The Relation Between Space Markets and Capital Markets
Can the Real Estate Asset Class Sustain Its Momentum?

Market Perspectives

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Like the children of Garrison Kieler's Lake Wobegon, who are all above average, in the world of investment returns, real estate has been above average for at least the last five years. To those of us who remember past boom-and-bust cycles, these halcyon years of appearing smarter than we know we are only serve to make us nervous. Can real estate values and performance stay the course or is a setback in the offing?

Our nervousness is increased when we read the warnings about the coming bust in housing and other real estate assets from distinguished academicians such as Yale University Professor Robert J. Shiller, the author of *Irrational Exuberance* (2000). Shiller attributes much of the rise in housing prices to the same type of herd instinct, emotionally based, speculative fever that preceded the "dot-com" bust of six years ago and the Dutch tulip bubble of 370 years ago. Other analysts believe the rise in prices, transactions and returns for office, retail, industrial and apartment properties since 2001 portends a fall that will exceed the slump in sales and drop in prices that have beset many single family housing markets. They believe return measures such as the NCREIF Property Index, which rose to more than 16% in 2006, are at their peaks and headed for a steep fall.

Arguing against such pessimistic views are those who believe that continuing, albeit slowing, economic growth in the United States and even stronger growth in Europe and Asia will enable the demand for space to support continued real estate value increases. Such optimists believe even housing values will re-ignite once the current surplus burns off.

In discussing the returns for all real estate investments, Alan Billingsley, Director of North American Research for RREEF, notes, "During the last five years, a perfect storm of the interaction between space and capital markets has propelled real estate returns in the U.S. and much of the rest of the developed world." While it is true that once prices start moving in either direction behavioral psychology does tend to magnify and extend value-increasing or -decreasing actions, psychology plays only a small role in igniting the direction of changes in value. Therefore, a good place to start gauging the likely future of real estate returns is with a review of the conditions within the markets for space and capital that produced the perfect storm cited by Billingsley.

SPACE MARKETS ARE LOCAL

The space markets and capital markets, which interact to determine real estate values, are very different from each other. The markets for space are local, while capital markets are global. In recent decades, political and legal changes in the rules that govern supply conditions within local markets have altered the long term secular trend of prices for many real estate products. Housing usually has been the most affected. Responses to price increases in local markets have gradually become weaker, more inelastic, because the entrepreneurs within those markets are less independent than they were in the past. Particularly on both coasts, the hand played by the body politic in determining what and where real estate can be built has become stronger, limiting the options and raising the costs of developers. While the private actors on the real estate stages of local markets still have a veto in that they cannot be forced to build financially infeasible projects, the costs and time associated with obtaining permission to build what they believe to be profitable have increased, while the certainty of getting a go-ahead has shrunk.

The shift to more inelastic supply conditions caused by the increasing politicization of real estate has been exacerbated by the worldwide increase in the price of building materials. While not as obviously permanent as the shift of decision making power toward the public sector, the higher construction costs show no signs of declining in the foreseeable future. It is important to remember that the secular changes in local spatial markets are all on the supply side. Demand is still a necessary second blade in the local market scissors that shapes values.

CAPITAL MARKETS ARE GLOBAL

Since 2001, liquidity within capital markets has been steadily increasing and interest rates declining. While, as always, capitalization rates have been higher in local markets perceived to be riskier, the ready availability of relatively cheap money has pushed down cap rates down across the board. From 2001 until very recently, cap rates for office, retail, apartment and industrial properties have been trending downward. From 2001 to the end of 2006, cap rates for office properties dropped between 280 basis points and 330 basis points, while retail cap rates slid 140 basis points; such rates dropped 240 basis points for apartments and 200 basis points for industrial properties. As a result, a much higher proportion of real estate value and return increases during the past six years can be attributed to appreciation due to capitalization decreases than can be attributed to increases in net operating revenue.

Unlike the long-term changes to supply conditions in local markets for space, the financial and economic conditions that have made capital cheaper and more readily available are not likely to be permanent. Finance markets will continue to be cyclical. The rise of interest rates in Europe, the reports that the U.S. trade deficit has been increasing at a slower rate and the dollar touching its historic low all suggest that the credit availability cycle has peaked. While worldwide interest rates probably will increase very slowly, the constant decline in cap rates is likely to soon become a memory. As these rates stabilize and even start to climb somewhat, future value increases will depend more on increases in net operating incomes. The existence and power of demand-inducing income increases within local markets will become the main generator of higher real estate values and returns as capital market conditions no longer drive down cap rates.

VALUE CREATION, DEMAND GROWTH TO DRIVE MARKET

For real estate consumers and local economic development, the shift from capital-driven to income-based value determinants is a good thing. Increases in costs will have to be offset by demand growth and the ability of new real estate to enhance the efficiency of business operations and the utility of residents. Fortunately, the U.S. real estate industry has shown that it has the creative imagination and flexibility to create products that enhance the productivity of business and the living standards of a changing consumer base. By selecting markets with real potential for demand growth, and concentrating on the skills needed to enhance that potential, real estate returns can continue to be healthy in the future. Until the capital market cycles turns upward again – an event that is likely to be quite far off -- development, marketing and selection skills will contribute more than financial engineering to the attainment of real estate investment performance.

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