

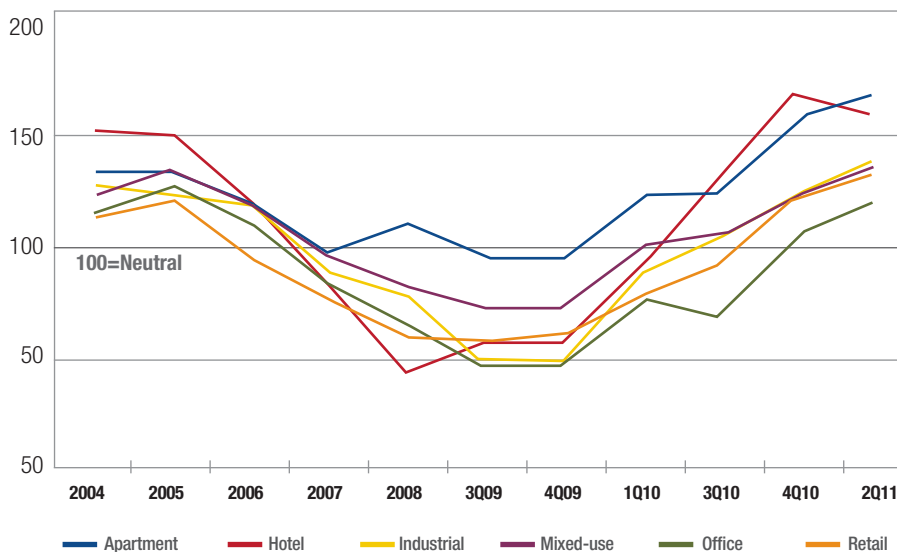
Second Quarter 2011 Real Estate Investment Outlook

Appetite for Real Estate Grows

Buyers are bullish on apartments and hotels, while retail's stock is on the rise.

FIGURE 1. INVESTOR SENTIMENT INDEX RISES ACROSS PROPERTY TYPES

The NREI/Marcus & Millichap Investor Sentiment Index rose to 164 in the second quarter, up from 152 in the fourth quarter of 2010. More notable is that each property sector reported a marked improvement in investor sentiment. Apartments recorded the highest index rating with a score of 166, followed by hotels at 158, industrial at 140, mixed-use at 139, retail at 135, and office at 123. Since 2004, *National Real Estate Investor* and Marcus & Millichap Real Estate Investment Services have conducted research on investor attitudes and expectations as part of a commercial real estate industry forecast. Research gathered on views related to anticipated changes in property values, as well as plans to increase or decrease total real estate holdings over the next 12 months, provides the foundation for the investor sentiment index.



Investors' renewed faith in the retail sector underscores the positive shift in sentiment toward commercial real estate since late 2009. Although many shopping center owners have endured high vacancies, weak consumer spending and a wave of store closures over the past few years, the latest NREI/Marcus & Millichap Investor Sentiment Index for retail properties has risen to 135, up from 68 in the third and fourth quarters of 2009.

What's more, the outlook for retail property values has climbed dramatically in the last few years. In the fourth quarter of 2009, nearly half of survey respondents (47%) expected retail property values to drop in the ensuing 12 months, with only 15% predicting an increase. Now those numbers have nearly flipped with 44% anticipating an increase, and only 9% forecasting a decrease in property values.

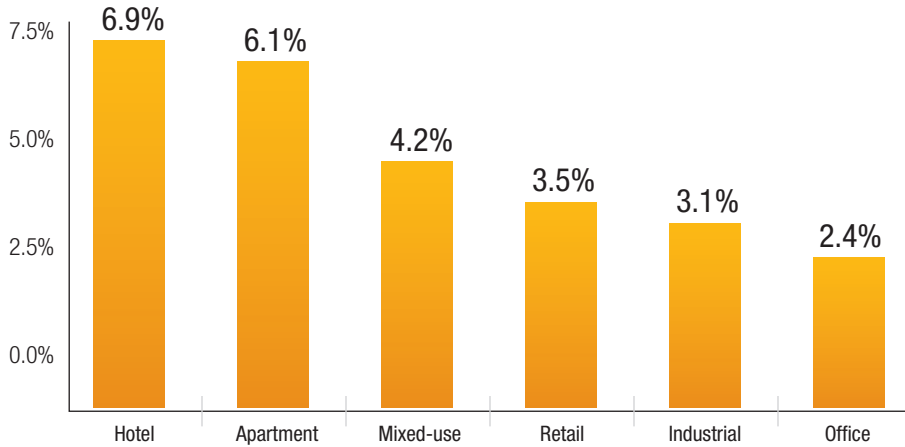
Overall, investors' increasing confidence in the U.S. economy and the commercial real estate recovery is fueling demand for assets across property types. The NREI/Marcus & Millichap Investor Sentiment Index has rebounded from a

Survey Methodology

In April, National Real Estate Investor's research unit and Marcus & Millichap e-mailed invitations to participate in an online survey to public and private investors and developers of commercial real estate. Recipients of the survey included Marcus & Millichap clients as well as subscribers of NREI and Retail Traffic selected from commercial real estate investor, pension fund, and developer business subscribers who provided their e-mail addresses. The majority of respondents are private investors (36%), developers (14%) and private partnerships (14%) with an average of \$38.2 million invested in commercial real estate. REITs and institutional investors represent 3% of all respondents. The survey yielded 478 valid responses.

FIGURE 2. BULLISH OUTLOOK FOR HOTEL PROPERTY VALUES

Hotel investors expect their property values will rise an average of 6.9% over the next 12 months. By contrast, office investors expect to see only a 2.4% increase.



Base: All respondents in each property type

low point of 91 in the fourth quarter of 2009 to 164 in the second quarter of 2011.

Nearly two-thirds of respondents (64%) plan to boost the size of their commercial real estate portfolios over the next 12 months, according to an online survey conducted between April 27 and May 11. The survey yielded 478 responses.

Among respondents who plan to grow their portfolios over the next 12 months, the average increase by total dollars is projected to be 23%.

“Apartments are leading on the road to recovery, but just about every sector is beginning to show the early signs of recovery,” says Hessam Nadji, senior vice president and managing director at Marcus & Millichap based in Encino, Calif.

Retail in particular may be poised to take a big leap forward in the coming months. “Tenants that survived the downturn are stronger and more aggressive about taking market share,” says Nadji.

Investors recognize that grocery-anchored neighborhood centers are performing well. Many of the Class-A malls also are exhibiting strong vital signs, adds Nadji.

Overall, half of respondents who already own retail properties believe now is the time to buy more, while 42% believe it is time to hold, 6% indicate it is time to sell and 2% have no answer.

That increasingly bullish investor outlook is evident across all property types. The apartment sector, which has already turned the corner in improving vacancies and rents, drew the highest rating on the Investor Sentiment Index at 166.

Hotels also are benefiting from the ability to react quickly to an improving economy and scored 158 on the index, followed by industrial at 140, retail at 135, and office at 123 [Figure 1].

Apartments remain the favored property choice with 59% of respondents indicat-

ing that now is the time to buy apartments followed by industrial (35%), hotel and retail (34%), office (31%), mixed-use (30%) and undeveloped land (29%).

Driving factors

The improving jobs picture and the relatively low interest rates are two key factors bolstering investor confidence. The addition of 244,000 nonfarm payroll jobs in April was the biggest monthly gain since 2006. The 10-year Treasury yield, a benchmark for long-term commercial real estate financing, hovers around 3.2%, near historic lows.

Eight out of 10 respondents cite low interest rates as the biggest factor driving their decision to increase the size of their commercial real estate portfolios.

Other top factors that are influencing buying decisions include the favorable returns the sector offers relative to other investment classes (77%), and confidence that the market has bottomed out (67%).

More than half of respondents (57%) cite the abundance of capital as one of the key factors fueling acquisition strategies.

Speed bumps

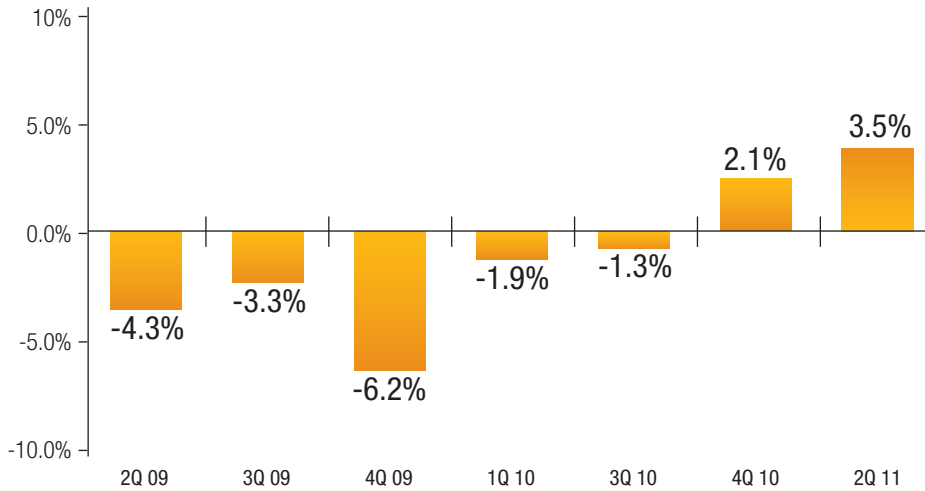
Although investor sentiment is clearly on the rise, respondents continue to keep a close watch on key issues that could derail a commercial real estate market recovery. Nearly seven in 10 respondents (69%) believe that the biggest threats facing the industry are high unemployment and underemployment.

Approximately six in 10 respondents (59%) indicate rising interest rates pose the biggest threat to the real estate recovery, 38% cite large federal and state budget deficits, and 37% point to rising oil prices.

“There are certainly still major concerns,” says Nadji, “but because the fun-

FIGURE 3. IMPROVING OUTLOOK FOR RETAIL PROPERTY VALUES

The average increase in retail property values over the next 12 months is expected to be 3.5%, the highest in the survey's history.



Base: Retail investors from each quarter

damentals of the economy are getting better, due largely to job growth, investors are reacting with more confidence.”

Leaders of the pack

Apartments and hotels continue to lead the recovery in improving fundamentals, so it’s no surprise that both of these property types are attracting the most attention from investors. Nearly three out of four respondents who already own apartments (72%) indicate now is the time to buy more.

That positive outlook for apartments is largely a story of the strong fundamentals, low interest rates and high expectations for rent growth over the next two to four years. The majority of apartment owners (69%) believe apartment values will increase over the next 12 months by an average of 6.1% [Figure 2].

“We are clearly in a phase of the re-

covery where concessions are burning off and apartment owners can register real rent growth,” says Nadji.

The national apartment vacancy rate in the first quarter registered 6.2%, according to real estate research firm Reis. Marcus & Millichap projects the vacancy rate to fall to 5.6% by the end of 2011.

“In our estimation, the next three to five years for apartments will show the strongest rent growth of any recovery period that we have seen,” says Nadji.

Checking in on hotels

Although investors remain bullish on the outlook for hotels, the sector saw investor sentiment slip slightly in the second quarter. A majority of hotel owners (68%) believe now is the time to increase their lodging holdings compared with 70% who held the same view in the fourth quarter of 2010.

The 63% of hotel owners who believe property values in the lodging sector will rise over the next year is down from 73% in the fourth quarter of 2010.

That slight pullback in sentiment is likely a reflection of the improvement in real estate fundamentals that the sector has already experienced, notes Nadji, coupled with concerns that the hotel sector may take a hit from higher fuel costs.

“When more discretionary income goes to gas consumption and higher overall energy prices, consumers pull back on vacations and other forms of discretionary spending,” says Nadji.

Survey respondents indicate that hotels will experience the biggest jump in valuations in the coming year with an average increase of 6.9%. Such an increase would come on the heels of an already impressive rise in all three key performance metrics.

During the first quarter, occupancies rose to 54.9%, up from 51.7% a year ago. The average daily rate increased 3.1% to \$99.37 on a year-over-year basis. Revenue per available room jumped 9% to \$54.56, according to Smith Travel Research.

Poised for recovery

Although apartments and hotels are the clear market leaders, retail, industrial and office are all on the cusp of recovery. Investors are clearly seeing occupancies stabilizing, which will pave the way for improving rents in the coming months.

On the retail side, 44% of respondents expect property values to be higher a year from now and 45% expect no change. Only 9% believe values will continue to fall, while 2% had no answer.

The average increase in property values in the retail sector over the next year is expected to be 3.5% That’s up from 2.3% in the fourth-quarter survey [Figure 3].

“It is the high vacancy rates in the newer product in outlying areas that is really skewing industry averages,” says Bill Rose, national director of the National Retail Group at Marcus & Millichap. “If you look at core urban retail properties, vacancies are in the high single digits,” he adds.

Retail vacancies among both multi-tenant and single-tenant properties reached 10% in the first quarter and are expected to decline to 9.5% by the end of 2011, according to Marcus & Millichap.

Respondents are more optimistic about the near-term outlook for the valuations of industrial properties than they were 18 months ago. Owners of industrial properties expect an average of 3.1% increase in property values over the next 12 months.

That is a marked improvement compared with the fourth quarter of 2009 when respondents predicted a 4.6% decline in industrial property values in the ensuing 12 months.

“Sentiment continues to rise, which makes sense because the movement of goods in the country has picked up, trade volume has picked up, and all of the readings for industrial are turning positive,” says Alan L. Pontius, Senior Vice President and Managing Director at Marcus & Millichap.

For example, the U.S. has added 200,000 manufacturing jobs and just short of 200,000 trade, transportation and utility jobs in the past 12 months. The U.S. industrial vacancy rate, which was flat for much of 2010, fell from 12.8%

in the fourth quarter to 12.5% in the first quarter of 2011, according to Marcus & Millichap.

The sector is expected to continue on its slow recovery in the second half of 2011 with the average vacancy rate dipping to 12.3% by year’s end.

The office market faces the steepest climb out of the recession. The U.S. vacancy rate topped out at 17.6% in the second half of 2010 and dropped only nominally to 17.5% in first quarter, according to Marcus & Millichap.

The good news is that the office market is showing signs of stabilization. Nearly half of office owners (49%) predict that property values will remain flat, while 36% expect values to increase over the next year, and 13% expect a decline. Overall, owners predict that office property values will increase 2.4% over the next year.

“Technically, you would expect even a better than moderate recovery in office right now because we added more than 500,000 professional and business service jobs in the last 12 months,” says Pontius.

The reason the job growth has not translated to robust office absorption is that companies are still sitting on excess space. In addition, many companies are waiting to see signs of sustained economic recovery before they pull the trigger on expansion plans.

Market challenges persist

Despite the growing optimism, there are a number of challenges in the econo-

my that could shake investor confidence in the coming months.

“There is a lot of positive news in this survey, and a lot of grounded reason for optimism,” says Nadji. “But I don’t want to lose sight of the fact that there are still major clouds on the horizon, and any one of them could erupt into a mini-shock that could turn sentiment negative again.”

Nearly three-fourths of respondents (73%) indicate that slow economic growth is their chief concern. Slightly more than half of respondents (52%) are wary about the availability of financing, followed by unforeseen shocks to the economy (45%), rising interest rates (45%), and government regulation on taxation and environmental issues (38%).

For now, the commercial real estate market is enjoying the return of positive investor sentiment and the beginnings of a recovery across all property types. The question that remains is whether or not that confidence — and the recovery — is sustainable.

Slower job growth, higher fuel costs and the expiration of the federal government’s \$600 billion bond-buying program (known as Quantitative Easing 2) at the end of June are just a few of the speed bumps that could slow the commercial real estate recovery.

“It is not necessarily going to be a straight up reading on the investor sentiment index. We may see some volatility,” says Nadji. “But the overall trend is clearly up, and it really shows that confidence is building.” ■