2007 Real Estate Investor Outlook
A SPECIAL RESEARCH REPORT

Survey Methodology
The fourth 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 August and September of 2006. Questionnaires were mailed to 8,000 investors, including 4,000 investment subscribers of NREI and 4,000 private and institutional clients of Marcus & Millichap. A total of 1,042 surveys were tabulated for an effective response rate of 14.2%. The purpose of the survey was to measure respondents’ appetite for commercial real estate vs. other investment alternatives, document their views on timely industry topics, and gain insight into their real estate investment plans for the next 12 months.

Despite an unprecedented run-up in the price of real estate assets and signs that job growth is slowing, a majority of investors still plan to increase their commercial real estate holdings in 2007, according to the results of an exclusive survey conducted jointly by National Real Estate Investor and Marcus & Millichap Real Estate Investment Brokerage Co.

Among the 1,042 private and institutional investors surveyed, 60% plan to boost their investment in the commercial real estate market by an average of 19% over the next 12 months.

While that’s a clear vote of confidence in commercial real estate, the results are less bullish than in recent years. When asked last year about their investment goals for 2006, nearly 70% of respondents indicated plans to increase their investment in commercial real estate. And in 2004, nearly three-quarters of respondents (74%) expressed plans to increase their commercial real estate holdings.

So, is the bloom coming off the rose in the commercial real estate investment market? No, say industry experts, but investment activity is likely to moderate.

Capital is continuing to pour into commercial real estate invest-
ments. More than $210.8 billion in commercial and multifamily properties traded hands during the first three quarters of 2006 — 5% higher than the $200.1 billion in properties that sold during the same period in 2005, according to New York-based Real Capital Analytics. The research firm tracks deals in excess of $5 million. Hotel transactions are not included in the researcher’s sales figures.

“The drivers of real estate capital flows are still strong, both from the standpoint of investor needs and improving property fundamentals,” says Harvey Green, president and CEO of Marcus & Millichap. “But the broad cap-rate compression cycle can no longer be taken for granted, and investors are sharpening their pencils and becoming more selective,” he adds.

In order to better gauge investor sentiment, NREI and Marcus & Millichap this fall conducted their annual real estate investment survey. Respondents have been in the industry an average of 18 years, with the majority (62%) listed as either private investors or private partnerships. On average, respondents have $35.7 million invested in commercial real estate [Figure 1].

More than half of respondents (55%) indicate they are currently invested in apartments, the most frequently cited property type [Figure 2].

Among some of the key findings in the fourth annual survey:

- When considering all investment alternatives, respondents are most likely to increase investments in U.S. real estate. Half plan to increase direct investment in U.S. real estate, while 26% plan to increase investments in U.S. stocks/equities, 17% in international stocks/equities, and 14% in U.S. REIT stocks.
- Some 62% of respondents are confident effective rents for apartments will rise. Meanwhile, 44% expect effective rents to increase for one or both types of office properties. And 41% indicate effective rents will rise for one or more types of retail properties.
- Six out of 10 respondents expect market pricing to increase in one or more property types next year. The largest number of respondents (35%) say apartments are poised to experience price increases, closely followed by industrial (24%), downtown office and mixed-use (23%), and hotel (21%).
- Among the 53% of respondents who say the single-family housing market is in a pricing bubble, more than half (56%) expect a modest pricing correction between 10% and 20%.
- 1031 exchanges continue to be popular among both private and institutional players. More than one in four respondents (28%) has executed a 1031 exchange transaction in the past 24 months. And 51% of those who have recently executed a 1031 exchange plan to increase their use of the popular financing vehicle in the next five years.
- Investors continue to search for value opportunities in a frothy investment sales market. Nearly half of respondents (45%) plan to acquire properties specifically for redevelopment, renovation or expansion.
- The most frequently cited concern of respondents is unforeseen shocks to the economy (43%), followed by the cost of building materials (31%) and rising interest rates (30%) [Figure 3].

Caution creeps in

The fact that the percentage of respondents planning to boost their real estate holdings over the next 12 months has declined compared with last year’s sur-
vey is an indication that investors are injecting a note of caution into their decision making, especially in light of high pricing [Figure 4].

“Investors’ pullback in acquiring commercial real estate is not surprising given the combination of the run-up in prices over the past few years, rising interest rates earlier in the year, and a slowing economy,” says Hessam Nadji, managing director of research services at Marcus & Millichap.

“The decline in the percentage of respondents that plan to increase real estate allocations from 69% to 60% is not alarming because it is accompanied by overwhelming confidence that rents will continue to grow,” Nadji adds. Indeed, 84% of respondents expect to see a rise in effective rents for one or more property types.

Yet buyers may be pausing a bit to revisit investment strategies. Nearly one-third of respondents (32%) indicate they have no plans to increase or decrease their commercial real estate investment, up from 23% in last year’s survey and 20% two years ago.

Nadji believes that’s further evidence investors are reassessing their strategy and choosing their investments more carefully. “There has to be conviction that rent growth will be there to offset potential risk since the rate of appreciation will depend more on operations, quality of assets, and strength of local markets. There is still a large appetite for top-tier properties,” he adds.

The intense competition for quality investments has prompted buyers such as The Shidler Group to curtail its acquisition spree. The San Diego-based investor has purchased $250 million in properties this year, continuing a gradual downward trend from $400 million in 2004 and $300 million in 2005. Although Shidler’s appetite for properties remains high, the drop in its target volume for acquisitions reflects market conditions that include a slew of competitors and aggressive cap rates.

Even though there is an ample supply of properties for sale on the market, there is still a huge amount of capital flowing into commercial real estate investments. “There is a lot more competition for every asset that comes to market, and we are very selective buyers,” says Matt Root, a managing partner at The Shidler Group, which is buying Class-A and B+ office properties in Southern California, Honolulu, and Phoenix. The company recently purchased the U.S. Bank Center in downtown Phoenix for $65 million.

**Banking on higher rents**

Investors are confident that effective rents will continue to rise across the various property sectors. Respondents’ optimism is most pronounced in the apartment sector, with six out of 10 respondents expecting an increase in effective rents over the next 12 months [Figure 5]. The bulls outnumber the bears, as only 21% expect a drop in effective rents for any property type.

“Investors who are buying at a 5% cap rate are buying into a rent growth story,” Root says. In order to realize those returns, institutions need to boost rents. In Honolulu, for example, where Shidler owns 2.5 million sq. ft. of downtown office space, the company has seen rents increase 25% in 2005 and 20% in 2006.

Most importantly, improving fundamentals in many markets are finally allowing owners to raise rents. Nationally, effective rents in the office
sector have risen between 5% and 6% in the past year, and most respondents expect the market recovery to continue in the coming 12 months. Nearly two-thirds of those respondents who own downtown office properties (65%) expect effective rents to increase, while 53% of suburban office investors expect rents to increase.

Despite concerns of slowing job growth and an increase in construction activity, strong tenant demand continues to put downward pressure on vacancies, justifying strong rent growth in the office sector. Completions for the first three quarters of 2006 reached 26.7 million sq. ft. compared with 22.4 million sq. ft. for the same period last year.

While the 41.3 million sq. ft. of office absorption during the first nine months of 2006 was down 8.5% over last year, it is still the second-highest total for a nine-month period since 1999, reports Marcus & Millichap. As a result, the office vacancy rate is expected to dip to 13.2% by the end of 2006, down from 14.7% at the end of 2005.

**Cap rates poised to climb**

Confidence in higher effective rents may explain why many investors say that both prices and cap rates are likely to rise. The expectation is that rents will rise more than prices and lead to higher cap rates. A greater percentage of respondents predict an increase in cap rates than a decrease. The largest number of respondents (46%) expect apartments to experience a rise in cap rates [Figure 6]. Meanwhile, 41% expect cap rates for one or more retail property types to increase, and 38% of respondents expect cap rates to increase for one or both types of office properties.

About one-third of respondents (35%) expect the apartment sector to experience price increases over the next year, but only 13% expect to see price increases in the regional mall sector [Figure 7].

“In terms of rising cap rates, respondents are telling us that the rate of rent growth may outpace the rate of appreciation,” Green says. But that could be wishful thinking, especially for the upper end of the market where buyer competition is intense. “The significant price appreciation of the past fours years is due partly to a structural re-pricing of U.S. real estate,” says Green. “Prices rose due to tremendous buyer demand, even though income was flat or negative. The market may need some catch-up time, but improving fundamentals will be a tangible driver of value,” adds Green.

**Bullish on apartments**

Expectations for growth in effective rents and sales prices are highest in the apartment sector. Nearly four in five respondents (79%) who are currently invested in apartment properties predict an increase in effective rents
over the next 12 months. And 43% of those invested in apartment properties expect to see an increase in the market pricing of apartment properties.

Investors are optimistic about the apartment sector for several reasons, including positive job growth and a softening single-family housing market. Although employment numbers were lower than expected in October, unemployment dipped slightly to 4.4% with the creation of 94,000 jobs, reports the U.S. Department of Labor.

Fears that home prices may fall have sidelined some potential buyers. Total existing-home sales — including single-family, townhomes, condominiums and co-ops — totaled 6.18 million units in September, a 14.2% drop compared to the 7.2 million units sold in September 2005, according to the National Association of Realtors.

Also bolstering the apartment market is the fact that the apartment industry is poised for significant rental growth. Apartment rental rates were either flat or declining between 2001 and the second half of 2005. The average effective rental rate climbed just $22 during that period, rising from $858 at the end of 2001 to $880 in the second quarter of 2005, according to Reis.

“We have a ways to go in terms of rising rents,” says Simon Wadsworth, CFO at Mid-America Apartment Communities Inc., which has ownership interests in more than 39,600 apartments in the U.S. Memphis-based Mid-America expects rent increases and operating efficiencies to boost its net operating income (NOI) in the months ahead. The firm, which enjoys a portfolio-wide occupancy rate of 95%, expects its NOI in the second half of 2006 to be 5% to 6% higher than the same period a year ago.

“A majority of investors say condo conversions are currently a good business tactic in select markets [Figure 8]. But 30% of respondents say that condo conversions are no longer a sound business practice in any market.

Those results indicate that investors are judging the health of the condo market on a local level, not a national level. One difference in this condo cycle is that demand remains strong from groups such as empty nesters and high-end professionals who want to live in urban areas. “The condo market didn’t run into a fundamental demand problem. Sure, the speculation and frenzy had to be rung out of the market, but the current situation is more a case of oversupply mostly limited to eight to 10 markets,” says Linwood Thompson, managing director of Marcus & Millichap’s National Multi-Housing Group.
A cooling housing market could have wide-reaching implications for both the economy and the commercial real estate industry. Over half of respondents (53%) believe the single-family housing market is experiencing a pricing bubble, up from 45% in last year’s survey. Some 21% of this year’s respondents indicate the bubble exists in certain markets compared to 25% last year. The majority of respondents who see a bubble expect a modest pricing correction between 10% and 20%.

The potential for a housing market correction, even slight, is a significant issue because housing has been a huge economic engine over the last five years. Homeowners have taken advantage of rising home values by tapping that growing equity as if it were a giant piggy bank. “The expectation is that the housing slowdown will take about one percentage point off the GDP,” Nadji says. Economists predict that the GDP growth rate for 2006 will reach 3.4% before cooling to 2.7% in 2007.

**Retail holds its own overall**

The potential for weaker consumer spending only reinforces the investment strategy for some shopping center owners. Equity One plans to buy nearly $250 million worth of grocery-anchored retail properties in 2006 — nearly twice what it purchased the prior year. “We don’t expect a decline in consumer spending to affect our shopping centers because people are coming to us to buy daily staples,” says Chaim Katzman, CEO and chairman at Equity One based in North Miami Beach, Fla.

A deep economic downturn has to occur before spending on staples is negatively affected, Katzman adds. In light of the premium pricing, Equity One is chasing higher-quality properties such as its recent purchase of the 152,239 sq. ft. Kroger-anchored Piedmont Peachtree Crossing in Atlanta.

When it comes to potential rent growth, respondents don’t rate all the retail niches equally. Slightly less than half of respondents (46%) expect an increase in effective rents at lifestyle/power centers compared with 29% who indicate that mall properties will experience a rise in effective rents over the next year (Figure 9).

“The recent pullback in energy prices and low unemployment are helping to balance the reduction in cash coming from home equity refinancing, which means the consumer is not likely to shut his or her wallet,” says Bernard Haddigan, managing director of Marcus & Millichap’s National Retail Group. “On the supply side, over 40% of retail construction is driven by growing big-box tenants. There could be some vacancy overhang, but the market is generally in balance,” he adds.

Concerns over a pricing bubble in the commercial real estate market are much more muted. Nearly half of investors (49%) do not believe the commercial real estate industry is experiencing a pricing bubble. Among the 33% who do believe there is a pricing bubble, 52% anticipate a modest price correction between 10% and 20%, and another 30% expect a minor correction of less than 10% [Figure 10]. Certainly one argument that supports the lack of a pricing bubble is the huge flow of capital into the industry. “I think that capital is here to stay. Real estate has been validated as an asset class, right next to stocks and bonds,” says Root of The Shidler Group.

Among respondents who say that there is a pricing bubble in commercial real estate, 58% indicate the apartment sector is experiencing a bubble while 28% cite the downtown office market.Ironically, these are the two leading property sectors for effective rent growth, implying that any perceived pricing bubble should correct itself. Cap rates for apartment properties have dropped from 8.7% in 2001 to 5.9% year-to-date through August, according to Real Capital Analytics. On the office side, cap rates have dropped from 9.8% in 2001 to the current 7.1%.
Economy slows its pace

There is no question that investors believe that 2007 will be a tougher year for the economy. Only 20% of respondents believe the economy will be stronger in the coming 12 months, which is a significant drop compared with previous surveys [Figure 11]. In last year’s survey, 41% predicted a stronger economy in the year ahead, and two years ago 63% of respondents were bullish on the near-term outlook.

In fact, 38% of respondents in this year’s survey predict a weaker economy over the next 12 months. That certainly jibes with what many economists are predicting. A slowdown in the housing market coupled with less job growth is likely to lead to slower economic growth in the coming year.

Respondents expect mortgage rates to move higher in the next 12 months. Still, a smaller percentage of respondents to the 2007 survey expect an increase in mortgage rates compared with the 2006 or 2005 survey results.

Slightly more than half of respondents to this year’s survey (54%) expect higher mortgage rates in the coming year compared with 87% in last year’s survey. “That may even be somewhat overstated,” Nadji says. “The economy is slowing, which means inflation pressures should ease and interest rates should be the same or lower.”

Respondents expect mortgage rates to increase by an average of 33 basis points over the next year. While more than half of respondents expect interest rates to rise, 35% expect that rates will remain the same and 10% predict a decrease. By comparison, 53% of respondents to last year’s survey predicted that interest rates would increase by more than 100 basis points. The 10-year Treasury yield rose to 5.25% earlier this year, but then receded. As of Nov. 2, it registered 4.6%, only 30 basis points higher than last year’s level.

Quest for higher returns

Yield expectations have clearly declined as evidenced by the incredibly low cap rates. Cap rates on commercial properties sold during the first eight months of the year averaged 6.7% compared with 7.2% in 2005 and 7.8% in 2004, according to Marcus & Millichap’s research. The question is whether this is a short-term by-product of the real estate cycle, or more of a long-term shift.

The answer may lie somewhere in the middle. Respondents appear split on whether the yield compression is a short-term or long-term phenomenon. While 38% of respondents believe yields will revert back to long-term averages, another 25% believe the yields will rise but will not reach long-term averages [Figure 12]. Only 12% say returns have been permanently lowered due to structural changes in the market.

“I see cap rates rising, and I see reason for that with higher net operating income, flattening prices and higher short-term interest rates,” Nadji says. “But it will require a major price correction for us to see cap rates go up significantly to approach historical levels. And I don’t see any reason for that. In fact, there is more evidence to the contrary. The wild card is the capital market shock where debt becomes unavailable.”

Another factor that will support higher prices is rising replacement costs fueled by mounting construction costs. The majority of respondents (84%) have experienced an increase in construction costs in the past 12 months, and 70% expect to see costs increase in the coming 12 months. One-third of respondents predict that there will be a less than 10% increase in construction costs in the coming 12 months, while 31% expect a 10% to 24% increase.

Clearly, higher replacement costs will limit new development, which should further bolster improving market fundamentals, says Green. “That is a good combination to support a relatively strong outlook for U.S. real estate investments in the coming year.”

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Our Research Services Division continuously monitors, analyzes and reports on a wide range of economic and real estate indicators. This specialized research, combined with the local, regional and national expertise of our agents, gives our clients the best possible advantage in developing the right investment strategy.

Put the finest real estate investment professionals in the industry to work for you today

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