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Special Research
REPORT

2005 Forecast

2005 Real Estate Investment Outlook

Economic Expansion on Track, Employment Growth to Accelerate

In 2005, Gross Domestic Product (GDP) is expected to cool off to 3.7 percent, down slightly from 4.2 percent in 2004. We expect employment growth to accelerate to 2 percent, or 2.6 million jobs' as companies begin to gain more confidence in the economy and move beyond profit recovery to expansion. The business/professional services and health care sectors are expected to account for large shares of growth. Employment growth in 2004 reached an estimated 1.8 percent.

Low Inflation to Limit the Rise in Interest Rates

The Federal Reserve has already instituted a number of rate hikes to stave off inflation, yet long-term rates have not responded due to uncertainty and foreign purchase of U.S. Treasuries. Long-term rates will close the gap in 2005 with the 10-year Treasury rising 100 to 150 basis points from the low-4 percent range, still well below the historical norm. With inflation still manageable, given the slack in the labor market, there is little reason to expect a dramatic rise in interest rates.

Are Consumers Spent?

The effects that low mortgage rates and tax cuts had on spending have dropped significantly and will fade further in 2005 as interest rates rise, making employment and wage growth the main catalyst for spending once again. In 2005, median household income is expected to rise 3 percent and retail sales are forecast to rise by 4.5 percent, which is down from an estimated 7 percent in 2004. Energy prices are likely to recede further from their 2004 peak and will be less of a drag on spending; however, strong demand and supply limitations will prevent a drop to "normalized" pricing, and volatility remains.

Improving Property Fundamentals to Spur Investment Activity

Investor demand for real estate has surprised on the upside. We expect activity to remain strong in 2005 as more properties are brought to market. Although sales activity and price appreciation have slowed in some markets, overall demand for properties will be spurred by improving occupancies and capital movement among markets and property types. Despite lower yields, investors continue to show a preference for tangible assets, trading short-term returns for long-term potential.

Rising Interest Rates Should Be Offset By Improving Property Performance

Although higher interest rates will place upward pressure on cap rates, expectations of significant price corrections are overblown. While certain markets and property types have become over-priced and will need to adjust to a more normalized market, evidence points to growing demand for real estate ownership. This is driven by:

- Aging baby boomers' (the dominant share of private investors) need for low-risk cash-flow investments and capital preservation for wealth transfer
- Institutional investors' rising allocation toward real estate to meet the cash-flow demands of their investors, particularly pension funds
- Rising demand by offshore investors spurred by the falling dollar and the perceived safety of long-term returns produced by U.S. real estate

A capital shift is to be expected when the stock market begins to post more reliable and healthier gains; however, strong real estate capital flows will limit the rise in cap rates.

Apartments: Inexpensive Capital, Condo Conversions Boost Prices

Owners are expected to experience increased demand in most markets across the nation during 2005. On the investment front, even with cap rates at all-time lows, for every investor who chooses to wait on the sidelines, there are two or more others willing to step forward.

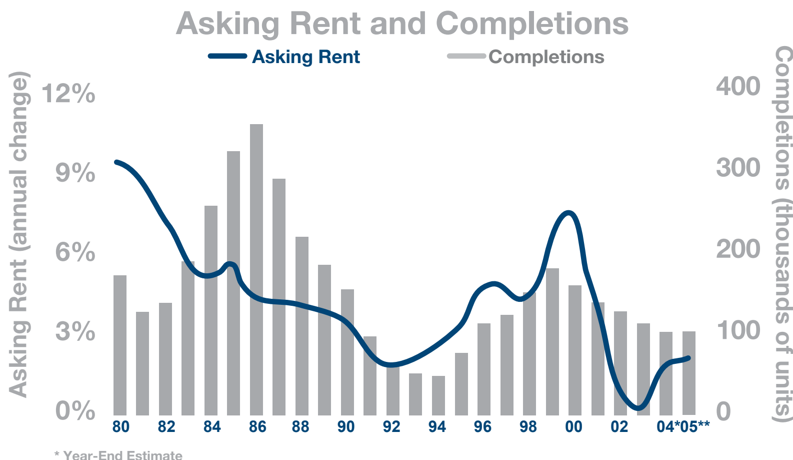
Storm Taking Longer to Pass

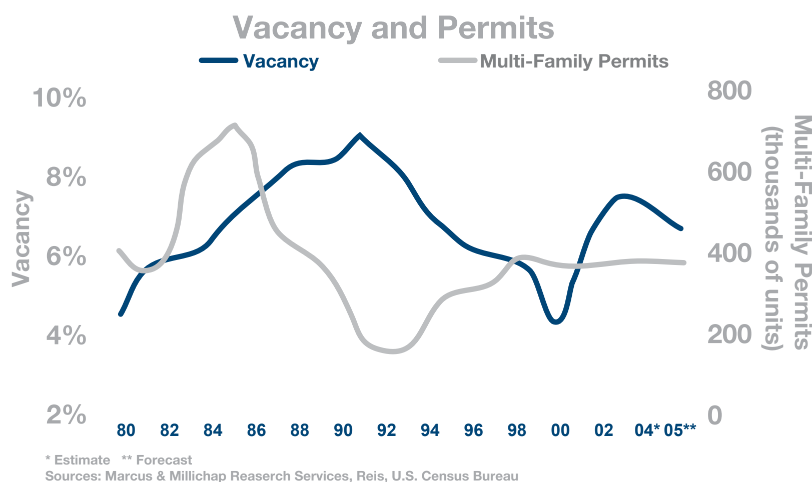
It is taking longer than anticipated, but the "perfect storm" is breaking. A combination of factors combined to cause apartment owners operational woes over the past few years. Historically low mortgage rates allowed many would-be renters to take the plunge into homeownership and lowered the cost of apartment development, which brought a tremendous amount of product to market. In addition, the jobless economic recovery caused many renters to double-up or move back home to conserve cash. The combination of these factors pushed the nationwide vacancy rate up 400 basis points from 2000 to the market's bottom in the first quarter of 2004.

With the economy slow to recover, consumer confidence has been shaky. Some improvement in apartment demand was noted during the latter half of 2004, with vacancy currently hovering at slightly less than 7 percent. A 40 basis point decrease in vacancy is anticipated in 2005 as improvement will still be held back somewhat by first-time home buying, since interest rates are only expected to rise modestly. A more rapid recovery will form in 2006.

As hiring activity picks up, we expect renter household formation to follow, particularly among the 18- to 24-year-old age cohort as the "unbundling" effect takes hold. Over the next five years, population growth among this age group and strong immigration figures bode well for the future of the apartment market.

Over the next 12 to 24 months, rising interest rates will benefit apartment fundamentals, limiting renter attrition to homeownership and also putting upward pressure on development costs. Higher debt-service payments, however, will also temper price appreciation.



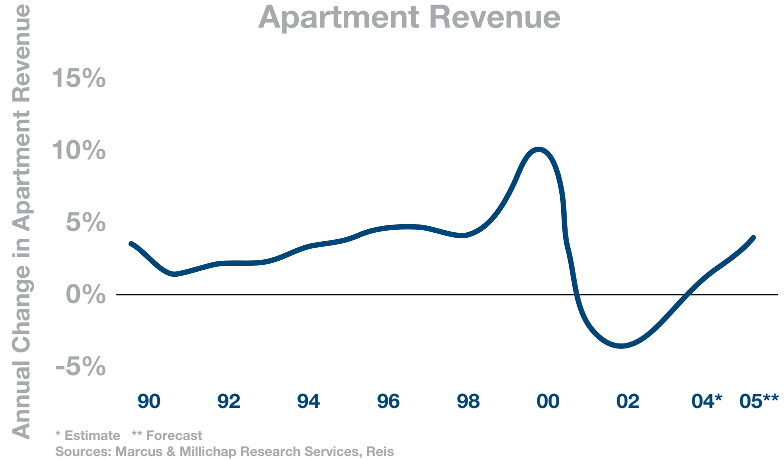


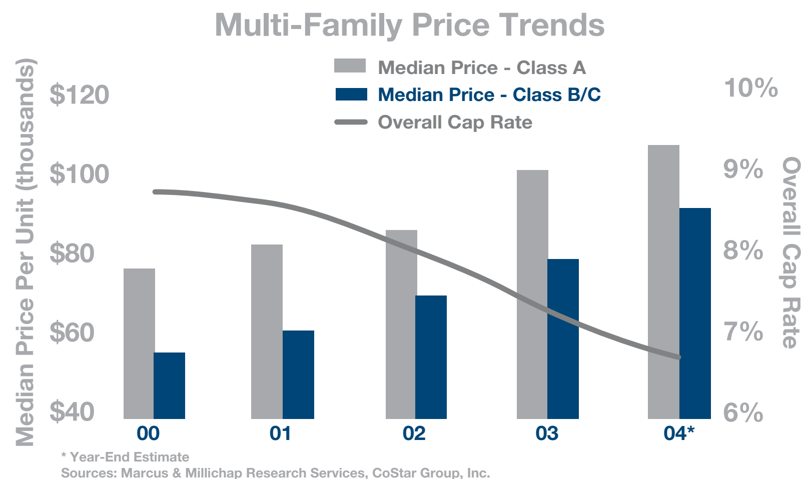
Condos, Condos, Condos – The Craze Is Limited to a Few Markets

Many multi-family developers in land-constrained markets, such as Southern California, have found it has become cost prohibitive to build anything other than condos. In addition, condo converters have become extremely active. Although some degree of cooling off is beginning to emerge in a few locales, buyer demand for condos appears to be quite strong. It should be noted that this market force is limited to the most expensive housing markets. The net effect of condo conversions is a benefit to the apartment market as the loss of supply is generally greater than the loss in demand. The condo buyer

pool is not only first-time homebuyers and investors, but also downsizing households and second-home purchasers. If the housing market slows abruptly over the next two years, many of the individual condo units will join those being purchased by investors as rental units, adding more supply.

In addition to unprecedented demand for apartment assets, condo conversions have led to significant price appreciation in markets with high single-family home prices, such as Boston, Northern New Jersey, San Francisco and Southern California. In San Diego, for example, apartment properties priced at more than $5 million sold for a median price of $131,000 per unit this year, compared to conversion deals, which sold at a 26 percent premium. In South Florida a similar comparison uncovered a 42 percent difference in sales prices. This trend will continue as new condo supply fails to keep pace with demand.





Concession Burn-Off Under Way

Concessions have begun to abate in several markets. Overall, however, effective rent growth has been nearly equivalent to gains in asking rents, with each on target to rise approximately 2 percent this year. On a national scale, we expect effective rent growth to outstrip asking rent gains by 150 basis points in 2005 as concession burn off becomes more widespread. Owners of Class A properties in markets with less-expensive for-sale housing, such as Atlanta, Dallas, Las Vegas and Phoenix, however, will likely still have to offer incentives to boost occupancy as they continue to try to keep tenants from defecting to homeownership.

We expect Class B/C concessions to disappear more rapidly as most markets continue to suffer a shortage of affordable apartment units.

Focus on Value Creation, Market and Property Type Rotation to Increase

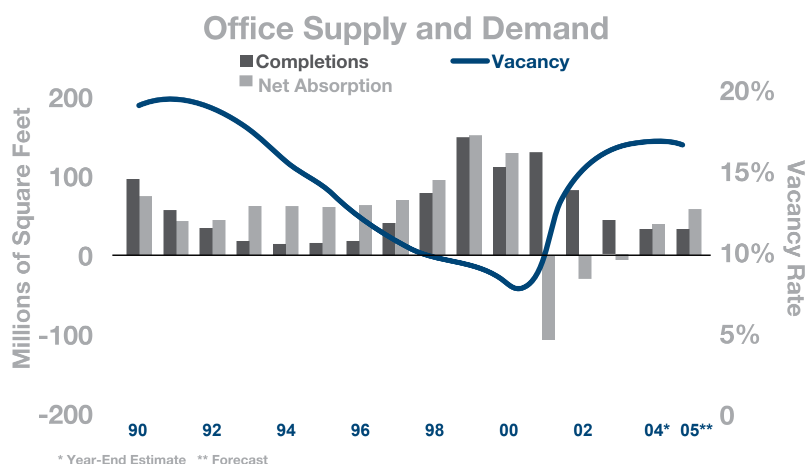
Nationwide, the median price per unit has increased 50 percent since 2001, to more than $93,000, despite a downturn in market fundamentals. The decline in NOIs coupled with steep appreciation put tremendous downward pressure on cap rates, which are currently at 6.5 percent nationally and substantially lower in a number of markets. With only a mild increase in rents and occupancy forecast next year, investors need to shift their focus to inefficiencies in current operations and to implementing plans to control expenses and retain tenants. Value creation through better operations will become more of a focus rather than capital market trends, which drove the market in the last three years. Many apartment sellers are also diversifying equity by entering into new markets and taking advantage of the cap rate spread that apartments have with retail, office and industrial properties.

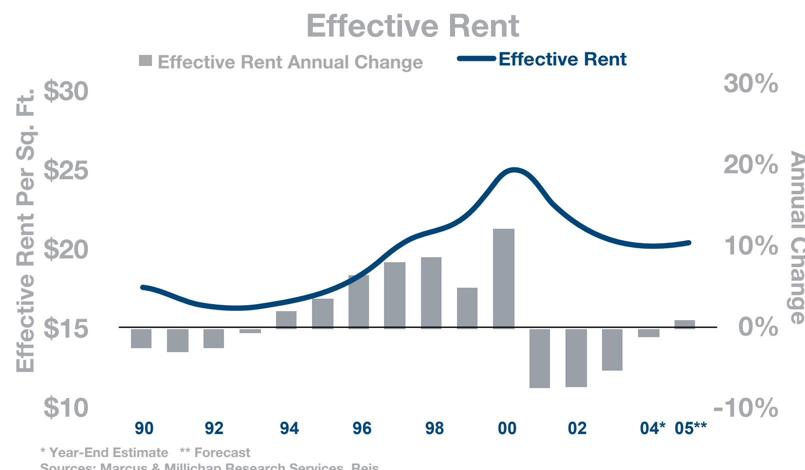
Office: Slow Recovery to Gain Speed

Office market fundamentals are improving, but it will take several years for the market to return to equilibrium. In 2005, we expect vacancy to decline 110 basis points, to 15.6 percent, allowing for a 1.5 percent gain in effective rents. Construction remains one of the greatest risks to our forecast. While office starts are down 65 percent from their peak in 2000, the pipeline of planned projects expanded by more than 50 percent in 2004. Unless office market fundamentals improve dramatically and developers are able to meet pre-leasing requirements set by lenders, however, it is unlikely that a large boom in construction will occur in the near term.

Absorption to Lag Job Growth

Office-using employment sectors are forecast to expand by 1 million jobs in 2005, which equates to a 3.5 percent gain, well above the overall nonfarm job growth projection. Office demand typically lags job creation. In 2005, absorption is expected to reach 60 million square feet, which is a healthy figure but below absorption rates reported in the late 1990s. By 2006, we expect demand to rise to 90 million square feet as the effects of job growth in 2005 are fully realized.





Price Gains to Moderate

Office property prices have nearly doubled in the past 10 years, with the current median at $140 per square foot. For institutional-grade properties, prices are in the $200 to $400 per square foot range. Prices have continued to rise over the past few years in spite of a spike in vacancy and rent cuts, which caused the nationwide rent index (a function of vacancy and effective rents) to fall 25 percent between the market's peak in the third quarter of 2000 to its trough in the fourth quarter of 2003. In 2005, we expect rent index growth of more than 3 percent, with an acceleration to nearly 6 percent in 2006. Approximately 55 percent of the rent index growth will be from gains in occupancy, with the remaining 45 percent attributable to effective rent growth.

The divergence in prices and fundamentals has led to significant cap rate compression, with the average down 140 basis points since 2000, to 8.4 percent. The cap rate spread for office properties, however, is approximately 100 basis points to 250 basis points over apartment and core retail assets. As a result, we expect to see an increase in activity among opportunistic investors who can look beyond the short-term weakness in the sector. While lease rollovers and rising mortgage rates will apply some downward pressure on prices in a few markets, we do not expect broad-based discounting. Overall,

we expect prices to continue to rise in most markets as fundamentals turn in the right direction and capital rotation into office based on the favorable yield spread ensues. Price appreciation, however, is forecast to moderate to a more sustainable pace.

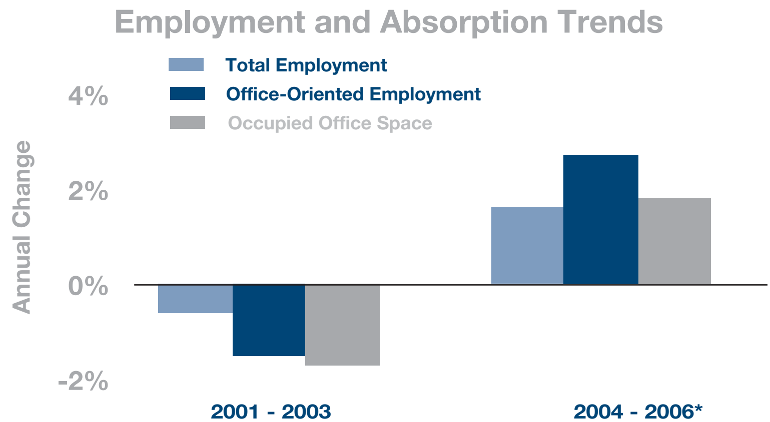
Matching Strategy to Opportunity

To match investment strategies to specific office market opportunities, we looked at several factors, including current price-to-rent ratios and our rent index, which is a function of vacancy and effective rents over a two-year forecast period.

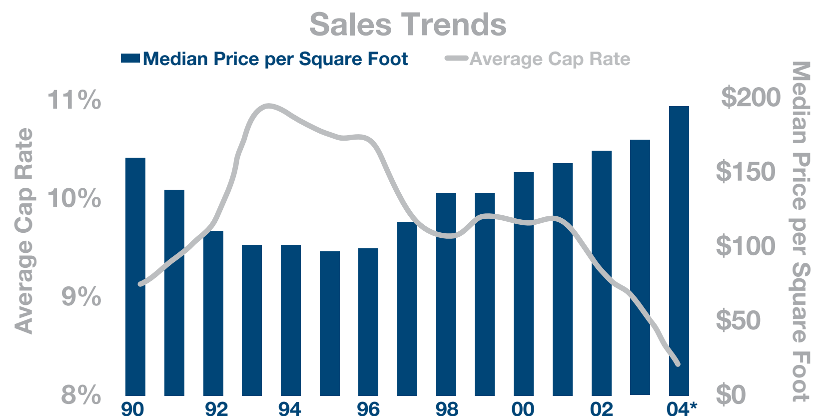
Markets with the most favorable combinations of price-to-rent ratios and rent index growth include Salt Lake City and Houston, which are both affordable given current rents, but each have only moderate rent index growth projections. Dallas is also affordable, but construction could rise beyond current expectations as there are few barriers to development. These markets are good choices for investors seeking low prices and who have a few years to wait for a recovery in fundamentals.

Riverside/San Bernardino and Fort Lauderdale have moderate price-to-rent ratios, but strong rent index growth is expected in 2005 and 2006, making them solid shorter-term investment candidates. Markets with moderate prices but strong projected rent index growth include Atlanta, Cincinnati, Miami, Charlotte, Phoenix, Sacramento and Orlando. Las Vegas has relatively high prices given current rents, but rent index growth is forecast to be very strong in 2005 and 2006.

For investors with longer-term strategies, markets such as New York, San Francisco and San Jose have relatively high prices given current rents. They also, however, have very positive outlooks beyond the two-year forecast period due to factors including high barriers to development and strong foundations in financial and/or new-economy industries.



* Forecast
Sources: Marcus & Millichap Research Services, Economy.com, PPR, Reis



* Estimate
Sources: Marcus & Millichap Research Services, CoStar Group, Inc.

Looking Beyond the Short-Term

It will be 2007 or beyond before vacancy falls below the 10 percent mark, given construction activity remains restrained. Prior to the market's peak in 2000, tight market conditions caused companies to hoard excess office space in anticipation of expansion. This led to a significant amount of sublease space returning to the market following the dot-com debacle and a rash of corporate downsizings and restructurings. With this in the not-so-distant past, many companies are waiting until a recovery is well under way prior to leasing additional space for expansion.

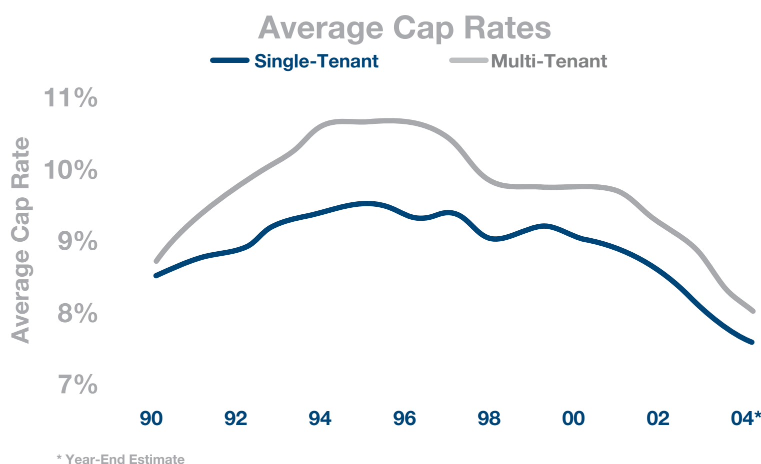
Retail: Investors Adapting to Changing Market Conditions

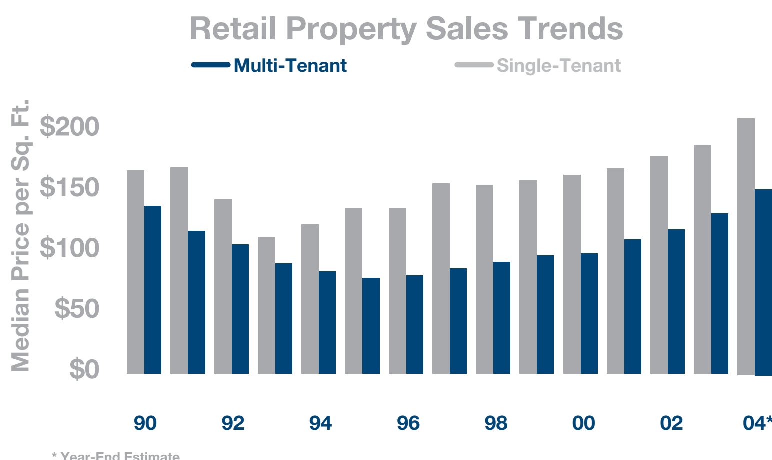
The face of retail is changing, and so too is the real estate investment market. The retail market was the most stable commercial real estate sector in terms of fundamentals through the most recent economic downturn, but within the retail industry itself, the weaker players have found it increasingly difficult to compete.

Retailer bankruptcies and closures of underperforming locations have left some vacancies, but they have also provided opportunities for healthy retailers to rapidly move in to new regions or expand their presence in existing markets.

Over the past four years, overall retail vacancy has hovered around 10.3 percent, and we expect minimal movement in the near term. Construction has been largely driven by demand, a trend we expect will continue.

In 2005, neighborhood and community center construction is forecast to rise moderately to 27 million square feet, up from 25 million square feet in 2004. Demand, however, will be strong enough to absorb new space, keeping vacancy relatively unchanged over the next 12 months.





Wal-Mart Expansion Continues

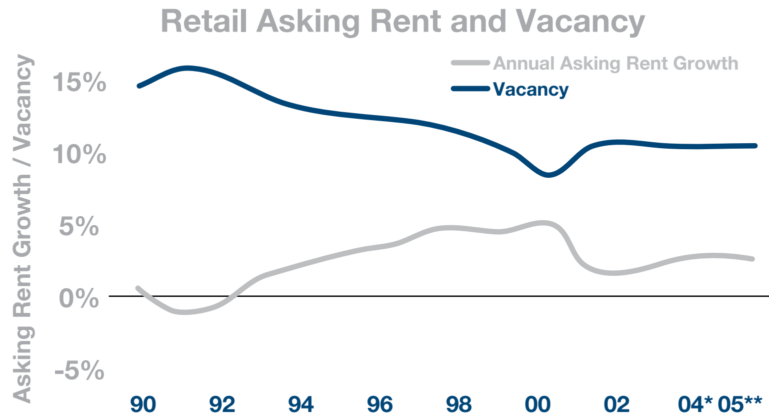
Wal-Mart continues to expand rapidly across the nation. In the corporation's fiscal 2005, Wal-Mart will open 230 new Supercenters, though 150 are conversions or relocations of existing discount stores to the larger format. In addition, 25 new Neighborhood Markets, the company's grocery-only concept, will open for business. Wal-Mart's ability to gain marketshare through its very favorable pricing is threatening the traditional grocery chains. It is estimated that for every new Supercenter, two grocery stores will close. It is forecast that traditional grocery stores will continue to lose marketshare to the retail giant and that within the next three years, traditional grocers will capture less than 50 percent of grocery spending.

Grocery-Anchored Centers: Inventory Low, Buyer Demand High, Caution in Order

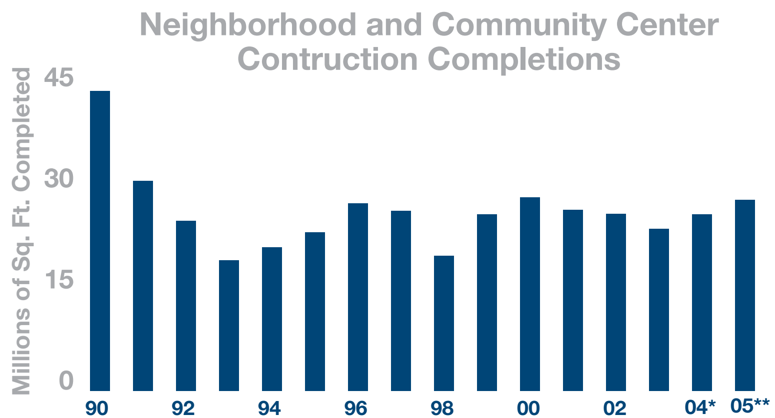
For years, grocery-anchored shopping centers were the darling of the retail investment market, as grocery stores were thought of as largely recession-proof. While we all still need to eat, we are now purchasing our groceries at numerous other locations. In addition to Supercenters, consumers can now purchase food and other household goods everywhere from drugstore chain stores to warehouse clubs. As traditional grocery stores close their doors, shopping center owners are faced with numerous challenges. While their anchor may continue to pay rent through the

remainder of the lease, inline shops can suffer tremendously from the loss of traffic.

Despite the shift in consumer shopping patterns and the numerous grocery closures that have ensued, grocery-anchored centers continue to attract strong investor demand. Buyers, however, have become more aware of the challenges facing the grocery industry and therefore are more thoroughly investigating an anchor tenant's staying power and the likelihood of a Wal-Mart moving into the area. Wal-Mart has found it challenging to develop Supercenters in largely built-out markets, such as those in the Northeast, and also in California, where there has been strong opposition to the chain's big-box concepts. In these areas, investors do need to keep a watchful eye on the market, as Wal-Mart's Neighborhood Market is 40,000 square feet and can fit into most spaces occupied by a typical grocer.



* Estimate ** Forecast
Sources: Marcus & Millichap Research Services



* Estimate ** Forecast
Sources: Marcus & Millichap Research Services, Reis

Strip Centers Command Attention

Strip centers are garnering the attention of many investors seeking a value play in today's market. Demand has been strong, as evidenced by a 12.5 percent increase in prices for this property type over the past year, to $139 per square foot. Strip centers are relatively affordable, providing private investors with an "in" into the market at the beginning of a new upcycle. Properties in close-in locations that may be in need of updating and repositioning can offer significant upside potential. The strongest activity for strip centers is reported in the $500,000 to $1.5 million range. Properties sold this year average slightly less than 20,000 square feet and have an average cap rate of 8.1 percent, similar to the overall multi-tenant average.

Single-Tenant Is Still Booming

Single-tenant investment has become increasingly popular over the past few years. Strong investor demand has pushed cap rates for single-tenant retail to an average of 7.6 percent, and the median price is closing in on $200 per square foot. Prices and cap rates vary significantly by tenant and location. Some properties occupied by credit tenants and located in top-tier markets, such as Southern California, can sell at sub-5 percent cap rates.

Appreciation in the single-tenant retail sector may slow over the next few years as investors react to steadier gains in the stock market and other investment vehicles. Demographics, however, support single-tenant demand. Baby boomers and retirees comprise a large share of the buyer pool, and many of these investors are willing to trade in strong returns for safety and minimal upkeep.

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Capital Markets: Rates to Rise, but Lenders Expected to Remain Competitive

Long-term interest rates did not jump as anticipated in 2004, as 10-year Treasury rates hovered between 4.0 percent and 4.7 percent during the year. Many commercial real estate investors took advantage of the low-rate environment to finance their purchases, and inexpensive capital for acquisitions will still be available in 2005. As economic growth gains traction, however, and inflationary pressure slowly builds, long-term rates will gradually climb 100 basis points to 150 basis points during the year. Granted, rates will remain low as measured against historical standards. But with rising rates a certainty, the financial dynamics of some deals may be altered.

At the end of 2004, low-leverage (50 percent or less) loans on superior-quality apartment properties were being written as low as 85 basis points over the Treasury, and lower quality assets could be financed at 120 basis points over with loan-to-values (LTVs) of 70 percent to 75 percent. Retail properties were being underwritten from 110 basis points to 180 basis points over the Treasury, and office properties were being financed in the 120 basis point to 170 basis point range.

Loan spreads may continue to contract in 2005, as conduits, life insurance lenders and agencies will continue to compete intensely. Borrowers with quality assets should be able to either optimize terms or maximize proceeds in the year ahead.

The Fed has begun raising short-term rates and will continue to tighten in 2005, though rates hikes are anticipated at a measured pace, assuming inflation does not rise beyond expectations. This implies higher borrowing costs for repositioning and opportunistic investors that rely on short-term financing.

Marcus & Millichap Office Locations

The information contained in this report was obtained from sources deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guarantee, express or implied, may be made as to the accuracy or reliability of the information contained herein.

Sources: Marcus & Millichap Research Services, ACLI, CoStar Group, Inc., Economy.com, ICSC, NREI, Property & Portfolio Research (PPR), Reis, U.S. Census Bureau, U.S. Department of Labor.