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AS THE COMMERCIAL WORLD TURNS

BY MARK G. DOTZOUR

Institutional pension fund investors met in Chicago in spring 2005 to consider how the global environment is likely to impact commercial real estate returns in coming years. The conference was titled "America's Place in the World."

William S. Cohen, Secretary of Defense during the Clinton administration and now a business consultant, said two major models are operating in the global business world today.

First is the spread of democratic capitalism throughout the world, with many countries wanting to join the core group of globalized nations. Second is the clash of cultures whose people hate each other.

The United States, Cohen said, is migrating to a dominance of "hard power" — military might and technology. Europe is trying to lead in "soft power," such as human rights and the environment.

War on Terrorism Weakens Economy

"America is in a long twilight of struggle against terrorism that we'll never know when we've won," said Cohen. "The war on terrorism will not be won by the military but by the police."

Cohen admonished the audience not to equate freedom with democracy, and suggested that the United States cannot afford to fail in Iraq because of the message it would send to all terrorists.

Cohen called for support of global trade, recalling an old military saying, "If you don't allow goods to flow across international borders, soldiers will."

The U.S. economy appears to be outperforming Japan and Europe because government stimulus has been stronger in this country. Job growth remains slow worldwide. Japan appears to be making a recovery after decades of stagnation, but its banking industry is burdened with massive amounts of bad loans.

So, Where's Inflation?

Adam Posen with the Institute of International Economics reported that problem bank loans worldwide have been reduced by 66 percent. He noted the savings rate in Japan is 30 percent, compared to near zero in the United States.

Jeremy Rifkin, president of the Foundation on Economic Trends, noted that the European economy is weak, and the job situation is bad. For Europe, job growth is likely to be slow until countries develop the political will to integrate their communities, transportation and finance.

The large decline in the value of the U.S. dollar has not yet led to inflation in the United States. Asian currencies have not changed much in relation to the U.S. dollar because China has its currency "pegged" to the dollar. Consequently, goods from China are still as cheap as they were a year ago. The dollar has fallen substantially against the Euro, making European goods more expensive to American consumers.

Because most of the goods Americans consume are made in China and not Europe, the dollar's fall against the Euro has had minimal impact on U.S. inflation. Rifkin noted that Saudi Arabia sells its oil in U.S. dollars, so the decline in the dollar has lowered Saudi purchasing power. He suggested that OPEC may try to keep oil prices at a higher level to make up for the lost purchasing power.

Jobs Lost in China

The Chinese economy continues to expand at a heated pace, leading to intense demand for oil, cement, steel and other commodities. Rifkin speculated that China's growth is likely to plateau in the near future.

Despite the strength of China's manufacturing sector, the country has eliminated 50 percent of factory workers in recent years. Machines are replacing people. Rising unemployment among China's manufacturing workers is likely to cause political and economic problems in coming months.

Panelists suggested that oil prices could be high for a long time. In 2004, demand rose to 84 million barrels per day, meeting supply for the first time in 50 years. To meet this elevated demand, all cheap capacity was brought online. New oil supplies will be much more difficult to find.

High prices do not seem to have any effect on U.S. demand, which is expected to grow by 1.5 million barrels per day. Oil and gas prices must stay high to support new oil exploration. Most new supplies are in places like Kazakstan and Africa, where oil is difficult to get, or in countries with uncertain political situations. While oil prices are at all-time highs, hitting $60 per barrel in June, they are far less than the 1981 price, which would be the equivalent of $92 a barrel today.

Grocers Fight It Out

Retail real estate continues to be buffeted by change. The grocery industry may be the most turbulent. Wal-Mart sold $113 billion in groceries in 2004, about 20 percent of all grocery sales. Grocery store square footage growth is flat, and comparable store sales are up slightly because of increased gasoline and pharmacy sales. Further consolidation is expected, with regional and local grocers continuing to lose ground to Wal-Mart and Target. Extreme no-frills value grocers are managing to compete with Wal-Mart. Wal-Mart is cutting the cost of groceries by up to 30 percent.

Stand-alone pharmacies are evolving into convenience stores that happen to have a pharmacy. Walgreens and CVS are winning; RiteAid is losing. These pharmacies hope to draw a customer into the store to fill a prescription and then spend another $10. However, more and more people are getting prescriptions filled through the mail. If this trend continues, it will be harder for pharmacies to compete.

Apparel sales appear to be an area of opportunity for retailers. Wal-Mart clothes are the company's weakest product line. That makes them a good bargain for parents who buy for kids.

Retailing has been good recently, said Scott Wolstein, CEO of Developers Diversified Realty. Malls have become the nation's fashion headquarters. Other products have moved into open-air centers or freestanding buildings. Department stores are becoming less relevant.

"Radical things are going on in our business," said Wolstein. "Specialty stores are migrating to open-air areas to take advantage of the traffic at Target."

He stated that more than one-third of regional malls are now out of commission. Retailers worry about deflation, not inflation. Prices of apparel and high-tech gadgets are dropping.

Consolidations Ahead

Joan Ellis, with U.S. Trust Company, said American banks are strong competitors in the global banking industry. U.S. banks comprise 60 percent of top ten banks in terms of market capitalization. Further disintermediation (movement of funds from low-yielding accounts to higher-yielding instruments) is expected.

Auto makers are now in the car loan business, and many companies are in the mortgage lending arena. Expect to see more consolidation in this sector, bringing down the cost of doing business.

The number of banks in the United States has fallen from 17,000 to 9,000 in the past 20 years. Eighty-five percent of credit card volume is now handled by the top ten providers.

Foreign investors are active in the U.S. commercial real estate market. Marc Baillie of Macquarie Bank Limited showed the sources of foreign investment (see chart).

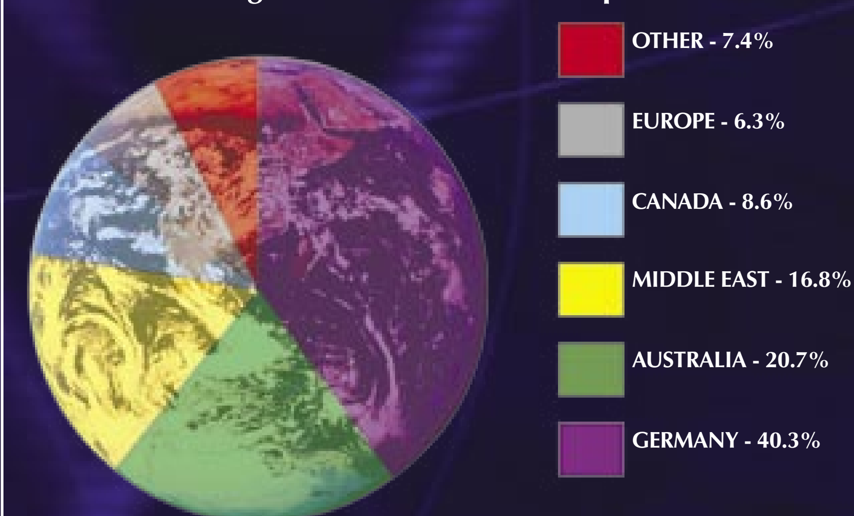
Global Investors Like America

Higher returns have attracted global investors to the United States. Returns in Europe are much lower. Apartments in Germany are being privatized and sold, providing a yield of around 3 percent. The German apartment cap rate is about 3 percent.

Australia has changed its "super annuation" policies, which allocate 9 percent of salary to the employee's pension fund. These funds are going to private accounts. The large amount of money flowing into super annuity programs has prompted them to look to the United States for conservative real estate investments. Australia typically buys with 50 percent leverage in U.S. dollars, so half the deal is hedged against the currency volatility. They may hedge the currency as well. Australians also invest in Singapore, Korea and Japan.

Muhannad Abulhasan, executive director of Arcapita — an investment bank in Bahrain — represents Middle Eastern investors. He stated that 90 percent of Middle East real estate investment is allocated to dollar-based investments because

Foreign Investment in U.S. Properties



Source: Macquarie Bank

their revenue comes from oil priced in dollars. Over time, these investors are likely to reduce their U.S. allocation and spread money into Europe and Asia.

Middle Eastern investors do not have an income tax, so they are not interested in tax benefits, just the fundamentals of the deals. Middle East investing is focused on industrial space, apartments, assisted living facilities and now residential development.

No Where to Go But Up

"The apartment sector has bottomed," says Richard Campo, CEO of Camden Property Trust. After three years of declining net operating income (NOI), 2005 should show positive NOI growth between 1 and 3 percent. The strongest markets are on the coasts and in Las Vegas.

Las Vegas has a negative supply because many apartments have been converted to condominiums. Also, house prices have risen so rapidly that they are less affordable, and apartments are in higher demand. The baby-boom echo generation should be good source of demand over the next three to five years.

Tim Callahan, CEO of Trizec Properties, stated, "The office market should feel better, but it doesn't yet." But he feels that the sector has turned a corner. Overall vacancies are finally starting to decline. Absorption was tremendous in 2004, especially in the fourth quarter. New construction has fallen by 75 percent from 2000 and may fall further in 2005. Rents have finally stopped falling, yet vacancy still hovers at 16 to 17 percent nationally.

Ten to 20 percent of buildings are rented at rates higher than today's market rents. NOI growth should be good in 2007–08; 2005 and 2006 will still see NOI flat or falling.

Tenants have leverage in the market, and 2009 may be the year 90 percent occupancy is achieved and rents start to rise again. Cap rates have fallen substantially in the past year. There is still pressure on cap rates, even on riskier properties. Premiums for office properties are definitely a lower risk.

Good Year for Hotels

Lawrence Geller, CEO for Strategic Hotel Capital, stated that terrorism, the SARS outbreaks and a slack economy combined to create a "perfect storm" for hotels after 2000. High-end hotels have been the first to come back. The strongest market is on the east coast, which is recovering fast.

Occupancy growth has led to room rate growth. Supply growth is pretty slow and likely to grow 1 percent next year. Some supply is taken up by condo converters. With GDP up and travel on the upswing, 2005 should be good year for hotels.

Perceptions of Investor Risk

Members of the pension fund industry identified key risks they perceive to be influencing commercial real estate owners in today's market.

Short-term risks include:

- terrorism in the United States,
- the potential for the huge fiscal and trade deficit to come home to roost,
- possibility of cap rates rising,
- concern over sustaining current property values and
- impact of rising interest rates on property values.

Long-term trends that might impact real estate investors include:

- loss of U.S. global dominance in the economy;
- increased long-term reinvestment opportunities in China, India and elsewhere;
- terrorism;
- global diversification of real estate purchased by large pension funds; and
- currency exchange risks resulting from investment in foreign real estate.

The fundamentals of U.S. commercial real estate appear to be improving. Vacancy rates are starting to decline, and rental rates are likely to increase over the next several years. Despite this optimistic scenario, anxiety persists.

Will the high U.S. trade deficit lead to higher interest rates? Will high oil prices lead to more inflation and higher interest rates? What will happen to commercial property values when interest rates start to rise significantly? Are real estate investors vulnerable to shocks in the economy from a domestic terrorist attack?

The U.S. economy is still the dominant driver in the world economy, but growth is most likely to occur in other countries, specifically China and India. Will this have a positive or negative impact on U.S. real estate demand?

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Overall the pension fund industry still is heavily focused on investing in commercial real estate inside the United States, where political stability and rule of law create a predictable investment climate. Most have 75 to 95 percent of their real estate dollars invested in the United States. While most suggested they would increase their Asian holdings over the next ten years, they predicted that by 2015 they would still have between 60 and 90 percent of their real estate portfolios invested in American properties.

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