically, comprising the second highest level recorded over the prior decade. With respect to average daily trading volume of the NAREIT Composite Index, year-end figures also broke record levels over the prior decade, surpassing the levels achieved during the previous peak period in mid-1997.

Although REIT performance and market cap levels were relative healthy throughout 2001, property acquisitions continued to eke out only marginal gains, dramatically below those of the acquisitive years surrounding the 1997 peak. These relatively flat activity levels can be attributed to a number of factors including deterioration in market fundamentals, increased competition from private equity sources, the spill-over effects of the national recession and the continued threat of new terrorist activities. In addition, REITs are pushing total debt thresholds that hover around the 50% level, making it difficult to benefit from accretive acquisitions that take advantage of low mortgage rates that have attracted additional capital to the private equity side of the market. A number of REITs are trying to free up capital for new acquisitions to either upgrade their existing portfolio or improve diversification benefits, but moderating investor demand has made it difficult to flip properties and capture net gains. As 2002 unfolds, the REIT industry will likely experience much of the same, although performance levels could slip moderately as real estate market conditions and investor demand suffer. Once the economy begins picking up speed and excess capacity starts to burn off, REIT returns should increase, benefiting from improved market fundamentals. In the meantime, REITs are expected to maintain an inner focus and seek stable performance by concentrating on existing assets and tenant relationships.

**Commercial Mortgage Market**

As 2001 wound down, the commercial mortgage market exhibited signs of moderate tightening, in the form of increasing lending standards to offset modest increases in delinquency rates and rising concern over credit quality. Going into 2002, the commercial mortgage market was characterized by conservatism. This was expected because of a sluggish economy and a moderate up-tick in delinquency rates. The Enron scandal and an increase in bankruptcy filings also clouded the market and dampened activity. Rising delinquency rates, with hotels leading the pack in response to terrorist-related declines in travel, also contributed to the situation. In addition, retail and multifamily delinquency rates increased in the fourth quarter, although they remain well below long term averages. While the multi-family delinquency rates should improve as the market stabilizes, the retail sector is still an unknown with some residual concern over the survival prospects of a number of retailers (e.g., Kmart and Service Merchandise) growing and the credit quality of other retailers eroding. The fate of the hardball tactics of Winn-Dixie to force landlords to buy out vacated store leases will be closely watched.

Given the confluence of these forces, it is understandable that the commercial mortgage market got off to a relatively slow start for the year. Despite this tightening, the outlook is for a relatively fluid mortgage market with no signs of an impending shutdown. Indeed, mortgage rates have remained relatively attractive, with a slight increase in rates and stable spreads. The continued use of interest rate floors should provide added stability to the market, which could experience wider sector-specific spreads and slower capital flows over the intermediate term. Capital remains scarce for new construction, but the private mortgage market should remain viable during the recovery period. Toward the second half of the year, the mortgage market is expected to pick up speed as the momentum of the economic cycle spills over to real estate and rising delinquency rates moderate. To the extent this scenario unfolds, there should be few shortages of capital, leading to lower spreads over Treasuries. The major wild card at this point in time is the ultimate resolution of terrorism insurance, although it looks like the issue will be resolved in a manner that will not thwart commercial investment activity. Interest rates should rise, but remain attractive, during the first half of 2002 as the economy improves.

As predicted, the CMBS market ended the year on a robust note, wrapping up a record year and pushing the $100 billion figure in terms of total issuances. This surge was somewhat surprising in light of the
uncertainty surrounding the future of terrorist-insurance, and the aftermath of the attacks. While dampening the demand for single-asset issuances, especially for highly visible assets that have characterized that niche, the diversification benefits of mixed asset pools mitigated some of those concerns among investors. CMBS fell in line with seasonal levels in early 2002, although off the pace of the prior year in terms of issuances and forward supply suggesting a moderate pace of activity through the first quarter. Despite a gradual start in terms of new issuances, the secondary CMBS market has been fairly active. While CMBS issuances are expected to pick up in the second half of the year, the outlook is for lower total volume than 2001 levels. This forecast does not signify a major reversal, but more the cumulative effects of rising delinquency rates, concern over the health of the hotel and retail sectors, the potential for increasing interest rates, a decline in loan maturities, and the threat of new terrorist activities. Overall, the CMBS issuances and secondary market volume should remain healthy throughout the year, responding to events as they unfold in an orderly manner.

**Foreign Investment**

On the foreign investment front, early 2002 suggests that capital flows will remain relatively stable, with some shifting among the players. While the terrorist attacks on American soil caught the attention of the world, foreign investors in U.S. real estate seemed to react in a similar manner to their domestic counterparts. Indeed, at the 13th Annual Membership Meeting of the Association of Foreign Investors in Real Estate (AFIRE) held in October, the general tone was characterized by frank discussions of the issues and a sense of resolve to carry on in a deliberate, albeit somewhat tempered, manner. Rather than dwelling on the potential for widespread disruption of U.S. real estate markets, foreign investors seem to have honed in on market fundamentals, keeping a close eye on supply/demand balance. This attention is consistent with the emphasis foreign investors have placed on the ability to capture attractive risk-adjusted returns in the U.S., especially compared to many other regions which offer one or the other of the two dimensions of performance.

The outlook for foreign investment is stable to moderately positive. In terms of property types, foreign investors should maintain their renewed interest in multifamily assets, followed by office, industrial, and retail. There will be fewer large deals, as the importance of diversification begins to play more of a role in the portfolio composition of foreign real estate holdings. As with domestic investors, hotel assets will remain a hard sell. With respect to sources of net inflows, Europe is expected to lead in terms of capital inflows, with the Mideast maintaining a relatively steady state, and Asia lagging. This situation could change, depending on economic and political events in the world.

**Real Estate Outlook**

Throughout 2001, the commercial real estate market took on an ever more sobering stance, with lagged effects of the dot-com contraction still playing out in the market and the impacts of the recession and terrorist activity rippling across the landscape. More recently, the fallout of the Enron collapse, and concerns over credit quality, and aggressive actions of a growing list of tenants are being factored into the equation. The issue of excess capacity and the dramatic increase in surplus space associated with losing tenants also hangs over the asset class, with vacancy rates and sublease space increasing in most markets. Within various property sectors and a selected list of local markets, these forces are even more pronounced, creating major concerns over the near-term health. Despite a relatively somber near-term outlook, the good news for the commercial real estate market is that the adjustments have been rather gradual, with most of the major downside risk already factored into the market. This is not to suggest that the real estate market will sail through the bottom of the cycle unscathed. Although, there is limited risk of a major collapse. A favorable scenario depends on a sustained economic recovery and the ability to keep domestic terrorism in check.

**Office Market**

Office vacancy rates rose moderately but consistently in the fourth quarter, continuing the trend that characterized much of the third quarter, albeit with the added stimulus of uncertainty associated with the terrorist strikes. Some signs indicate the economy is picking up in early 2002, but the spillover of such activity will likely lag into the next year. Negative absorption rates are projected for the office sector overall, causing vacancy rates to continue to climb to the mid-twenties in CBDs and pushing 20% in the suburbs as companies dump excess space on the market. The
good news is that the current imbalances were due in large part to over-exuberance of tenants who were positioning themselves for expansion, rather than excess capital flows to the asset class. Without this discipline that pulled the plug on speculative construction early on in the cycle, the current condition and the outlook for the office market would be much more dismal. As might be expected, the more dynamic markets that rode the last waves to their peaks have seen the most effect, with little near-term relief in sight and prospects of further erosion. Office construction starts declined when the recession began to be more visible in mid-year 2001, but the lagged delivery times still resulted in a surge of new products that flooded the market in the fourth quarter. As might be expected the combination of new products and sublet space has created a rather soft leasing market, with inducements increasing and rents abating. These conditions should carry through much of the year, with the suburbs and commodity product suffering more than the central business districts.

The office component of the real estate capital markets shared the pain of the spatial markets, with income returns falling and values declining. As predicted, the value component of the Office Subindex of NCREIF declined in the fourth quarter, effectively wiping out the income component of returns. In a relative sense, the office sector led all property types on the downside, with the dubious exception of the hotel sector. The good news is that the sector avoided negative total returns, and logged in the year over 6%, the long-term target level that institutional investors assume in making real estate asset allocations. A similar scenario unfolded on the public market front, with total returns in the NAREIT office index slightly edging out those in the private sector. In this environment of softening fundamentals and rising risk, transaction volume declined. In terms of players, private buyers have done most of the investing, followed by institutional investors and REITs. Office cap rates have moved up, although no major repricing of the sector is expected.

**Retail Market**

The retail market operated through last year under a number of clouds, with investor skepticism and tenant actions all but negating consumer optimism. Despite the unexpected strength in consumer sales throughout much of the year, the spatial component of the retail market lost ground. The good news is that the sector avoided major additional erosion in fundamentals as more retailers focused less on market share and more on store productivity to avoid cannibalization of sales, at least from their own outlets. However, as in the past, this discipline and bottom-line focus has not been the case in many markets, especially the stronger growth markets in which retail development has continued uninhibited by concerns over overall market fundamentals and spatial balance. The good news for owners of existing product is that the rate of mall openings is projected to decline over the next several years, providing at least a brief period of respite from competition from new superregional malls that characterize new projects.

The strong consumer demand for retail goods that fueled the economy during much of the recession was not distributed evenly across subsectors, with value merchants benefiting and traditional department stores lagging. However, as Kmart vividly pointed out, the notion of value itself is no guarantee of success in such an environment. Shoppers still seek the total retail package in selected outlets. Winn-Dixie's aggressive stance against landlords holding leases in its closed stores will be closely watched by industry players on all sides to see if it is an isolated case or a precursor to a new wave of efforts to abrogate leases without bothering to go the bankruptcy route.

As in the past, the experience of malls has been mixed, with dominant class A malls holding their own, and new class A malls all but putting the nail in the coffin of functional and economically obsolescent class C properties. Middle of the road malls have also struggled, as an increasing number of department stores face declining same-store sales and others continue to execute repositioning strategies. A number of specialty retailers have also struggled (e.g., Gap), failing to adjust to changing markets and new competition, both instore and online. Overall, store closures were up during 2001, with some evidence of a spillover effect during 2002.

In terms of investment performance for the retail sector, the private and public markets provide a significantly different picture. The NCREIF Retail Subindex experienced negative value changes for 2001, dampening relatively competitive income returns. While not quite as pronounced as its office counterpart and nowhere near the hotel debacle, retail returns continued to lag to apartment and in-
Industrial. These somewhat disappointing returns relative to other property sectors, coupled with the clouds that continue to hang over the retail industry, have added fuel to the tendency of institutional investors to under-allocate the retail sector. This situation is unlikely to change during the year, suggesting that retail investment demand from institutional investors will be relatively moderate. Within retail subcategories, the picture is a bit brighter, with small retail holding its own on the value front although still lagging other sectors overall.

On the public frontier, the investment performance of retail properties through year-end and into the first part of 2002 continues to belie softening market fundamentals as well as the performance of private market counterparts. For 2001 as a whole, the retail sector led all property types, with returns logging in over the 30% mark. Not only was this figure attractive relative to other asset classes, it far surpassed anything else that is considered real estate. On the public front, there was also a significant level of compression among subsectors, with most retail categories converging on the 30% level, led by regional malls and lagged by freestanding retail. Overall, retail investments are expected to hold their own through much of 2002, struggling with gradual weakening in market fundamentals. The sector should improve as the benefits from moderating supply and the economic recovery are factored in, but performance will be uneven, with more big losers than winners.

**Industrial/Warehouse Market**

Over the past 18 months, the industrial/warehouse property sector has faced challenges ranging from fall-out from the failed dot-com revolution to a prolonged recession that has plagued the manufacturing sector much longer and deeper than the overall market. The good news is that supply quickly contracted in the second half of 2001 as demand fell and companies slowed down to see if the economy would declare itself on the road to recovery. This supply-side elasticity has been one of the saving factors over the recent business cycles, with the industrial sector able to rein in stock relatively quickly. This added discipline could be attributed to a number of factors that do not operate in other property sectors including shorter production cycles, more transparency, and a smaller scale of individual development decisions.

In terms of market fundamentals, the rapid curtailment of new supply helped take the momentum out of the rise in vacancy rates with a number of indications that they will peak below the 10% level and then gradually taper off as the recovery kicks in. While disappointing to insiders, this situation is mild compared to other property sectors and to the last recession when conditions deteriorated much more significantly. This is especially true in light of the breadth and depth of the manufacturing recession which could have had a much more significant impact on the sector. Part of the cushion from a harsher, but plausible, market correction that the industrial sector has enjoyed stems from the lower absolute and relative carrying charges for excess capacity compared to many other sectors with higher carrying costs. Within the industrial sector, the R&D component suffered the most during the downturn from the double blows of the demise of dot-coms and the cannibalization of tenants from the softening office market, especially on the margin.

In terms of investment performance, the private market experienced a moderate decline in value during the fourth quarter. Negative appreciation was on par with retail, which had been undergoing price pressure for some time, but below that of other property classes with the exception of apartments. Within the sector, industrial/flex space eked out higher performance than warehouse, although this advantage was lost when comparing the two subsectors on a risk-adjusted basis. With respect to the public markets, industrial REITs enjoyed returns throughout 2001 that were on par with the private sector, but a dramatic decline from the prior year. Going forward, it is expected that industrial returns will be stable to positive, with the sector benefiting from an improving economy more quickly than most other property types.

**Apartment Market**

The apartment market has continued to be one of the bright spots on the institutional frontier, benefiting in part from the same fundamentals that have fueled the single-family market. Demographic trends are improving with an increasing number of households in the young adult category. Despite continued strong interest in home ownership, the economic downturn and job losses have caused many apartment residents to rethink ownership preferences, skewing them toward rental and bolstering apartment demand. With moderate interest rate increases likely when the economy improves, the rent/owner-
ship preference should not undergo dramatic change over the near term, helping stabilize the outlook. There are a number of markets where apartment fundamentals are in much weaker conditions than the national averages, especially the higher growth markets in which construction levels continued to add to stock despite signs of an economic downturn. The number of shelved projects causes some concern, with developers ready to pull the trigger when the market recovers or the economy begins to pick up speed and the capital markets start loosening up on new product.

With respect to investment performance, the apartment sector continued to be the darling of the private, institutional market, with total returns leading all other property types. Indeed, with the exception of some minor value losses in the second half, the sector would have provided low double-digit returns instead of slipping moderately below that threshold. Institutional investor demand remains relatively strong for private apartments, with some foreign investor segments joining their domestic counterparts on the acquisition front. The public sector posted comparable returns to their private market counterparts, although the private sector squeezed out slightly higher returns. As with other property types, however, the year-over declines on the public front were much more dramatic, speaking in part to the greater liquidity of REITs. Because of the increasing focus of analysts and greater transparency in the public sector, the public market has been quicker to respond to research reports and early warning devices, causing greater volatility in returns. The outlook for private and public apartment investment is stable to moderate, with some improvement anticipated as the economy recovers and occupancy rates move back up. In the meantime, institutional investors are expected to concentrate on market fundamentals and avoid overpaying for assets, as well as taking advantage of softening conditions to round out portfolios, improve diversification, and expand their dominance in particular niches that they may have carved out for themselves.

Conclusion
As 2002 unfolds, the U.S. real estate market seems poised to weather the business cycle and to recover to from some of its own excesses without a major disruption in performance. The overall outlook is for a slip in market fundamentals, but more of a bottoming out pattern than a major correction or adjustment. This outlook might catch those who are experiencing more significant challenges and greater uncertainty off-guard, but this divergence among property sectors, markets, and submarkets from broader national trends is to be expected. We have pointed out that the domestic real estate markets will be characterized by more product stratification than in the past, creating greater dispersion in performance within the broader asset class. While some might bemoan this occurrence, from a philosophical perspective it is healthy for the market because it will help drive out players who have been riding the ebb and flow of capital market trends and have failed to focus on underlying fundamentals. Real estate investors and other observers will have to become much more introspective than in the past. At the same time, to be able to pick the winners and avoid the losing propositions they will be offered, investors will have to pay much more attention to space users. This scrutiny will be necessary when modifying investment strategies, portfolio allocations, and investment criteria to incorporate driving forces that affect the level, and nature, of demand for real estate. The prospects for downside risk remain, but astute investors and other market participants should be able to take advantage of a market in transition to position them for the future and lock in attractive risk-adjusted returns.

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