2005 Real Estate Investor Outlook

A SPECIAL RESEARCH REPORT

Still Bullish

Exclusive survey shows investors plan to boost their total allocation to commercial real estate by a median 17% over the next 12 months.

In the eyes of investors, commercial real estate remains highly attractive despite some obvious signs of stress in occupancies and rents. During the first half of 2004, sales among apartment, industrial, office and retail properties totaled $71 billion — a 32% increase over the same period in 2003, according to Marcus & Millichap Research Services.

If that pace continues, the volume of property transactions for the year will easily surpass the $124 billion in properties that traded hands in 2003 and reach more than $163 billion.

The money is pouring in from a variety of sources — private investors, institutions and international sources. "I believe it will be another record-breaking year in terms of transactions and capital invested," predicts Harvey Green, president and CEO of Encino, Calif.-based Marcus & Millichap.

Commercial real estate remains in high demand despite uncertainties related to the slow economic recovery, the upcoming presidential election and turmoil in the Middle East. "Those variables are actually encouraging the flow of capital into real estate," Green says.

Survey Methodology

The annual Real Estate Investor Outlook was conducted by *National Real Estate Investor* and Marcus & Millichap Real Estate Investment Brokerage Co., which sponsored this special supplement. Data was collected in the third quarter of 2004.Questionnaires were mailed to a list of *NREI* investment subscribers and Marcus & Millichap's private and institutional clients. A total of 648 surveys were tabulated.

The purpose of the survey was to gain insight into the current holdings of commercial real estate investors and gauge their prognosis for the office,industrial, retail and multifamily sectors over the next year. Additionally, the survey measured respondents' views on a host of timely topics, ranging from the state of the economy to interest rates to the impact of the 2004 U.S. presidential election on the commercial real estate industry.

NREI provides in-depth analysis of trends in commercial real estate with an emphasis on investment activity. Readers include owners/developers/managers, brokers,finance and investment professionals, as well as corporate real estate executives. This special report also appears in each of the following publications within Primedia's Financial Services Group: *Registered Rep*, *Trusts & Estates* and *Retail Traffic*.

The nation's largest firm specializing in real estate investment, Marcus & Millichap closed $10.3 billion of investment transactions for private and institutional investors in 2003. The company has more than 850 brokers nationwide, the largest sales team in the industry.

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Investors perceive U.S. real estate as a safe haven for investment dollars, even though landlords in many markets are still waiting for fundamentals at the property level to improve. Double-digit vacancies remain stubbornly persistent in many of the nation's leading office markets, for example.

While steady consumer spending has continued to fuel the appetite for retail space, the office, industrial and apartment markets are dependent on job growth to spark demand and fill vacancies.

So far, such job gains have been slow to materialize. In fact, employment has grown more slowly in the past three years, economists point out, than during any previous economic recovery in the last 50 years. After a dip in employment growth in June and July, when a total of 110,000 jobs were added, the pace of growth accelerated in August with the creation of 144,000 jobs, according to the Department of Labor.

To better gauge investor attitudes, *National Real Estate Investor* and Marcus & Millichap Real Estate Investment Brokerage Co. jointly conducted an exclusive real estate investment survey from July 2 to Aug. 6. About two-thirds of the 648 survey respondents are private investors.

Of the respondents, 70% have invested in commercial real estate for more than 10 years, and 46% report total holdings valued at $10 million or more. Respondents are most likely to be invested in apartments [Figures 1-3].

Among the study's major findings:

• Nearly three-fourths (74%) of respondents plan to boost their investment in commercial real estate over the next 12 months by a median 17%, compared with 12.9% in last year's survey.

• Investors are most likely to expect the apartment sector to experience improvement over the next 12 months. About half of respondents (51%) expect apartment rents to rise.

FIGURE 1. **SLIGHTLY MORE THAN TWO-THIRDS OF SURVEY RESPONDENTS ARE PRIVATE INVESTORS**

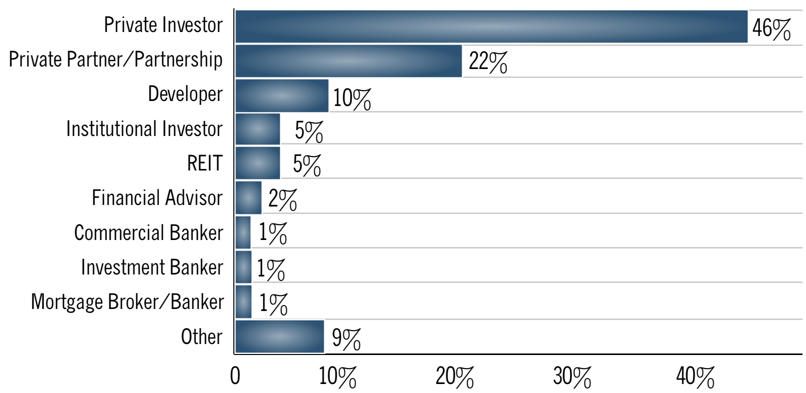
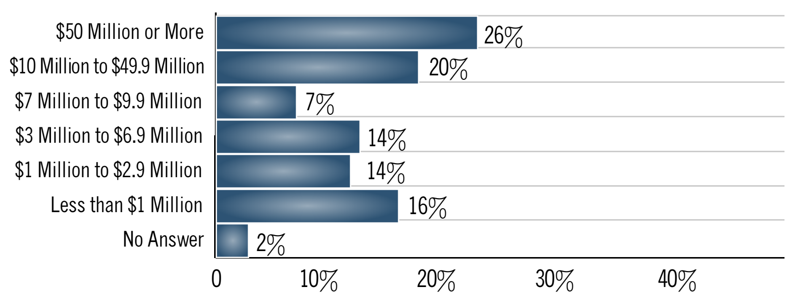


FIGURE 2. **NEARLY HALF OF RESPONDENTS HAVE MORE THAN $10 MILLION INVESTED IN COMMERCIAL REAL ESTATE**



Additionally, 40% of respondents predict apartment property values to rise.

• A clear majority of respondents believe a victory by George W. Bush in the upcoming presidential election will more favorably impact the commercial real estate industry than a win by John Kerry. Specifically, 75% of respondents believe a win for the Republican incumbent will have a more favorable effect on the tax climate for commercial real estate.

• Investors most frequently cite unforeseen shocks to the economy as their top concern (62%), compared with 37% a year ago. The second most frequently cited concern on this year's survey is the availability and cost of insurance (43%), up from 33% a year ago.

• The vast majority of respondents (93%) expect mortgage rates to be higher 12 months from now, compared with 44% in last year's survey. Additionally, more than one in four (28%) anticipate debt financing will be more difficult to obtain, up from 14% a year ago.

• Nearly half of investors (46%) plan to increase their use of the 1031 tax-deferred option over the next five years. Respondents also indicate that they expect private partnerships to be bigger players in 1031 exchanges over the next five years.

• More than half of respondents (54%) plan to acquire properties specifically for redevelopment, renovation or expansion, up from 44% last year.

"What is surprising is the level of optimism among respondents,particularly at a point when pricing is at an all-time high and property fundamentals have not improved all that much," says Hessam Nadji, managing director of research services at Marcus & Millichap. One explanation is that a dearth of alternative investments is driving capital to real estate at a feverish pace, Nadji says.

Although strong consumer spending has buoyed the retail sector, the office, industrial and apartment markets have all struggled with increased vacancies and flat or discounted rents. "What that tells me is that the forces that have made real estate perform the way it has in the last three years are very much alive and very much of a factor going forward, but the market will have to adjust to a capital shift at some point," says Nadji.

What follows is analysis of some of the study's key findings:

FIGURE 3. **MORE THAN HALF OF RESPONDENTS ARE INVESTED IN APARTMENTS**

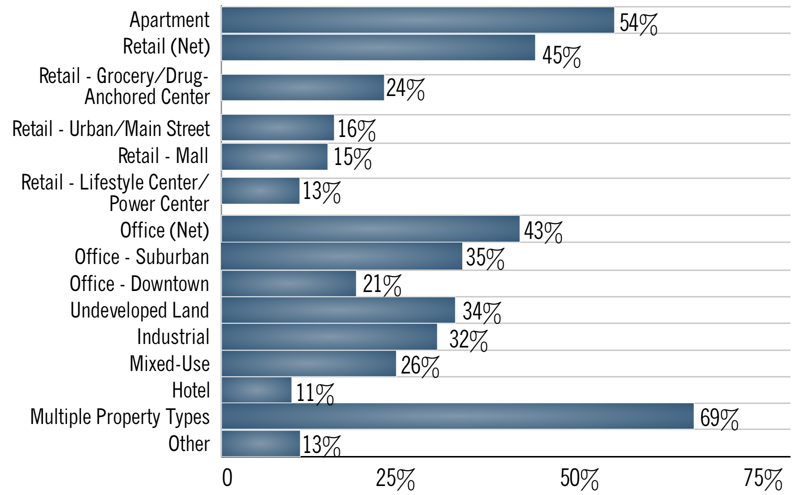
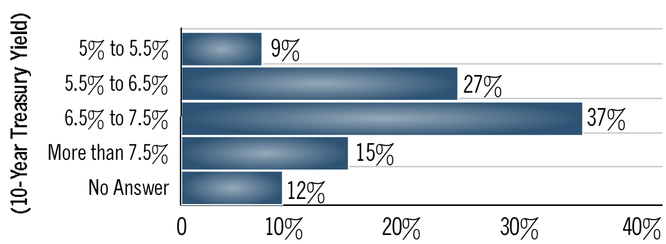


FIGURE 4. **MOST RESPONDENTS SAY INVESTMENT ACTIVITY WOULD BE NEGATIVELY AFFECTED IF THE 10-YEAR TREASURY YIELD EXCEEDS 6.5%**



All Eyes Are on Interest Rates

Investors are much more optimistic about the future direction of the economy than at this time last year. Nearly two-thirds (63%) of respondents to this year's survey expect the economy to be stronger a year from now, compared with 37% who felt that way a year ago. One reason is that the job-growth figures, while falling short of expectations, are showing positive momentum.

The big question is how high and how quickly interest rates will climb. As of mid-September, the 10-year Treasury yield registered 4.2%. "If rates go up 100 to 150 basis points in the next 12 months, and it occurs in a relatively orderly fashion, I don't think it will create any major disruption in the marketplace," Nadji says.

Thirty-seven percent of respondents believe that the 10-year Treasury yield would need to rise to a range between 6.5% and 7.5% before it would have an adverse effect on the commercial real estate market [Figure 4].

A modest jump in interest rates would bring welcome relief to some investors, experts say. For example, higher interest rates would help to stem the boom in single-family home sales, and in turn drive more demand for apartment units. Higher mortgage rates also would curb escalating prices and heightened competition among real estate buyers. In some cases, upwards of 20 bidders are chasing the same property.

"It's clear that the continued ability to borrow at interest rates lower than cap rates [the initial yield to the buyer based on the purchase price] continues to drive purchase prices," says Steve McCarthy, managing director of Atlanta-based WestWind Capital Partners, a privately held real estate investment advisory firm.

"As interest rates rise, it will likely curtail investment momentum. It won't happen immediately, but there will be some softening in prices, even for core properties," says McCarthy.

Despite a high degree of optimism about the U.S. economy, investors still have concerns. Aside from unforeseen shocks to the economy and the availability and cost of insurance, what keeps them up at night? High vacancy rates rank third on the list of concerns

(39%), followed by the slow pace of rent growth, (37%), and creditworthiness of tenants (30%) [Figure 5].

Office Buyers See Opportunity

With the office vacancy rate above 16.5% nationally, effective rents have dropped by nearly 20% since the first quarter of 2001, to an average of $20.12 per sq. ft., according to data researcher Reis Inc.

Although most investors agree that both effective rents and property values are likely to stay the same or increase over the next year, a sizable minority appears skeptical of the stability in this sector. Twenty-one percent of investors in downtown office properties expect the value of those properties to decrease over the next 12 months. By comparison, 16% of investors in suburban office properties believe valuations will fall [Figure 6].

The office sector typically lags job recovery. Another obstacle is that many leases were signed in 2000 and 2001 when rents were peaking. As those five-year leases roll over in the next couple of years, rates on the new leases will drop significantly to meet current market rents.

"That actually poses a big challenge for investors at a time when prices have continued to rise, but yet you have this looming air pocket in terms of office cash flow," says Green of Marcus & Millichap.

Yet some investors are taking advantage of high sale prices to sell apartment and retail properties and are seeking more opportunistic buys in the office sector. Apartment cap rates in some markets are as low as 4.5% to 5%, while prime retail neighborhood shopping centers have cap rates ranging from 6% to 7%, Nadji notes.

"When you have that type of cap-rate compression, because prices are so high, we're seeing some investors take profit and then re-invest their capital in office properties at more of an 8% to 9% cap rate," he says.

FIGURE 5. A MAJORITY OF RESPONDENTS CITE UNFORESEEN SHOCKS TO THE ECONOMY AS THEIR GREATEST CONCERN

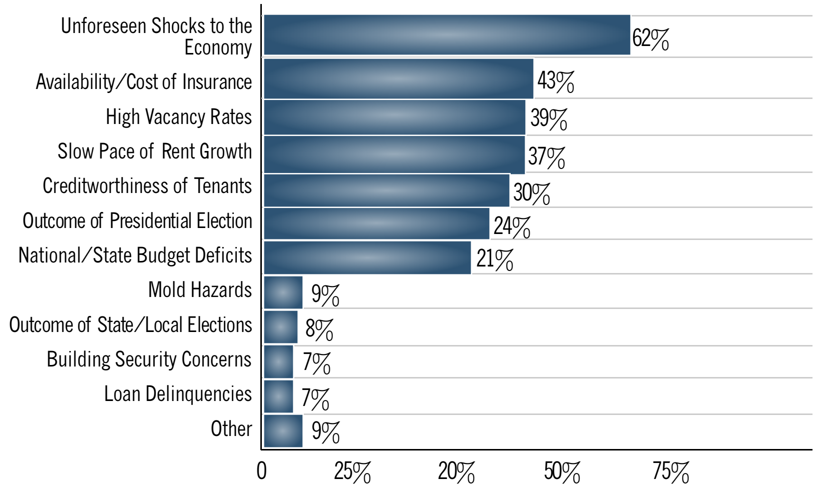
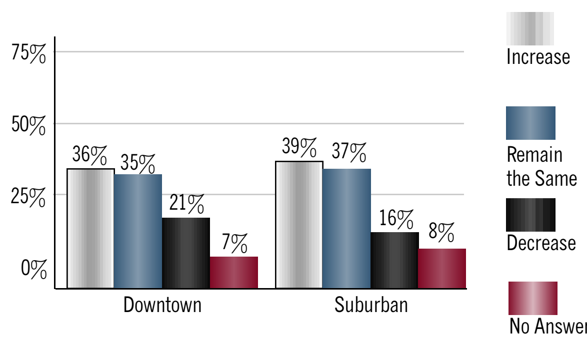


FIGURE 6. ABOUT 20% OF INVESTORS IN DOWNTOWN OFFICE BUILDINGS EXPECT PROPERTY VALUES TO DECREASE OVER THE NEXT 12 MONTHS



Office investors are showing a bit more confidence in the near-term health of suburban properties than urban ones. Among respondents invested in office properties, 15% expect a decline in downtown effective rents, compared with 9% that predict a decline in suburban office rents.

"Our view at this juncture is that we want to be extremely opportunistic," says Mitchell Hersh, president and CEO of Mack-Cali Realty Corp. based in Cranford,N.J.

For example, Mack-Cali purchased a 317,000 sq. ft. building in Parsippany, N.J., for $34 million, or roughly $107 per sq. ft. in April that has a high-quality, investment-grade tenant with a lease that terminates in about two years.

"We will be repositioning that building in a vastly improving economy, and we will see a significant return on investment while that's all happening," he says. The real estate investment trust (REIT) owns and manages roughly 30 million sq. ft. of Class-A office space.

Apartment Investors Undaunted

The multifamily sector has been hard hit by an unprecedented home-buying spree coupled with job losses. Compounding matters is new construction, which has only added to the rising vacancy rate and proliferation of rent discounts and concessions. Apartment vacancies have climbed from 4.7% at the end of 2001 to 6.8% at mid-year, according to Reis.

Yet apartments remain the favored property type among investors, with 29% of respondents who are not currently invested in apartments indicating that they would like to invest in multifamily.

One reason that investors are partial toward apartments is that they believe the apartment sector is poised for recovery. Two-thirds of respondents who are currently invested in apartment properties predict an increase in effective rents over the next 12 months [Figure 7], while 48% expect property values to rise in the next 12 months.

"If not at a bottom, then the industry is within one quarter of reaching bottom," says David Levin, executive vice president of acquisitions for the Chicago-based Laramar Group. The company owns approximately 13,000 apartment units around the country. "Our portfolio is starting to see improvement on both the income side and occupancy side," he says.

The apartment market posted positive absorption of 37,500 units during the second quarter, which helped to lift average rents by 0.7%, according to Reis.

Laramar has taken advantage of market conditions to sell some of its apartment holdings. But after a year-long hiatus on the buying side, Laramar is shifting back into acquisition mode with two strategies. One is to target investment opportunities in recovering markets such as Atlanta, Austin and Denver. The second is to focus on core markets with barriers to new construction, such as Chicago and Washington, D.C.

"Now we are starting to see opportunity, so we will be playing both sides of the fence — looking to acquire property while also continuing to sell off some assets," Levin says.

Optimism that the apartment market is headed for an upswing is fueling buying activity. "What we're really excited about is that we're seeing certain multifamily markets around the country that have been under-performing over the last three to four years, such as Atlanta, Austin, Charlotte, Raleigh and Denver, that we believe are poised for a comeback in the next 12 to 18 months," says Marc Goldstein, a principal at Creekstone Partners LLC in Houston.

Creekstone plans to purchase roughly $500 million in Class-A apartment properties in 2004. Currently, Creekstone is buying new Class-A multifamily properties at about 5% to 15% below construction costs. "We believe we are coming into this next wave in the multifamily sector at a distinct advantage," Goldstein says.

FIGURE 7. A MAJORITY OF APARTMENT INVESTORS EXPECT EFFECTIVE RENTS TO INCREASE OVER THE NEXT YEAR

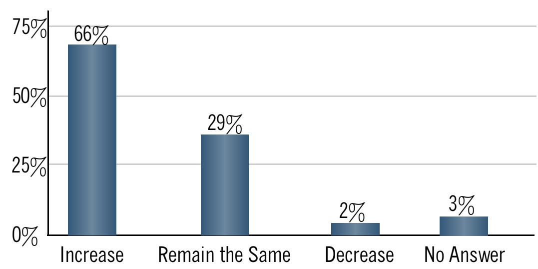
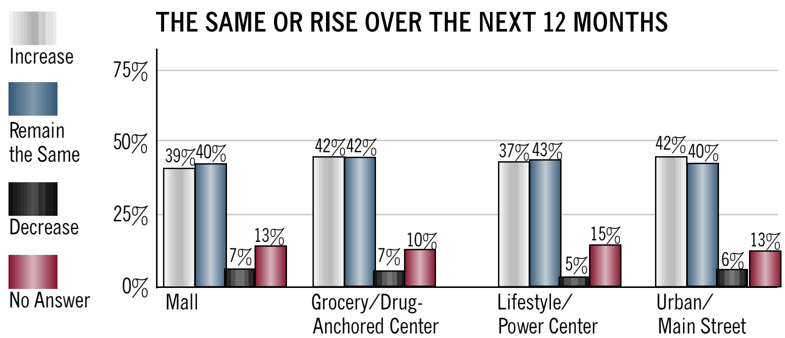


FIGURE 8. THE VAST MAJORITY OF INVESTORS EXPECT RETAIL EFFECTIVE RENTS TO STAY THE SAME OR RISE OVER THE NEXT 12 MONTHS



A Crowded Retail Market

Shopping centers continue to be immensely popular with investors. For each specific property type (mall, grocery-anchored center, lifestyle/power center and urban main street), at least 79% of investors in that retail niche expect effective rents to increase or remain stable [Figure 8].

The resilience demonstrated by the retail sector during the recent economic downturn that hit many other property types so hard has only enhanced retail's reputation. For example, the vacancy rate for neighborhood and community centers has fluctuated only slightly between 6.9% and 7.1% for nine consecutive quarters, according to Reis.

"We are still a spending society. It's hard to imagine, but even though we are over-retailed in some markets, occupancies are up," says Bob Parks, CEO and chairman of Oak Brook, Ill.-based Inland Real Estate Investment Corp.

The stability of the retail sector has created intense demand for properties. "We are still very much in the acquisition mode," says Lonnie Mimms, CFO of Mimms Enterprises in Roswell, Ga. Mimms owns about 7.5 million sq. ft. of retail property in Atlanta and Ft. Myers,Fla., and the firm has about $40 million of properties under contract to purchase.

But stiff competition for deals has prompted investors such as Mimms to pursue unique opportunities. "It is tough. What we're finding are special situation deals," he explains.

For example, Mimms purchased the 321,000 sq. ft. Perimeter Square in Athens, Ga., for $8.35 million in April. The property requires significant re-tenanting due to vacancies by Wal-Mart and Food Lion. Mimms is not alone in its strategy. In fact, 62% of respondents indicate that they have plans to renovate, redevelop and/or expand properties in which they currently invest.

Perhaps the biggest challenge in the retail sector is competition to buy real estate. In some cases, a score of bidders representing everyone from individual 1031 exchange buyers to public REITs is chasing the deals.

As a result, Class-A retail properties are selling at cap rates in the range of 6.5% to 7%, and in extreme cases cap rates in California have even dipped below 6%. "We are hoping that cap rates are at the bottom," Parks says, "but our fear is that they will drop a little lower."

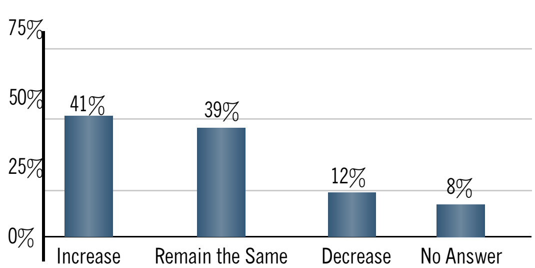
Industrial Market on the Mend

The conventional wisdom is that the industrial market will improve, or at least hold its own, over the next 12 months. Among respondents currently invested in industrial properties, 48% expect effective rents to increase and 41% expect rents to remain the same over the next 12 months.

At the same time, 41% of respondents expect industrial property values to increase, while 39% anticipate values to remain the same over the next year [Figure 9].

The national industrial vacancy rate peaked at 11% last year, according to Marcus & Millichap, and should decline to 10.5% by the end of 2004. "The industrial market is showing signs of recovery because space demand in this sector is closely tied to economic activity, which has been picking up steadily for the past year," says Green of Marcus & Millichap.

FIGURE 9. A MAJORITY OF RESPONDENTS EXPECT INDUSTRIAL PROPERTY VALUES TO RISE OR REMAIN THE SAME OVER THE NEXT 12 MONTHS



The warehouse and distribution sector is improving rapidly due in large part to a healthy retail market propelled by strong consumer spending and signs of recovery in the business sector, Green notes.

In addition, the just-in-time inventory and distribution revolution is translating to consolidation of warehouse centers in strategic hub-and-spoke markets as tenants seek more efficient delivery systems. That shift also is creating a demand for new, larger facilities. Approximately 65% of new projects are 250,000 sq. ft. or larger, Green adds.

Whether investors are looking for opportunistic buys in a recovering market or simply trying to add balance to their portfolio, industrial facilities — particularly warehouse and distribution properties — are in demand. That demand is putting pressure on prices and cap rates.

Industrial net-lease properties in California's Inland Empire, for example, are selling for cap rates of 7%, notes James Clark,managing principal of investment services at EnTrust Realty Advisors, an affiliate of the Chicago-based Alter Group.

The Alter Group is currently building approximately 500,000 sq.ft. of spec industrial space in the Inland Empire. The firm already has an offer to buy the facility at a substantial profit — even though it has no tenants and it is not scheduled for completion until mid-2005. "That's an indication of the fervor of the market," says Clark.

Use of 1031 Exchanges Grows

Investors taking advantage of 1031 tax-deferred exchanges also continue to fuel buying activity. Exchange buyers defer capital gains taxes by rolling profits from a sale into another real estate investment. Forty-six percent of respondents expect their use of 1031 exchanges to increase over the next five years [Figure 10]. "I think it is going to become a more popular vehicle for investors," Nadji predicts.

One reason for the boom in the 1031 sector is that property values have risen so dramatically that many investors are looking to cash in on rising sale prices, while simultaneously diversifying their real estate holdings into different geographic areas and different property types.

Private partnerships are more likely than institutional investors to have experienced a five-year increase in their use of 1031 transactions (38% vs. 20%). Additionally, private partnerships also are more likely than institutional investors to predict an increase in their usage of 1031s in the next five years (49% vs.27%).

Owners who are aging baby boomers also are looking to unload high-maintenance properties in favor of more passive holdings, according to Green. For example, Marcus & Millichap recently helped Edward Young, an attorney and investor in West Babylon, N.Y., use a 1031 exchange when he rolled the proceeds from the $1 million sale of a 4,000 sq. ft. office building in Deer Park, N.Y., into the purchase of a $3 million Walgreens in Danbury, Conn.

Not only did the exchange enable Young to defer capital gains on a property that he had held for 20 years, but overseeing the new property requires much less time and effort. "It was a blueprint for a possible exit strategy for myself and my family," says Young, who owns roughly $10 million worth of real estate, primarily apartment properties.

At 53, Young is contemplating estate planning, and similar exchanges would be an ideal way to shift those holdings to less management-intensive real estate either for his own retirement or for his family to manage.

FIGURE 10. NEARLY HALF OF RESPONDENTS EXPECT TO UTILIZE THE 1031 EXCHANGE OPTION OVER THE NEXT FIVE YEARS

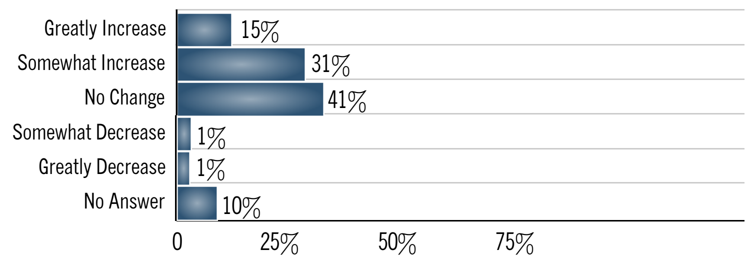
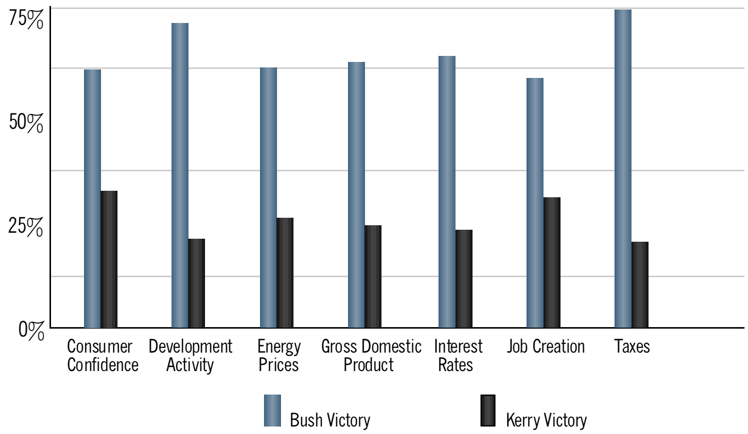


FIGURE 11. RESPONDENTS SAY A VICTORY BY GEORGE BUSH IN THE PRESIDENTIAL RACE WILL HAVE A MORE FAVORABLE IMPACT ON THE COMMERCIAL REAL ESTATE INDUSTRY



A Vote of Confidence for Bush

The outcome of the presidential election will influence the investment decisions of slightly more than one-quarter of respondents (27%). Among this group, 54% indicate that the dollars they allocate toward new development would be affected by the election results, while 52% state that real estate allocations within their investment portfolios would be affected. Institutional investors are less likely to alter investment plans than are private partnerships (17% vs. 34%), based on the outcome of the election.

Nearly three-fourths of respondents believe that a Bush victory in November would have a more favorable impact on development activity [Figure 11]. The survey results are only slightly less lopsided on the issues of job creation and consumer confidence. Some 59% of respondents indicate that a Bush victory would more favorably impact job creation. Meanwhile, 62% believe the re-election of Bush would more favorably impact consumer confidence.

Ray Torto, principal and chief strategist with Boston-based Torto Wheaton Research, believes that neither a Bush nor Kerry victory will have an adverse effect on commercial real estate. "I think they are both responsive to business needs," Torto says, "and clearly real estate is a major industry."