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## Market Overview: Commercial Real Estate

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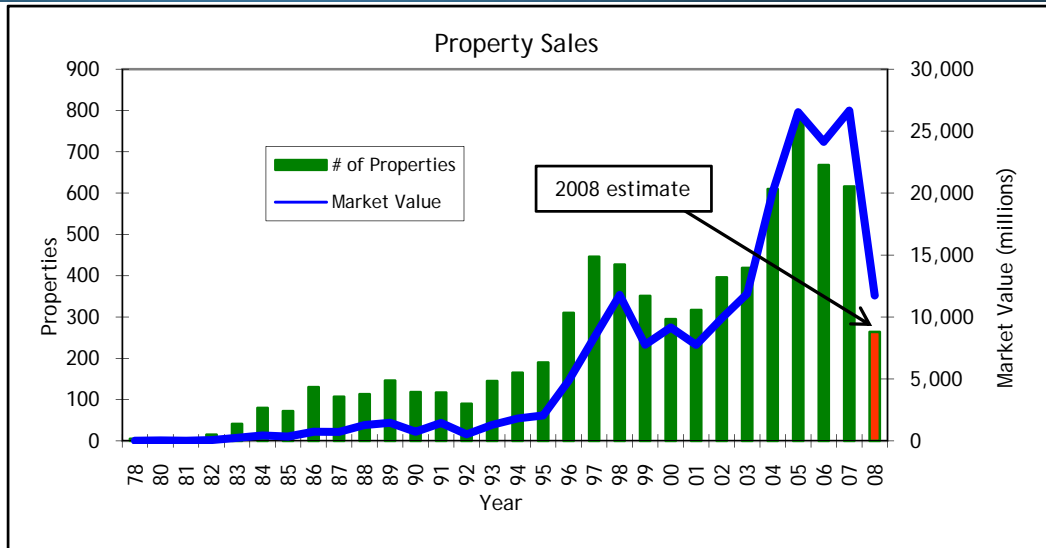
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# Current Market Environment - Commercial Real Estate



Source: NCREIF

Rent & Vacancy Forecasts

Sector	Current Vacancy	2007		2008 Forecast		2009 Forecast	
		Year-end Vacancy	Annual Rent Growth	Year-end Vacancy	Annual Rent Growth	Year-end Vacancy	Annual Rent Growth
Apartment	5.9	5.7	4.7	6.2	3.4	6.5	3.3
Hotel	36.4	32.6	6.7	33.9	-0.4	33.7	1.0
Industrial	9.8	9.4	3.6	10.3	1.8	10.7	2.0
Office	12.9	12.5	9.8	14.7	1.8	15.8	-0.5
Retail	7.7	7.5	2.5	8.3	1.1	8.4	1.9

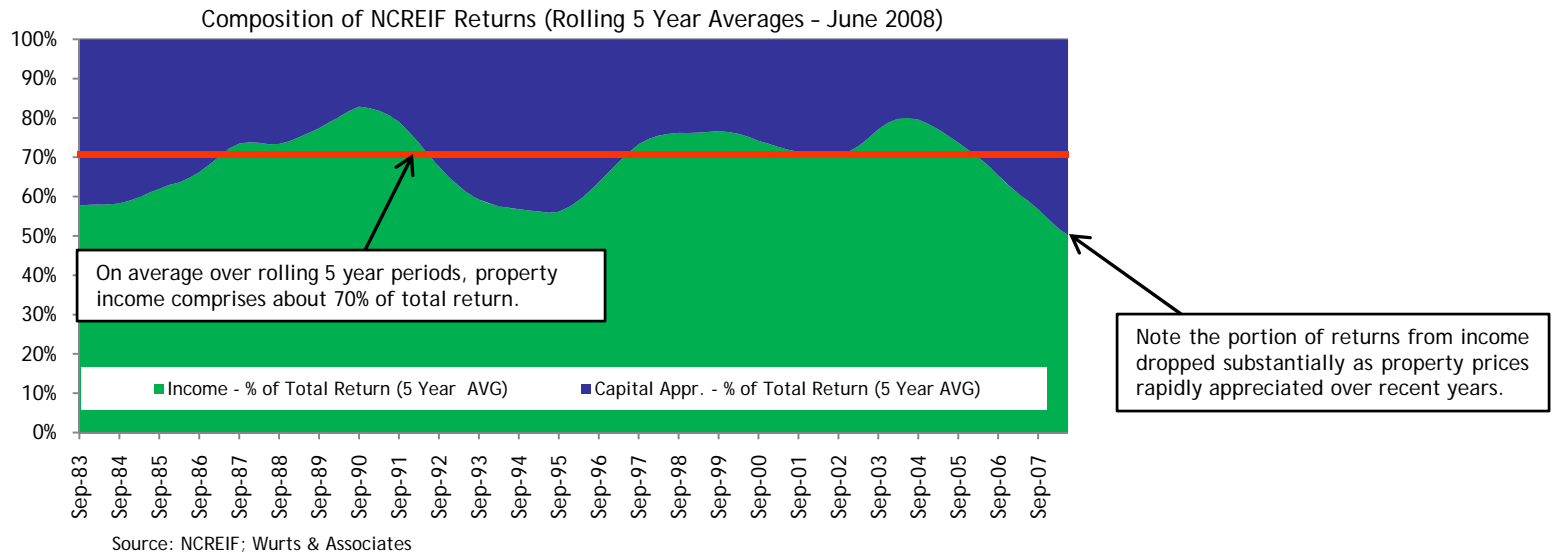
Source: UBS

## Key aspects of current market environment:

- Credit woes are both increasing the cost of financing and reducing the supply of capital for real estate purchases.
- This is resulting in less money chasing commercial real estate, lowering prospective price appreciation.
- Slowing consumer spending is weakening activity in the hotel and retail sectors.
- Industrials are finding some insulation through the increase in US export activity as the dollar weakens.
- Office properties are also becoming affected by the economic slowdown.
- Conversely though, apartment properties are expected to be somewhat resilient as credit issues are lowering the home ownership rate, thereby pushing more people into apartments.
- Overall vacancy rates are expected to increase near term, but not dramatically.
- As property prices decline, capitalization rates will increase, raising expectations for return from income.
- Generally speaking the commercial real estate market still presents a reasonable opportunity to diversify relative to public market exposures.



# Composition of Real Estate Returns



Composition of NCREIF Returns Over Time (as of June 2008)

	Income Return	Capital Appreciation Return	Total Return
Annualized Return (Since Mar-78)	7.8	2.3	10.2
% of Total Return	76%	22%	100%
Standard Deviation of 1 Year Returns	0.93	5.94	6.29

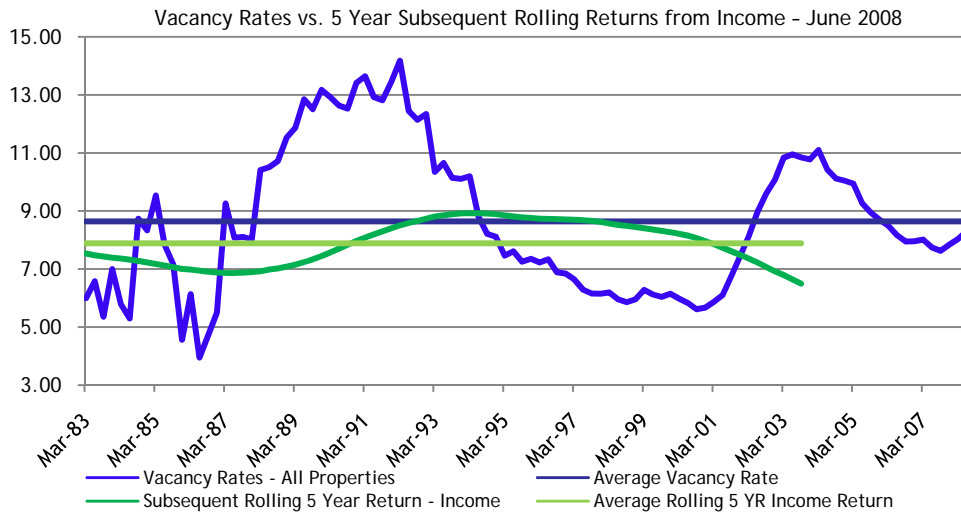
Source: NCREIF; Wurts & Associates

Note the sizeable difference in return volatility between income and capital appreciation.

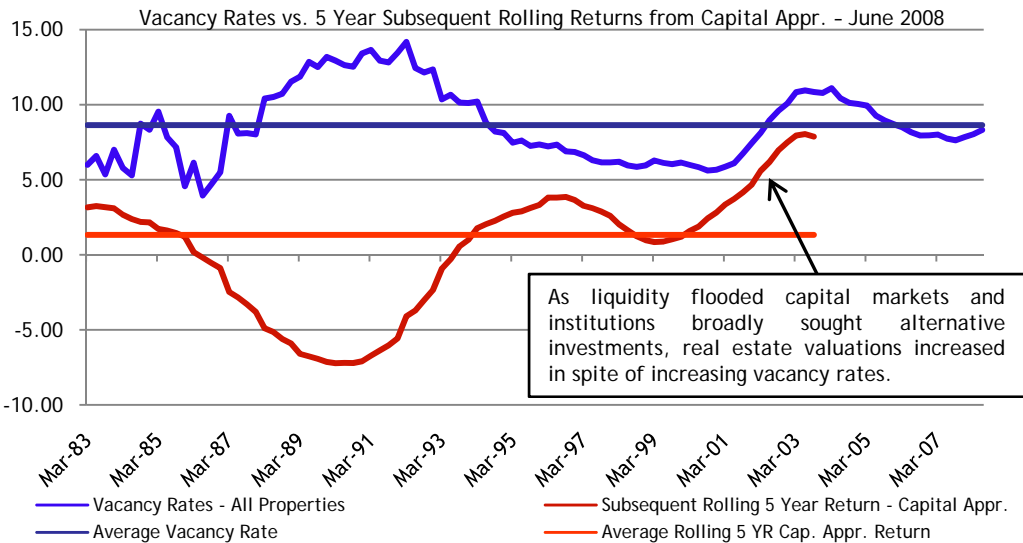
- It is important to note that that not only does income comprise the majority of real estate returns, it is not very volatile in nature.
- Returns from capital appreciation are about six times as volatile as those from income, but comprise a modest portion of total returns.
- Conclusion: Real estate investors should mostly be concerned with factors affecting prospective income as this will comprise the bulk of returns.
- Capitalization rates for property sales have been shown to have a strong relationship with prospective income returns; see following pages.



# Vacancy Rates & Prospective Returns



Source: NCREIF; Wurts & Associates



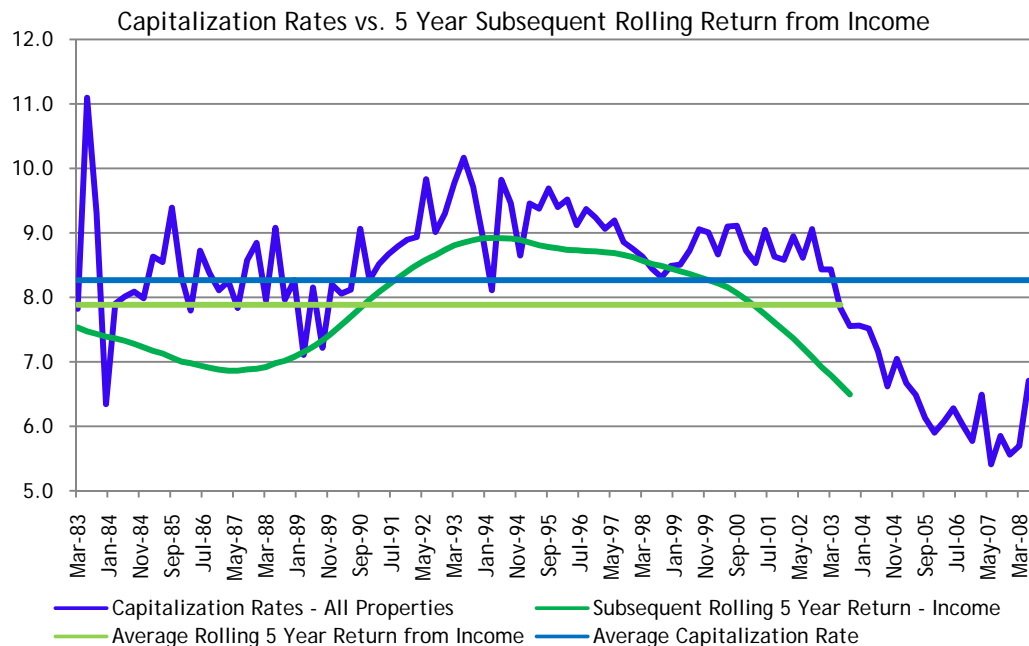
Source: NCREIF; Wurts & Associates

- An examination of historic returns for the NCREIF index generally reveals the expected theoretical relationships between vacancy rates and expected return.
  - A vacancy rates rise, prices go down as a result.
  - As prices go down, the percent of income derived from properties increases; or the capitalization rate goes up.
- Over the last five years through June 2008, capital appreciation has been 7.8%, annualized, which is well above the average rolling 5 year return of 1.3% and a result of tremendous inflows into this asset class.
- With this in mind, recent property appreciation seems anomalous in nature, and is very unlikely to continue at this pace.
- Investors should not reasonably expect this trend to continue over the short or long term.
- However, as prices decline, we expect upward pressure on prospective returns from income.



# Capitalization Rates & Prospective Return

- The strongest predictive relationship we can find in real estate markets is between the capitalization rate at which properties are sold and the subsequent return from the income those properties generate.
- As the chart illustrates below, there is a clear relationship between these two factors. Historically it appears that prospective return from income over five years lags the capitalization rate by about 0.30%
- With credit conditions reducing the flow of capital into real estate, we expect downward pressure on prices, causing capitalization rates to increase in the near term.
- As of June 30, 2008, capitalization rates stand at 6.7%. Therefore we would expect the subsequent return from income to be around 6%, annualized, over the next five years.
- On the other hand, as capitalization rates rise property values must fall. However, returns from capital appreciation have accounted for well less than one third of total returns from real estate.



Source: NCREIF; Wurts & Associates



# Summary & Conclusions

## Strategic Outlook

- The overall market for commercial real estate should slow from recent levels primarily due to diminished access to credit and higher costs of financing.
- While this bodes poorly for capital appreciation, it does not necessarily portend large capital losses. One must keep in mind there remains a very strong interest amongst institutional investors for real estate investments .
- Furthermore, although vacancy rates are rising, it is not estimated these rates will spike tremendously in the near term. In fact, vacancy rates from apartments should hold relatively steady as credit woes are decreasing the rate of home ownership. Industrial properties are benefiting from the weak US dollar as exports rise.
- Returns from income should increase as capitalization rates rise and values modestly decline. Since returns from income comprise the majority of total real estate returns, this is where investors should focus their attention.
- We would expect returns from income to be at least 6% annualized from this point going forward. Returns from capital appreciation should be well below recent periods, and probably more in line with the historic average of low single digits in coming years.
- Prospectively we believe mid to high single digit returns for the next 5-10 years seems a reasonable expectation for commercial real estate. This is in line with equity expectations, and well above returns for Treasuries which are currently yielding around 4% (10 YR).

## Market Timing Issues

- Though it may seem intuitively appealing to engage in market timing in real estate due to potential price declines in property values, such a practice will likely provide little benefit even if successful. This is because capital appreciation comprises such a small portion of total returns.
- To illustrate, consider market timing in the context of a 5% total allocation to real estate.
  - Returns from income should comprise at least 70% of returns, affecting 3.5% of the total allocation.
  - Returns from appreciation should comprise about 30% of returns, affecting only 1.5% of the total allocation. Therefore even if successful, market timing should yield minimal benefit to the total portfolio.
- Therefore, we do not recommend marketing timing (or not implementing allocations) due to current market conditions. Over a ten year time horizon, we remain confident commercial real estate offers a reasonable risk/reward trade off.

