The Real Estate Cycle: Is the Perfect Storm Brewing?

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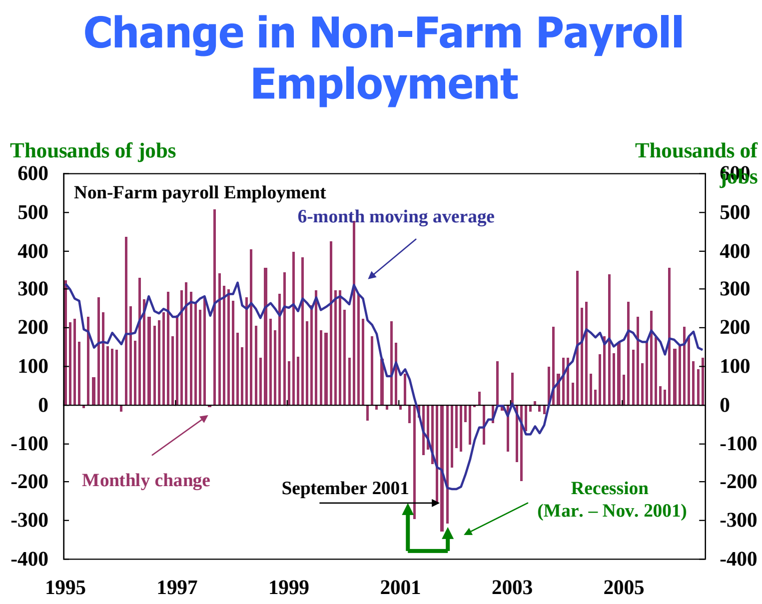
Real estate owners know where their investments are in the Real Estate Cycle, but the challenge lies in predicting movement from one phase to the next. The objective of the buyer or advisor is to maximize risk-adjusted returns. Therefore, the timing of the buy/sell decision is essential. Coupled with this decision is the risk associated with the evolution of the property through the cycle. A portion of this risk is geographic, while other drivers include the capital markets and the national economy. Integra Realty Resources recognizes four phases in the real estate cycle: recovery, expansion, hyper-supply, and recession. While the definitions of these phases are summarized on the following graphs, it is worthwhile to briefly review the composition of each phase:

- Recovery: Fundamentals of the sector are showing signs of recovery, including increasing sale or leasing volume, indices suggesting increasing demand, etc.
- Expansion: The sector is experiencing positive rent growth and the building costs and capital markets readily accommodate new construction and/or renovation.
- Hyper-supply: Usually this is the result of a marketplace where supply has generally met demand, and property that is marginal in either quality or location begins to experience softening in occupancy or rent levels.
- Recession: Oversupply has resulted in the repositioning of the market, which typically includes negative absorption and/or reduction in market rents.

Depending on their yield parameters, real estate investors choose when to buy and sell, aiming to buy low and sell high. Investors seeking high yields, sometimes termed opportunity buyers, buy at the end of the recession cycle and sell in stage two or stage three of the expansion cycle. Investors seeking less risk, sometimes termed value investors, try to ensure that the fundamentals of recovery are present and there is minimal risk in predicting some positive fundamentals in the marketplace. A value investor might purchase in stage one or two of the recovery phase and attempt to sell in stage two of the expansion phase.

Historically, the real estate investor has focused on supply and demand. However, today's investor must consider more parameters than these. The U.S. economy and the real estate market are joined at the hip. In fact, real estate investors must now examine the global economy as well as the U.S. economy. Thus, it would be naïve not to examine the trends in the economy, as well as the abundance of capital in the marketplace, when making a buy or sell decision. According to the National Bureau of Economic Research, the last recession occurred from March to November 2001. The following 10-year chart (Exhibit I) notes employment in the United States and identifies the recession, which was in part a remnant of Sept. 11, 2001.

EXHIBIT I

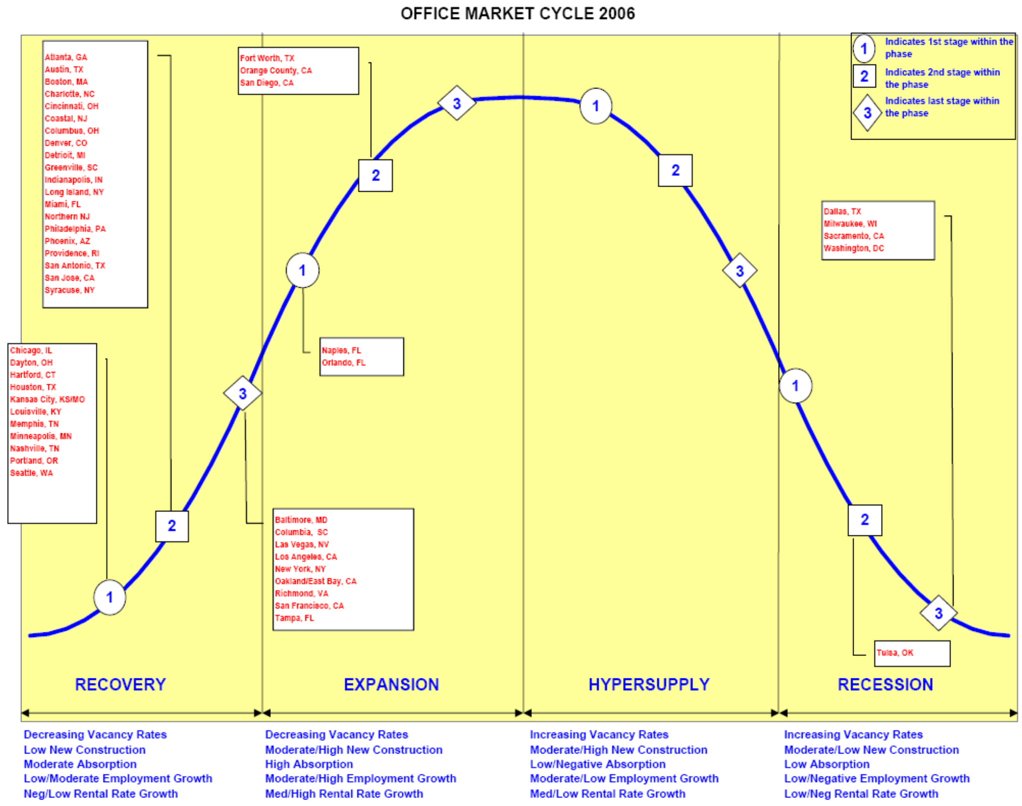


Data: NBER; Federal Reserve Bank of Kansas City
Graph: Integra Realty Resources

While the U.S. economy suffered through the recession, the U.S. real estate sector set records for investor yields and lending originations. Why did the commercial and residential real estate community flourish during a full recession? The simple answer is the abundance of capital in the marketplace. This article examines what drives the marketplace and the relationship of those drivers with related real estate “food groups,” as well as the underpinnings of what could be the perfect storm for the real estate community.

Integra estimates that the overall office market vacancy rate is approximately 14.1 percent. The cycle graph (Exhibit II) recognizes that most cities are in either the recovery phase or the expansion phase of the cycle. Despite a fundamental shift in this sector, as virtual workers and hoteling continue to reduce demand, job recovery has positioned most markets for a turnaround. Class “A” offerings generally have 10 to 15 serious buyers, with the final sale prices at record low yields and high dollars per square foot of rentable area.

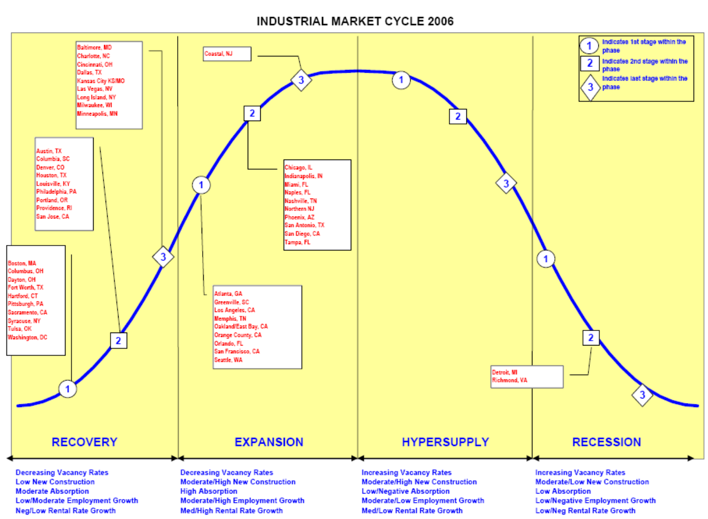
EXHIBIT II



*City data compiled using the following sources: IRR Surveys & REIS

Likewise, manufacturing and warehousing have enjoyed a robust recovery with the creation of jobs and steady growth in gross domestic product. Today's snapshot of that sector is noted in Exhibit III:

EXHIBIT III



*City data compiled using the following sources: IRR Surveys & REIS

The retail sector, the most robust sector over the past decade, continues to build new product to meet demand. Only recently have retail sales begun to soften. ICSC reports retail sales have slowed compared to fiscal year 2005. Drug stores and luxury stores are in the lead with a 6.7 percent and a 4.7 percent year-over-year increase in sales, respectively. Exhibit IV summarizes category-specific increases in average comparable store year-over-year percentage sales change for June 2006 and for the 2005 fiscal year. Exhibit V shows where specific markets are in the 2006 Retail Market Cycle.

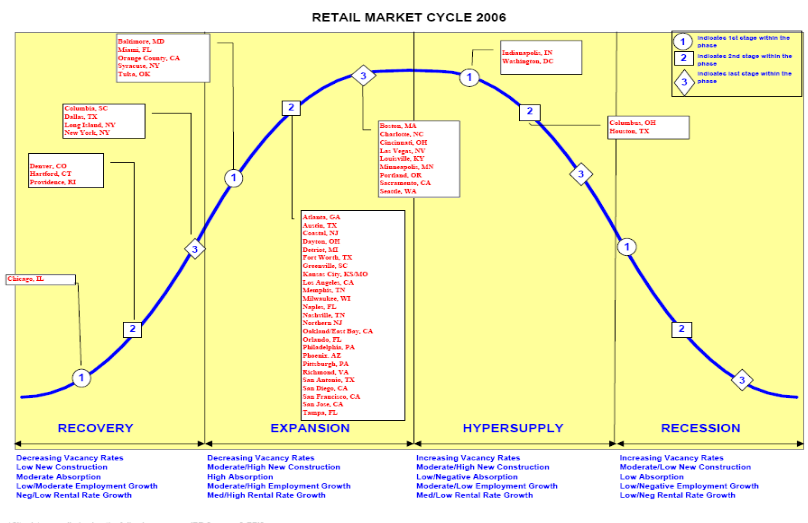
EXHIBIT IV

	June 2006 Year/Year Percentage Change	Fiscal Year 2005
Apparel Chain Stores	0.1%	1.9%
Department Stores	3.6%	2.2%
Luxury Stores	4.7%	6.2%
Discount Stores	3.2%	3.4%
Drug Stores	6.7%	5.6%
Footwear Stores	NA	4.1%
Furniture Chain Stores	-5.4%	-4.7%
Wholesale Clubs	5.6%	6.5%
Total Comparable Store Sales	3.8%	3.9%

Source: ICSC

ICSC notes that high gas prices and poor weather in the Northeast affected June retail sales, although Internet and mail-order sales increased. Consequently, many cities are now nearing the end of the expansion phase due to an excess supply of retailers in the marketplace. In fact, ICSC reports the U.S. Gross Leaseable Area (GLA) per capita is 20.44 square feet, while some markets that Integra tracks are as high as 29.86 square feet per capita.

EXHIBIT V



While an abundance of opportunities in the retail sector remain, Integra expects many will be redevelopments of existing sites, either through de-malling or razing and rebuilding. Generally, these redevelopment projects will require some form of public assistance to raise the necessary capital.

With the economy hitting on all cylinders and the "four food groups" in most cities in either the recovery or the expansion phase, one might conclude that happy days are here again. However, given the intricacies of today's real estate economy, a prudent investor must consider the relationship of all indices that affect value when making purchase or sale decisions. Moreover, understanding the changes in capital sources in the commercial real estate community is essential to understanding the relationship of capital to the industry. The following IRR chart (Exhibit VI) examines the changes in sources of capital from 1995 to 2005.

EXHIBIT VI

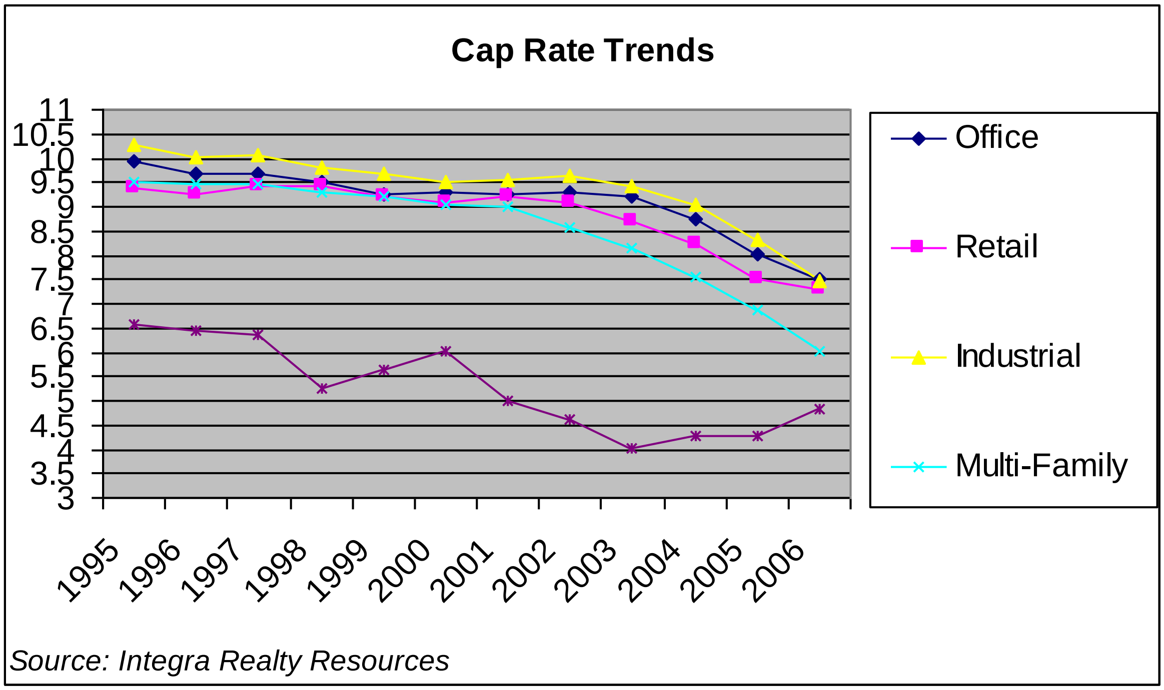
IRR Capital Flows ($ Billions)					
	1995 IRR ESTIMATES	% of Total Capital	2005 IRR ESTIMATES	% of Total Capital	% Change
Private Debt					
Life Insurance Companies (1)	$196.0	18.77%	$255.0	9.24%	30.09%
Banks & Mortgage Companies (1)	$399.7	38.28%	$855.7	31.02%	114.07%
S&Ls and Mutual Savings Banks (1)	$118.0	11.30%	$361.3	13.10%	206.27%
Pension Funds	**$21.8**	2.09%	**$42.0**	**1.52%**	**92.23%**
Subtotal	**$735.6**	70.45%	**$1,514.0**	**54.88%**	**105.83%**
Public Debt					
Government Credit Agencies	$61.2	5.86%	$73.0	2.65%	19.33%
Commercial Mortgage Securities (3)	$63.5	6.09%	$613.9	22.25%	866.08%
Mortgage REITS (2)	$3.4	0.33%	$23.4	0.85%	589.17%
Public Real Estate Partnerships	NA	NA	$0.2	0.01%	NA
Subtotal	**$128.1**	12.27%	**$710.5**	**25.76%**	**454.57%**
Total Debt	**$863.7**	82.72%	**$2,224.5**	**80.64%**	**157.56%**
Private Equity					
Pension Funds	$102.4	9.81%	$173.1	6.27%	68.92%
Foreign Investors	**$28.62**	**2.74%**	**$46.8**	**1.69%**	63.37%
Subtotal	**$131.1**	**12.55%**	**$219.8**	**7.97%**	67.71%
Public Equity					
REITs (Equity & Hybrid) (2)	$49.4	4.73%	$288.8	10.47%	485.13%
Public Real Estate Ltd. Partnerships	NA	NA	$25.6	0.93%	NA
Subtotal	**$49.4**	**4.73%**	**$314.4**	**11.40%**	**536.89%**
Total Equity	**$180.4**	**17.28%**	**$534.2**	**19.36%**	**196.06%**
Total Capital	**$1,044.1**	**100.00%**	**$2,758.7**	**100.00%**	**164.21%**

Sources: Federal Reserve, NAREIT, CMSA, Bureau of Economic Analysis, NCREIF, PriceWaterhouse Coopers, HUD, and Equitable Real Estate Investment Management

The primary change is the Commercial Mortgage Bank Securities (CMBS) industry. Ironically, this capital source evolved due to the Resolution Trust Corporation’s savings and loan crisis of 1989, and now banks typically lay off their short-term capital in the secondary CMBS marketplace. The good news is that borrowers have been able to secure highly leveraged fixed rate non-recourse real estate loans over the past few years at incredibly low rates. But have we created the perfect storm? It is important to examine what has happened to value over this period. The following chart (Exhibit VII) shows the relationship of capitalization rates to the 10-year Treasury rate.

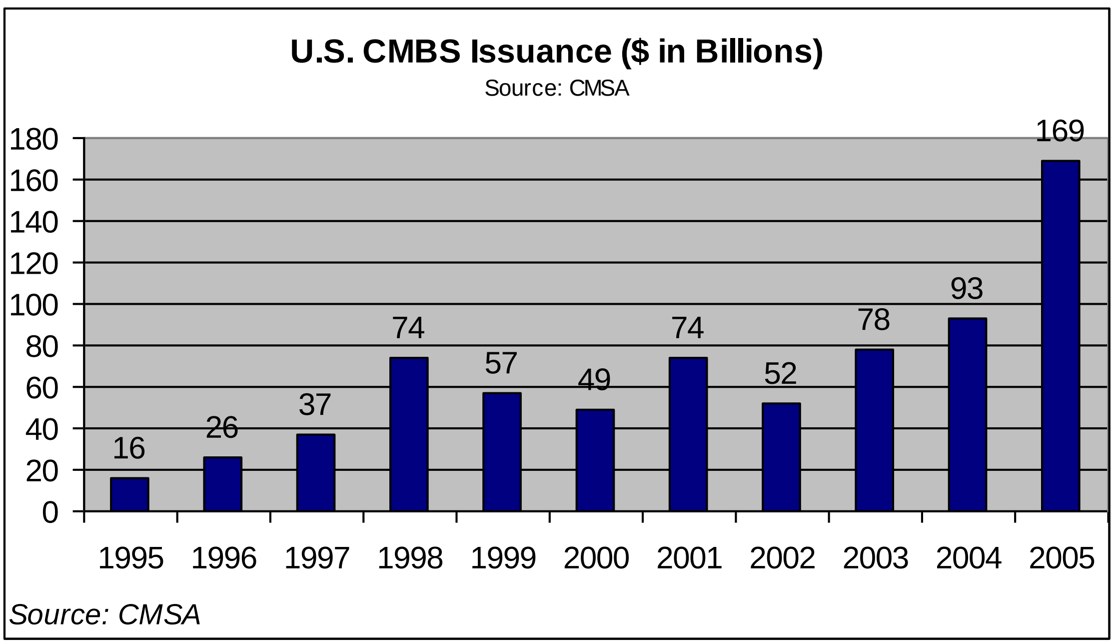
The chart clearly denotes that real estate values were the beneficiary of the accommodative interest rates, especially since Sept. 11, 2001. The CMBS market spreads over the 10-year treasury have varied, but they generally range from 100 basis points (bps) to 125 bps.

EXHIBIT VII



During this same period, the capital markets have flourished. Exhibit VIII denotes U.S. originations of CMBS. Since 1995, the capital deployed in this sector has increased from $63 billion to $613 billion.

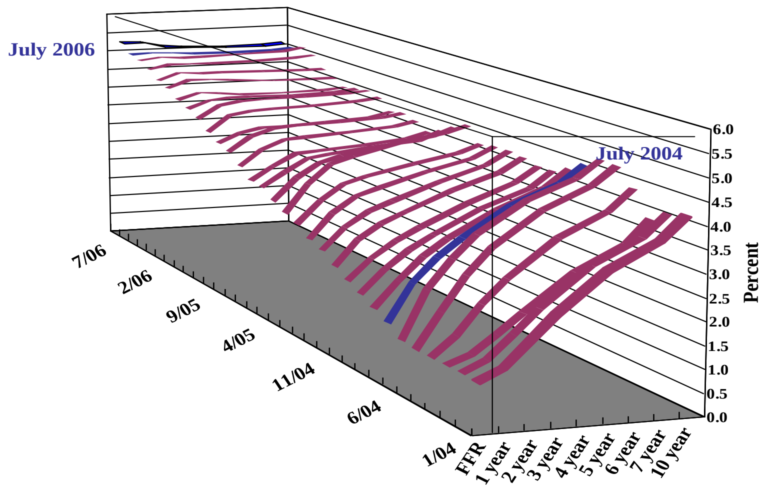
EXHIBIT VIII



Between 1998 and 2000, prior to the accommodative interest rate environment, the CMBS market originated an average of $60 billion per year. Since 2000, the average origination has been $93.2 billion per year. Again, the correlation to the accommodative interest rate is obvious. Moreover, the real estate sector has benefited from an unusual yield curve (Exhibit IX). In recent months, long-term rates have been nearly inverted, thus fueling capital flows into the CMBS bucket.

EXHIBIT IX

Changes in the Yield Curve



With the average CMBS loan roughly 68 percent of value, and banks lending between 70 and 80 percent of value, the relationship between the cost of debt and capitalization rates raises the question: How much real estate equity will erode if the 10-year Treasury rate rises to more typical spreads over the cost of short-term money? In fact, as the Federal Reserve Board reacts to inflation creep, many borrowers may get caught in what some term the “perfect storm.”

Fortunately, the capital flows table (see Exhibit VI) denotes that those loans originated in the CMBS market will benefit from their favorable financing for seven to 10 years. Developers in the construction phase of a project are in a more vulnerable segment of the capital markets as they near the end of their construction loan, which is based on old capitalization rates. These are the developers that will get caught in the perfect storm. Since capitalization rates are beginning to rise, up 25 to 50 basis points, those developers and lenders might face an exit environment where a significant portion of value has eroded due to the capitalization rate creep.

The only hope for these developers caught in the short-term squeeze is to recoup their value loss in the near term with rental growth and controlled expenses. This will only be possible in a robust economy. However, if the conflict in the Middle East worsens, and long-term housing rates continue to rise, the boundaries of the perfect storm could widen. Back of the envelope economics would suggest that for each $10-per-barrel price increase in oil, GDP growth will be negatively affected by approximately 0.4 percent.

Likewise, moderate increases in the lending rate for single-family mortgages might also affect GDP. Should these two events happen in the near term, which is not out of the question, the economy could slow substantially and probably affect rent growth. While there are no crystal balls to predict the future, decision makers in the near term certainly should consider the risks associated with our global economy, the effects on the capital markets, and how they might affect the real estate cycles.