Is U.S. Real Estate Over-Priced?

If U.S. commercial real estate prices are at a peak, should savvy investors be selling their holdings?

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FRESH EXAMPLES OF high prices being paid in the most sought-after markets are posted weekly by the trade press. Individual properties regularly sell for record prices, like the MetLife Building in New York City, which sold for $1.7 billion earlier this year. Prime office buildings in Washington, D.C., have traded for more than $600 per square foot. Apartment buildings, especially those that are prime candidates for condominium conversion, trade for twice the price they were purchased for three or four years ago. Sellers of institutional-quality buildings are inundated with dozens of offers, often far above carrying values. NCREIF reports that properties sold in 2004 traded at an average of 30 percent over appraised values.

Prices are up substantially over the past two to three years. Here are the key questions for pension funds and other institutional investors: Are real estate prices getting ready to fall? If so, when and by how much? Even if real estate pricing pressure eases, does real estate still make sense in a multi-asset portfolio, given expected returns and volatility of other asset classes? Does it make sense to try to time the market, that is, to sell real estate now, with a plan to buy back into the market in the future? What should an investor do?

The answer to the peak pricing question varies by market, property type, and even individual building. But few market observers see any let-up in the intense capital pressure propping up prices today. The answers to the second and third questions depend on the nature of the investor and what he hopes to achieve in the real estate asset class. Institutional investors and individual investors each have different expectations and requirements for real estate. To assist investors in making strategic asset allocation decisions, we offer our perspective on the current high levels of capital market interest in real estate.

IRRATIONAL EXUBERANCE

As most investors know by now, pricing in the major coastal markets of New York City, Washington, D.C., and Southern California comes close to earning the "irrational exuberance" label. But even in less prominent markets, the winning bidders have pushed prices up by using high levels of leverage or because they are driven by tax avoidance. For example, breakaway bids are not uncommon when an investor has a tax-driven need to roll a capital gain within a certain time frame, as dictated by Section 1031 of the Internal Revenue Code. The tax-deferred exchange buyers even have a new vehicle, the so-called "Tenant-in-Common" (TIC) structure, to make it easier to roll these gains. The price these TIC buyers are willing to pay is often several notches above an already fully valued market level.

However, it is also clear that investor demand for real estate is diverse and deep, and a precipitous fall in prices is unlikely over the next several years. Also, "same store" property level income will continue to increase over the next three to five years after falling from 2001 to 2003. Shopping center income has already been growing nicely; we expect the office, industrial, and apartment sectors to also turn the corner between 2006 and 2010.

Given the high prices for core assets in the top markets, many investment advisors (including LaSalle) recommend an increased emphasis on value-add investing and secondary markets. These strategies can take advantage of the strong capital markets in two ways: first,

by repositioning a property as a "core" asset through leasing or capital improvements; and second, by seeking higher yields in secondary markets and sectors that are likely to become accepted as "core" asset categories, but are not today. In other words, investors should consider accepting more risk in exchange for higher returns. But these risks should be carefully underwritten and investors should be well-compensated for assuming them.

Investors who need stability in their portfolios should not abandon core assets, which many believe can deliver a 6 percent to 8 percent unleveraged return over a seven- to ten-year hold (down from 11 percent over the past ten years.) For core investors, active portfolio management makes the most sense (including selling weaker assets) and careful asset selection in order to create a diversified portfolio, and averaging into the market over the next two to four years.

CONVENTIONAL WISDOM

In recent months, *The Wall Street Journal, The New York Times* and other national publications have devoted an increasing level of coverage to commercial real estate pricing. The following provides perspective on some of the comments that were made in recent articles.

"With commercial real estate prices hitting records in many markets, some of the shrewdest players are cashing out." Many of the "shrewdest" investors are selling some assets but not necessarily cashing out of real estate. CalPERS, which is described in the press as "getting out," continues to invest in creative property deals. Over the past few years, the largest pension fund in the United States has been transitioning its real estate portfolio to better reflect the retirement fund's overall objectives. In particular, CalPERS is in the process of moving its portfolio from a core to a higher return orientation, including a larger commitment to non-U.S. real estate. The shift was partly driven by the demographics of CalPERS' plan participants and the assumptions of the funds' future liabilities. CalPERS' "crossover" point (when payouts would exceed contributions) was shifted out by several years to reflect new assumptions in its most recent asset/liability study. This allows the plan to take a longer view than other plans with lower funding ratios.

Most institutional investors plan to increase or maintain their allocation to real estate over the next several years. Institutional Real Estate, Inc. reports that institutions are targeting $51 billion in new equity in 2005, a 15 percent increase over 2004. Institutions have generally come to the conclusion that a long-term commitment to real estate is an important component of a balanced portfolio.

"Driven by low interest rates and almost insatiable demand, real estate prices rose strongly in most areas last year." While prices for high-quality assets in the top markets have risen at a rapid pace, it is not clear that real estate prices have peaked or that value declines are likely. There is still a lot of uncertainty about valuation levels in the stock and bond markets and investors are generally underweight in real estate. The strong demand for real estate may keep prices moving up throughout 2005.

There are some indications that prices have not peaked. Through the fourth quarter of 2004, cumulative appreciation in the NCREIF Property Index (NPI) totaled 7.8 percent since turning positive in the second quarter of 2003. (Excluding retail properties, appreciation was 4.2 percent.) Appreciation during the prior cycle (1996-2001) was 21.3 percent. Although NPI tends to lag market transactions, real estate prices have not exceeded peak values (after taking inflation into account) in most markets. Moreover, values relative to income are also within historical ranges. Cap rates are low relative to just a few years ago, but they were even lower in the mid-1980s.

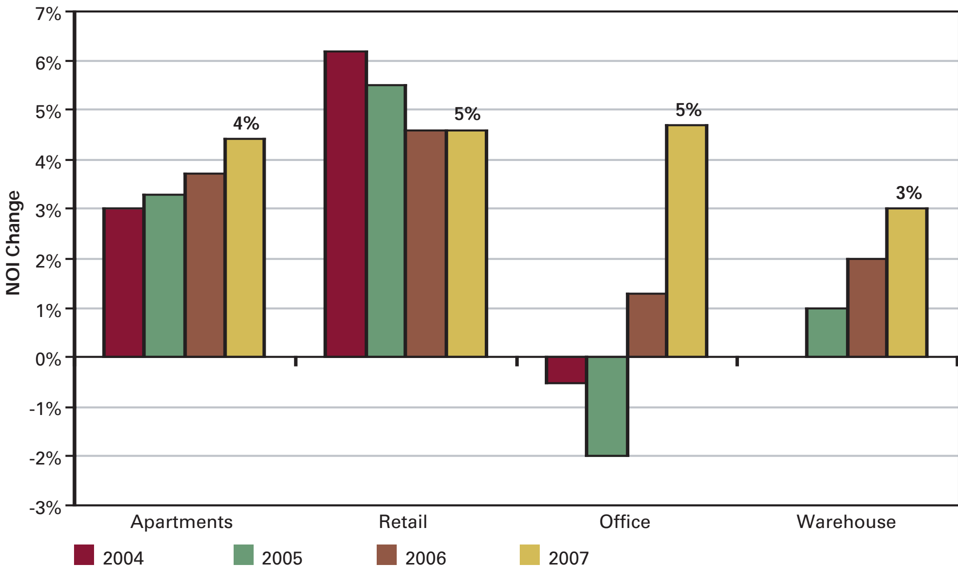
Low interest rates have clearly played a role in the most recent run-up in prices. Lower debt costs and higher levels of leverage have translated into higher prices. The net effect of these changes is that equity returns are close to prior levels when institutions used less debt. Real estate has also benefited from lower spreads—lenders have reduced the risk premium for real estate due to its strong recent performance and improving fundamentals. Mortgage delinquencies and defaults are well below average levels.

Interest rates are also providing important information about the required return from all asset classes. As shown in Figure 1, the real risk-free yield has fallen more than 250 bps over the past three years. Investors across the globe are requiring real returns of less than 2 percent for a ten-year investment. Real estate yields, which over the long term afford some inflation protection, seem reasonable at 6 percent to 7 percent.

The consensus among economists is that interest rates will eventually move up, although that view has been in place (and incorrect) for more than a year. The most recent consensus forecast for the ten-year Treasury Bond is 4.6 percent for the fourth quarter of 2005 and 5.1 percent in March 2006. These rates are still low by historical standards and will still be favorable to real estate investors. With a ten-year Treasury rate just above 5 percent, borrowing rates for real estate will be around 6 percent and real estate prices will see little impact. There is a risk that interest rates could go higher than the consensus forecast: a ten-year Treasury rate of greater than 6 percent would likely lead to higher cap

Figure 1: Yield on 10-year Treasury inflation protected securities

Figure 2: Net operating income (NOI) is improving



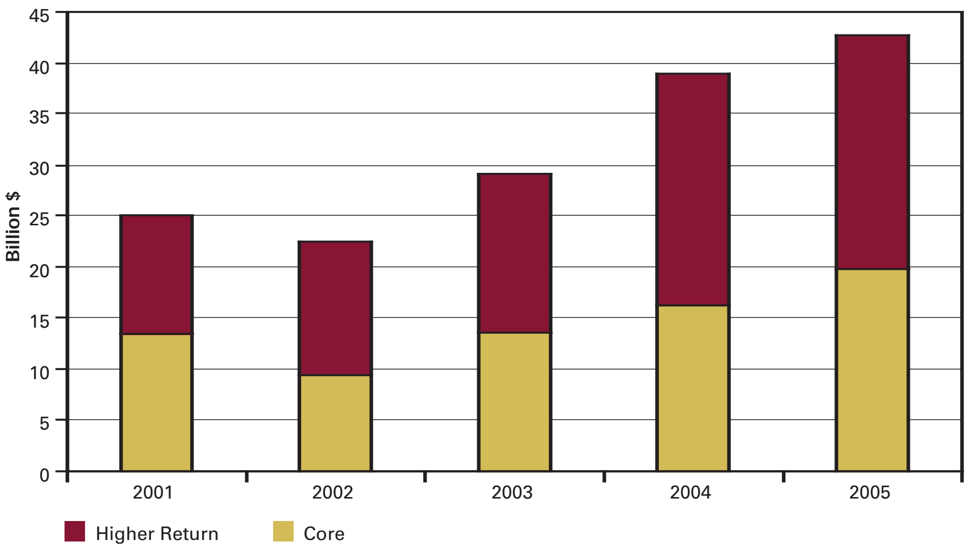
rates, although some of the resulting value change will be offset by higher incomes. There is also a chance that interest rates could stay low—the fall of the ten-year Treasury below 4 percent in May 2005 shows that higher rates are not a certainty. The most likely scenario of steadily rising long rates is consistent, though, with stable commercial real estate prices.

"The prices for buildings keep rising even though vacancy rates remain high in many areas and rents are stagnant or falling." While cap rates may be near their cyclical low and may increase over time, the impact of rising cap rates will likely be partially or wholly offset by rising income returns. Vacancy rates fell for all property types in 2004, and should continue to decline in 2005 and 2006. Rents generally stabilized in 2004 and should start to increase in 2005 in most markets. More important, for U.S. real estate as a whole, property level Net Operating Income (NOI) increased in 2004 after two years of decline. During the prior real estate cycle, NOI increased for nine years from 1992 to 2001.

As shown in Figure 2, net operating income growth should be positive for all property types in 2006 and reach growth levels of 3 percent to 5 percent in 2007. This growth in income should continue beyond 2007 and will offset some of the potential increase in cap rates. If cap rates stay at or near their current levels, real estate prices would continue to escalate.

Even though property prices have risen recently, there is no indication that capital will withdraw from the sector any time soon. There is broad-based demand (institutional, REITs, foreign, private investors) for real estate, providing support for the market's current pricing levels. While initial yields are lower than they were a year ago, they are above levels of the late 1980s, and are like to grow over time as fundamentals

Figure 3: Expected net capital flows to U.S. equity real estate



improve. This was not the case in the 1980s, as market conditions deteriorated from 1990 to 1992.

"Some of the biggest price jumps occurred in markets where occupancy and rental rates have suffered the most, such as the Houston and San Francisco metro areas." Short-term price movements are not unique to real estate and can be caused by a change in market conditions or a change in the consensus view about future conditions. Price movements tend to be greatest in markets that are less diversified and where a single sector like energy or high-tech drives the market. San Francisco in particular was one of the worst-hit markets in the country in terms of price drops as well as occupancy and rent declines. However, it has clearly started to improve. Downtown San Francisco's office vacancy rate has declined from 18.5 percent in 2003 to 14.1 percent, and rents are on the upswing. Rents are less than one-third of their peak levels in 2000, and are significantly below the levels needed for new construction. Higher building prices reflect the fact that rental growth is likely to occur sooner than appeared to be the case 12 months ago.

RECOMMENDED STRATEGY

For 2005, LaSalle's strategy team recommended that, at the margin, investors shift from core assets in core markets to more growth-oriented investments, including some in secondary markets. The two main reasons for this recommendation are that many markets have started to recover (leading to rental and income growth) and that pricing has become more expensive in core markets. This is not to imply that investors should rule out all core investments in 2005, particularly those that provide portfolio benefits such as property type, market, tenant, and lease expiration diversification.

There are several ways to invest in the current market that will minimize the likelihood of future disappointments:

- Be careful of pricing assets for perfection. Build a margin of error into each proforma.
- Don't even try to compete against 1031 tax-exchange money.
- Look for off-market or non-mainstream investments. Focus on markets or properties that have the potential to become mainstream in the future.
- Consider joint ventures that can change the risk characteristics of an investment, such as providing preferred returns in exchange for less upside.

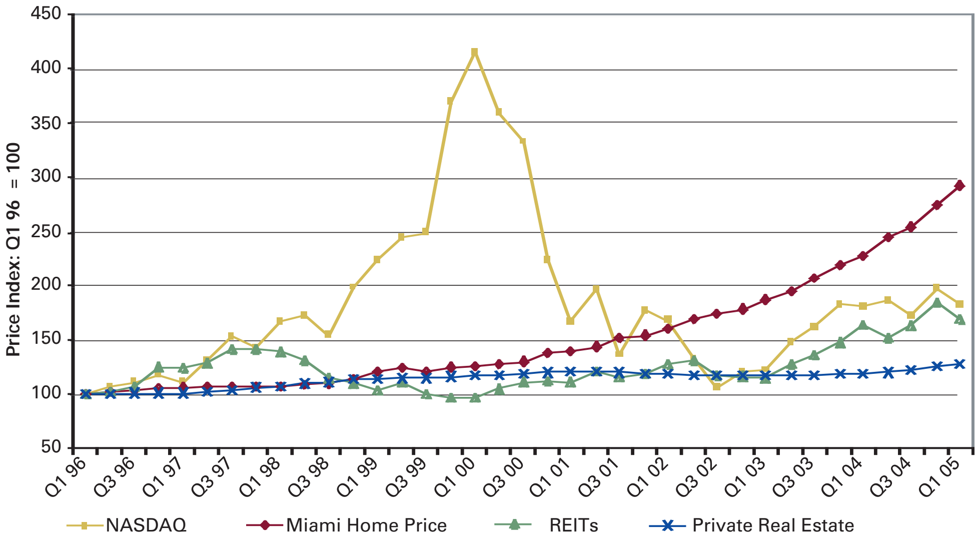
We recommend that core investors maintain the flexibility to consider a wide range of opportunities and to continually adjust strategy to take advantage of market conditions. This should produce attractive

Figure 4: Price appreciation

	Previous Through to Peak	Appreciation
NASDAQ	Q3 90 - Q1 00	1,127.3 %
Miami Home Prices	Q4 97 - Q1 05	174.3%
REITs	Q4 99 - Q4 04	90.9%
Private Real Estate	Q4 95 Q1 05	28.4%

Source: NAREIT, NCREIF, Bloomberg, Economy.com

Figure 5: Price appreciation in real estate vs. NASDAQ



Source: Goldman, Sachs, NAREIT, NCREIF, Bloomberg, Economy.com

returns consistent with a low to moderate level of risk.

The question about peak pricing in commercial real estate is a difficult one. Price bubbles are typically recognized only after they have burst. Commercial real estate investors also resist comparisons with the owner-occupied housing market, although both asset markets share the common link of low borrowing costs propping up prices.

Figures 4 and 5 answer the “Is this a bubble?” question better than any long-winded analysis. Yes, commercial prices are up. Yes, they are hitting new records in nominal terms in the United States and many other developed countries. No, it is not clear that this is a bubble or that prices are poised to fall. Yes, real estate prices are still cyclical and will eventually pull back, especially when the cost of borrowing rises. Assets and markets with income stream

growth are better protected against yield expansion (or multiple contraction). Finally, investors looking for better relative value in other asset classes, like stocks and bonds, will face many of these same challenges. The asset markets are awash in a sea of liquidity, and real estate is no exception. Finding the best relative value and growth opportunities within the asset class remains the primary job of any responsible real estate investment manager.