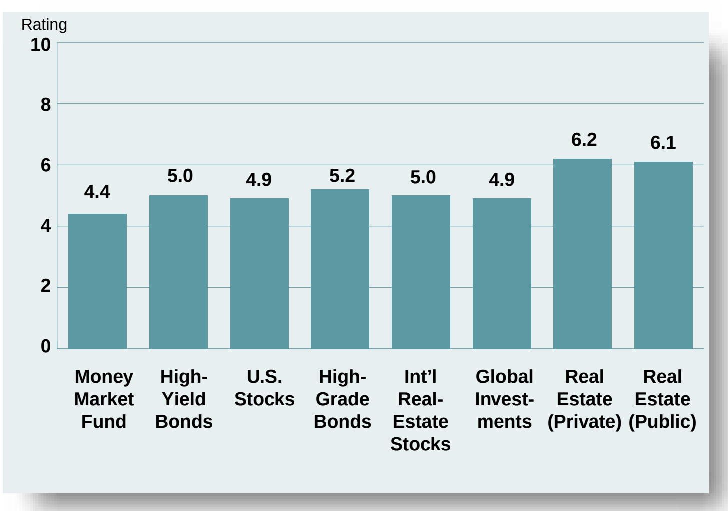
CHAPTER 2

THE SURVEY: INVESTMENT TRENDS 2002

a recession followed by modest economic growth will nudge down returns for real estate investors into 2002. But overwhelmingly, *Emerging Trends* interviewees are convinced that real estate—both private equity and REITs—will outperform U.S. stocks (72% of respondents) and bonds (92%) during the year. In the battle of public versus private, interviewees predict that real estate securities and private real estate will deliver similar returns.

Asset Class Investment Potential for 2002



Ratings for charts in Chapter 2 are based on the 0-to-10 (poor to excellent) scale.

Source for exhibits in Chapter 2: Emerging Trends in Real Estate 2002 *interviews*

Respondents favor income-oriented investments—apartments, community shopping centers, and industrial properties. The staying power of downtown office shows signs of flagging, and suburban office slips still further from last year's picks. Not surprisingly, research and development (R&D) also loses ground in the wake of the high-tech implosion, but its rating doesn't sink dramatically. Regional malls and power centers garner little enthusiasm.

THE ECONOMY

Interviewees are realistic about the economy's fitful slide: "An awful lot of wealth vaporized, and there is no way the consequences won't work their way into real estate." But hope reigns that any recession will be short-lived. Our respondents expect inflation to be held in check and interest rates to level off and eventually edge back up. Almost unanimously, respondents view the economic and worldwide political tides as determining the health of real estate markets in 2002.

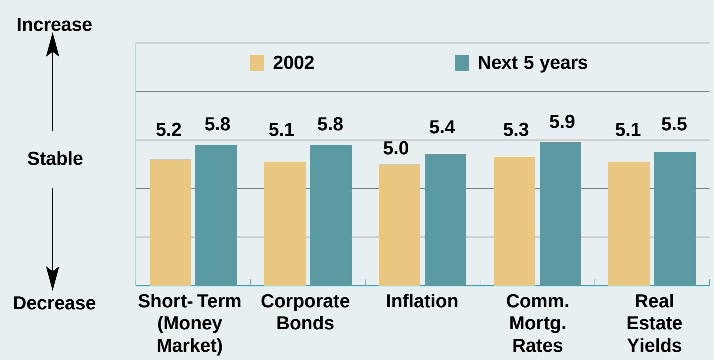
PRICING, YIELDS, CAP RATES

As further evidence of overall market slippage, interviewees see pricing in most sectors stagnating or declining slightly. Only apartments and community shopping centers generate expectations for mild upward pricing momentum. Yields are edging higher—especially in out-of-favor hotel categories, malls, power centers, and R&D. Cap rates are expected to drop as a recovery takes hold.

Emerging Trends *interviewees almost always tout property returns over alternative investments in the survey—and they've been right for at least the past two years. To no one's surprise ("I'm shocked, just shocked") real estate again ranks first.*

Of note, enthusiasm for global investments—both real estate and stocks—waned significantly with perceptions of increasing risk.

Rate Outlook: 2002 and Next Five Years



Capitalization Rate Bid/Ask Characteristics

PROPERTY TYPE	BID	ASK	BID/ASK SPREAD (BASIS POINTS)	DEAL
Downtown Office	9.1%	8.5%	60	8.9%
Suburban Office	10.0	9.3	70	9.7
Industrial	9.2	8.6	60	9.0
Research & Development	9.9	9.1	80	9.6
Apartments	8.6	8.1	50	8.4
Full-Service Hotels	10.8	9.8	100	10.4
Limited-Service Hotels	12.2	10.8	140	11.6
Community Shopping Centers	9.6	8.9	70	9.3
Regional Malls	8.8	8.2	60	8.5
Power Centers	10.9	9.8	110	10.3

> "An awful lot of wealth vaporized, and there is no way the consequences won't work their way into real estate."

VALUE CHANGES

Predicted value gains continue to shrink, compared with previous surveys for one-year, five-year, and ten-year returns. Value changes underscore views that investors should expect strong cash returns but only modest appreciation during the next cycle. Small value dips are predicted for limited-service (-2.7%) and full-service (-0.3%) hotels, power centers (-2.2%), suburban office (-1.4%), and regional malls (-0.6%).

BUY, SELL, HOLD

Interviewees view 2002 as a good time to buy real estate in the market trough, but a bad time to sell. For core players, holding onto properties makes sense, in the expectation that markets will regain their footing. Without a surfeit of distressed sellers, transaction volume may be tempered. Again, apartments and community centers are the sought-after categories, followed by industrial and downtown office. Power centers and limited-service hotels are definite sells—another replay of recent surveys.

Anticipated Price and Yield Changes: 2002

	RESPONDENT RATING	
PROPERTY TYPE	PRICE CHANGE	YIELD CHANGE
Apartments	Up	Stagnant
Community Shopping Centers	Up	Stagnant
Industrial	Stagnant/Up	Stagnant
Overall	Stagnant/Down	Stagnant/Up
Downtown Office	Stagnant/Down	Stagnant
Regional Malls	Down	Stagnant
Research & Development	Down	Up
Full-Service Hotels	Down	Up
Suburban Office	Down	Up
Power Centers	Down	Up
Limited-Service Hotels	Down	Up

Investment Recommendations: by Property Type

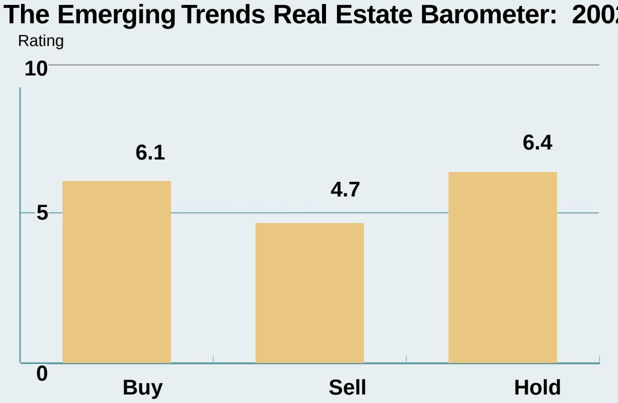
PROPERTY TYPE	BUY	SELL	HOLD
Downtown Office	42%	10%	48%
Suburban Office	39	18	43
Industrial	44	21	35
Research & Development	24	28	48
Apartments	$\boxed{58}$	26	16
Full-Service Hotels	21	21	$\boxed{58}$
Limited-Service Hotels	8	$\boxed{65}$	27
Community Shopping Centers	$\boxed{48}$	16	36
Regional Malls	7	30	$\boxed{63}$
Power Centers	6	$\boxed{72}$	22

Highest recommendations

Value Changes

PROPERTY TYPE	2002	5-YEAR	10-YEAR
Downtown Office	0.9%	14.1%	26.2%
Suburban Office	(1.4)	10.7	20.9
Industrial	2.5	13.7	25.5
Research & Development	0.4	10.9	21.5
Apartments	3.4	16.1	29.7
Full-Service Hotels	(0.3)	10.4	20.7
Limited-Service Hotels	(2.7)	5.4	12.3
Community Shopping Centers	2.1	10.8	20.6
Regional Malls	(0.6)	8.2	15.9
Power Centers	(2.2)	4.7	10.0

The Emerging Trends Real Estate Barometer: 2002



BEST INVESTMENT BETS FOR 2002

1

"Hold your powder," *but be ready to move quickly.*

Some opportunity funds will be trying to sell out, while new opp funds, REITs, and pension funds hunt for bargains. Everybody will be looking for bottom before making a move. Recent market equilibrium has shored up most investors, reducing the volume of sellers.

2

Buy multifamily, *but only in select markets.*

Housing shortages in high-growth Southern California markets and the supply-constrained Northeast corridor (Boston to Washington, D.C.) make apartments almost a can't miss in these markets. Home affordability problems—the construction barriers are high in these regions—put icing on the cake. Acquire, or develop if you can find the site. Elsewhere, apartments are getting too pricey for any bang.

3

Buy office in the **battered high-tech markets.**

"Focus on everywhere that was hot and turned cold." The San Francisco Bay area should top a list that includes Seattle, the Virginia suburbs, the Boston 128 corridor, Austin, and suburban Denver. Fundamentals in most of these markets will revive fairly quickly. "This downturn is nothing like ten years ago." Despite hitting a brick wall, high-tech businesses will become an ever more important part of the economy. San Francisco, in particular, remains one of the country's premier office markets and is highly diversified. Move quickly to grab a bargain: the window will be narrow and you'll have lots of company trying to pick off "motivated sellers."

4

Leverage **core assets.**

"It's an extremely good time to finance properties." The low-interest-rate environment and relative market equilibrium signal moving to put debt on well-leased assets to enhance equity returns. "Almost every corporation in the S&P 500 has a form of leverage to improve their performance," says a core portfolio manager. "Leverage on core assets is a fundamental business precept that investors need to entertain."

CONTRARIAN PLAYS

5

Buy or hold **24-hour downtown office.**

Prices have softened from record or near-record highs—"there's been enough instability that you'll be able to buy below replacement cost again." Big Five markets (New York, Boston, Washington, D.C., Chicago, and San Francisco) will not experience material declines, despite possible short-term jumps in vacancies, and are "positioned to sustain long-term growth above inflation, with good absorption and less overbuilding." Urban lifestyles will remain in vogue. Subcities—suburban nodes with 24-hour dynamics—will also remain sturdy markets and should be targeted.

6

Watch for REIT correction and buy into **larger-cap office, apartment, and industrial stocks.**

Expect REITs to correct in the face of some erosion of net operating income, and then rebound. Use the opportunity to concentrate holdings in the bigger, better managed companies. Hotels should be a great buy after their post September 11 mauling. The retail sector, after a 2001 run-up, is more problematic as consumers pull back their spending.

7

Buy well-leased suburban office *in established nodes and leverage up.*

Lackluster suburban office is saddled with cap rates north of 10%. "Pricing is all out of kilter, and offers a short-term acquisition opportunity." Acquire property, enhance upside with financing, then flip when markets recover. "The long-term rent growth and appreciation won't be there."

8

Look for commodity properties in top **infill locations.**

Cyclical bottoms can savage pricing on lesser-quality properties—tenants bail out when rents come down in better space. Focus only on product that can be upgraded—in markets with high barriers to entry. It's a great time to buy parking lots. Avoid obsolescence at all cost—that's throwing money down the rat hole. Fringe suburban office, away from subcities, should be off limits. "It's too much of a stretch to be on the edge."

9

Prepare for the future—look for land in **megalopolis infill areas.**

Land prices usually suffer when development prospects dim at market bottoms—i.e., right now. In the future, population growth will drive more suburban development and densify growing subcities along the Atlanta-Charlotte corridor and within the great Northeast megalopolis. Suburban agglomeration markets offer similar significant opportunities. Target locations destined for the next growth wave. "Now is the time to position for the future."

10

Hold industrial in major regional **distribution hubs.**

These markets will gain in favor at the expense of local warehouse centers. Look for bigger, more flexible space; truck access and room for maneuverability are absolutely essential to moving goods quickly. Concentrate on the usual suspects—Los Angeles, San Francisco's East Bay, Seattle, Dallas, Chicago, Atlanta, Northern New Jersey, and Miami. In general, industrial markets will experience an off year—sluggish economies increase vacancies and hit revenue streams. But good industrial properties stand out as premium core investments, and sizable portfolios are difficult to accumulate.

11

Hold **R&D.**

After the abrupt downturn in these markets, some upside will be recouped over the medium term. Last year, we recommended "sell" after extraordinary rent spikes moved values to all-time highs. It's too late to sell now.

12

Hold **fortress malls.**

The best regional centers retain their reputations as excellent core investments and premier retailer magnets. These malls are highly coveted, and few-and-far-between. Some interviewees suggest that only 50 exist; others will stretch the number up to 200. Either way, the pickings are slim. REITs have cornered the market for these properties, in some instances joint-venturing with private owners who can gain leverage with national tenants.

13

Hang on to **full-service hotels.**

Another case of "you missed the market top, so hang in there, baby." Steep drops in room revenue and occupancy could have vultures circling for bargains. But if the economy revives by late 2002, then "2003 should be a strong year for profit growth."

14

Be careful of **grocery-anchored retail.**

Core investors, especially pension funds, have fallen in love with these bite-sized cash machines. They've bid up pricing to uncomfortable levels despite increasing risk from grocery chain consolidation, Wal-Mart's widening supermarket share, and mounting retailer distress as the economy weakens. Buyers should be cautious. Sellers have a great opportunity to cash out.

15

Prune **apartment portfolios.**

The demographics—budding Echo Boomers, aging Baby Boomers, immigrant influx—point to a strong decade ahead for multifamily. But prices are "too high" now, especially for B-minus or C apartments in hot-growth markets where new competition can be tossed up quickly. "At 8% cap rates or lower, there's no bang left—not a lot of good can happen." A weak economy will temporarily soften tenant demand as more renters double up and 20-somethings move back home. Owners should strike while the iron is hot—sell older, commodity multifamily assets into the demand curve, and get better buying value when cap rates rise.

16

Back off **development.**

Higher vacancies, lower rents, and uncertain demand prospects blunt appetites for development. Ample product will be coming on line into 2003, so construction lenders are certain to pull back further. For 2002, buying existing product at discounts to replacement cost will offer much better risk-adjusted returns. New projects will be non-starters in most markets and sectors.

17

Steer clear of **limited-service hotels, power centers, B and C malls, and resorts.**

Limited-service hotels "just aren't institutional product." Interviewees again peg the risk-versus-return prospects of this category off the charts on the downside, although most development has stopped and today's travelers are searching out lower-cost accommodations. Power centers remain overbuilt and are subject to the vagaries of a thin big-box/category-killer tenant group. Only the best-located centers, typically near fortress mall hubs, offer solid prospects. In over-retailed America, the competition—fortress malls, power centers, lifestyle centers—slowly picks apart the store line-ups of many B and C malls. "They have no exit strategy." When booms end and frugality kicks in for the lodging industry, luxury hotels feel the most pain. New travel hassles and fear of hijacking may rule out frivolous trips. Modest economic growth prospects will weaken any rebound in demand, but property costs stay high—all that brass needs constant polishing.

18

Avoid **second-tier and tertiary markets.**

Their less-than-mediocre prospects are detailed in "Markets to Watch."