Commercial Real-Estate Cycle Peaks and Will Pull Back in 2007

By Ryan Chittum www.wsj.com

The commercial real-estate cycle appears to have reached its peak and will begin pulling back in 2007, according to a new survey of industry executives.

The Urban Land Institute, a Washington-based nonprofit planning and research group, and PricewaterhouseCoopers surveyed more than 600 developers, investors, brokers, consultants and lenders this summer for an annual report on the industry, dubbed Emerging Trends in Real Estate 2007.

The survey suggests commercial real estate is beginning a return to its norm as an income-producing investment rather than the wildly appreciating asset-class it has been this decade. The easy lending of the past several years will tighten next year in part because of worries about the economy, surveyed executives said. Investors will have to turn to asset management and operating performance to raise returns as investment inflows slow because of lower return expectations, respondents added.

"I think it's a clear mandate from people that you're going to have to make money the old-fashioned way," says Stephen Blank, an Urban Land Institute senior fellow who specializes in real-estate capital markets. "You're going to have to earn it" through leasing, cost control and other asset management.

The report also says real-estate investment trust stock prices "appear to have more downside risk than upside potential over the short term."

Still, those surveyed expect commercial real-estate cash flow to continue to grow as factors such as reduced vacancies and higher rents keep improving across most property types. One reason: High construction costs are putting a damper on new construction.

While the commercial real-estate market has exhibited some signs of a bubble in recent years -- driven by low interest rates and an influx of investment -- it has differed from the residential market. A key difference is that supply and demand have been more tied to vacancies and rents and not as closely linked to the rising interest rates that have cooled the housing market.

The report advises investors to sell marginal properties and hold on to well-performing ones, with an eye to improving their performance in advance of a potential economic downturn. It advises developers to "hunker down," saying most property markets don't need much new space.

A pullback in the galloping commercial real-estate market will raise capitalization rates -- the initial return on investment in the first year -- by as much as 0.7 percentage point in some property types and restrain the increase in property values, the report says. Falling cap rates mean investors are willing to take a lower return for their money. Cap rates are already rising in some areas, especially in lower-quality properties, after dropping between 2.5 and three percentage points to record lows over the past five years. Cap rates vary by property type, but high-income apartments, for instance, averaged a 5.66% cap rate in July, while limited-service hotels brought a 7.93% cap rate.

The property sectors with a "buy" in the report are warehouse, which the executives interviewed said will boom on the East and Gulf Coasts because of overflow import traffic from the West Coast, and moderate-income apartments, especially on the coasts. Retail property fared worse; with executives suggesting consumer spending will be "middling" and advising investors to sell weak properties while holding strong ones.

Those surveyed said Seattle is the best office market to invest in right now, with office rents set to rise and supply tight. The city is also sitting in a prime position to benefit from explosive growth in Asia and has the best potential of any American city to become the next "24-hour" hub like New York or San Francisco, according to the report. The report lists five U.S. cities as "global pathways" with bright futures for real-estate investment: New York, Seattle, San Francisco, Los Angeles and Washington.

Philadelphia and Chicago are ranked among the worst markets for investment in all property types in the survey. Chicago is being dragged down by economic problems, the "Midwest malaise," the report says, while investors question Philadelphia's future as a global city since it lies between New York and Washington.

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