INVESTMENT RESEARCH REPORT

U.S. Real Estate Investment Outlook 2005

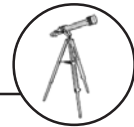
CBRE INVESTORS
CB RICHARD ELLIS INVESTORS, LLC

U.S. Real Estate Investment Outlook 2005

Contents

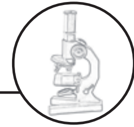
Executive Summary .... Page 2

The Structural Environment



Investment Implications of Long-Term Rent Trends.................5
Globalization: Capitalizing on the Winners...........................9

The Cyclical Outlook



Overview 13
Economy 14
Capital Markets 15
Apartments 16
Retail 17
Industrial 18
Office 19

The long awaited signs of recovery are finally present. The nation's economy is progressing toward a business-led expansion, accompanied by gradual job market improvements. Tenant demand is positive for all four property types for the first time since 2000, and vacancy rates are falling. Capital markets have been very kind to owners and sellers, as lofty property values are driving returns up, especially for well-leased, core assets. Buyers are not quite as fortunate, as historically low cap rates are keeping some on the sidelines, and forcing others to adjust their return expectations downward.

The steady improvement in the cyclical conditions of the property markets takes some of the focus off short-term shifts, and back onto structural trends. The behavior of long-term rents across the four major property types has significant implications for portfolio design, highlighting the need to emphasize different property types for different investment strategies. Across all property types, increasing globalization is causing dislocations, but also creating opportunities for investors who are poised to capitalize on the winners.

The Structural Environment

Long-term rent trends matter. Each property type has its own distinctive pattern of rent growth, ranging from the steady gains of apartments to the volatile peaks and valleys of office. History shows that rent growth is rarely, if ever, consistent with the underwriting assumption of 3% growth, year-in and year-out. Property types that experience real rent growth, or at least keep pace with inflation, are those that have the highest average annual returns. However, the property type with the lowest average annual return – office – can be the most appropriate for investors seeking higher short-term returns.

The structural effects of globalization reach well beyond today's often alarmist headlines. **Globalization reinforces the nation's income bifurcation, the growth of international gateway markets and the importance of knowledge industries.** These by-products of globalization have important implications: retail investments should be focused in affluent trade areas; upscale urban towers and lofts, lifestyle low-rise communities and townhouses, and seasonal properties are likely multi-family winners; gateway industrial markets will be the nation's strongest; and, office demand will be most robust in metro areas with an agglomeration of exportable knowledge industries.

The Cyclical Outlook

The U.S. economy is transitioning from a consumer- to business-led expansion. The resurgent driver of growth in 2005 will be corporate investment. While there are some warning signs of the sustainability of the current expansion, the most likely forecast is for steady GDP gains and stronger job growth. The business-driven property types – office and industrial – will experience continued improvement, as demand for these property types is most connected to corporate investment. The consumer-driven property types – apartments and retail – will continue to benefit from increasing household formations and growing incomes, especially among the affluent.

While tenant demand for commercial real estate has only recently shown signs of improvement, **the nation's capital markets began the decade strong and have only gotten stronger.** Even though the number of properties on the market increased considerably in 2004, investor demand grew even faster, especially for well-leased, high quality assets. Cap rates will shift higher, but they are not likely to return to their mid-1990s levels. Real estate has proven its mettle as a legitimate asset class for institutional investors, and this level of acceptance combined with growing demand for income-producing investments will sustain demand for quality properties.

The outlook for apartments is brightening. Three major demand drivers are turning around as the economy improves: job growth is accelerating; the number of twenty-somethings, the prime renter age group, is surging; and, interest rates are finally heading up, making it more difficult for renters to move into homeownership. Major metropolitan areas with supply constraints and low housing affordability are the best long-term bets for multi-family housing.

Retail absorption has been consistently positive since 2000, driven by resilient consumer spending and the rapid expansion of key retailers. Going forward, the positive effects of lower mortgage rates and tax cuts will wane, but stronger job growth will maintain retail sales gains. Stores that are thriving in today's environment are clustered at the low- and high-ends. Shopping centers and districts that provide attractive and convenient locations for these retailers and their customers are positioned to be desirable investments.

The performance of the national industrial market is finally turning positive, but the road to recovery will be protracted. Availabilities are near record levels, and are especially high in unconstrained, local-serving markets. Going forward, tenant demand will be strongest in the nation's largest metro areas. Gateway markets will continue to lead the pack given their substantial structural advantages, and the cyclical turnaround in major regional distribution centers presents opportunities for investors looking to capitalize on the market recovery.

The office market has notably improved in the last year. The direct leasing market is gradually recovering, but the dramatic drop in sublease space is even more responsible for falling vacancy rates and stabilizing rents. As vacancies drop from today's high levels, rent growth will pick up steam. Most metro areas will experience improving office demand, but centers of knowledge industries in particular will be the strongest performers over both the near and longer term.

Investment Implications of Long-Term Rent Trends

When it comes to long-term performance of the four major commercial property types – apartments, retail, industrial and office – long-term rent trends matter. Each property type has its own distinctive pattern of rent growth, ranging from the steady gains of apartments to the volatile peaks and valleys of office. History shows that rent growth is rarely, if ever, consistent with the underwriting assumption of 3% growth, year-in and year-out.

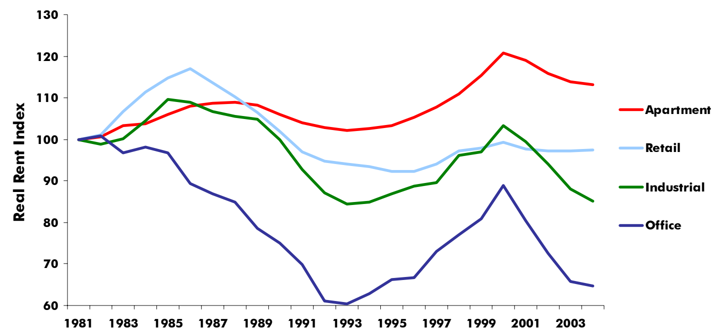
Long-term real rent growth (i.e., nominal rent growth adjusted for inflation) matters because it is the most important underlying determinant of total returns over the long-term. Property types that experience real rent growth, or at least keep pace with inflation, are those that have the highest average annual returns. Now that rents have been systematically tracked for over 20 years – spanning two full real estate cycles – these long-term trends are meaningful. And these trends have profound implications for allocating portfolios across property types.

Positive Rent Growth Drives High Returns

	1981 to 2004 Average Annual	
Property Type	**Real Rent Change**	**NCREIF Return**
Apartments	0.6%	10.0%
Retail	-0.1%	9.1%
Industrial	-0.7%	8.7%
Office	-1.9%	6.3%

Source: NCREIF; CBRE Torto Wheaton Research; Reis; CBRE Investors

Cycles Vary by Property Type



Source: CBRE Torto Wheaton Research; Reis; CBRE Investors

Cyclical Divergence

What's striking about the long-term real rent graphs for apartment, retail, industrial and office properties, is how different they are from one another. There are a few periods during which all property types did well, and some during which all did poorly, but also periods in which rent trends are moving in different directions. The other striking characteristic is how different the magnitude of the cycles is across the four property types. Office and apartments, for instance, couldn't be more different; the former is prone to high volatility and dramatic swings, the latter by very gradual year-to-year changes.

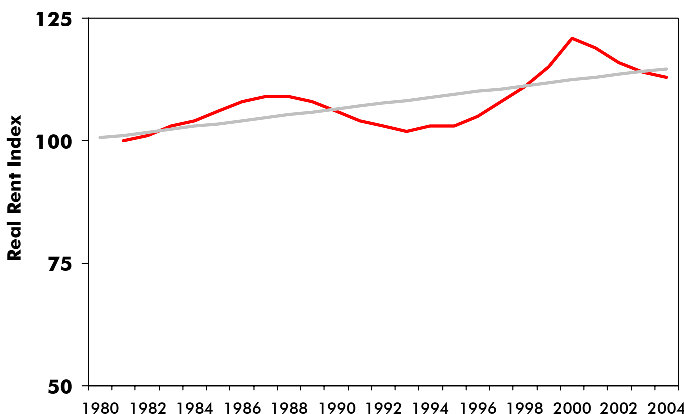
The two property types that are primarily driven by consumer spending and demographic trends – apartments and retail – have the lowest rent growth volatility and the highest average annual change. This is because spending and demographics tend to move fairly slowly, making future demand somewhat predictable, and because aggregate personal wealth growth is almost always positive. By contrast, the two property types that chiefly rely on business investment – industrial and office – have the highest volatility and the lowest average annual rent growth. Business investment is more cyclical than consumer-driven segments, and this is in part why the rent growth in these property types is more volatile.

Long-Term Rent Trends (cont.)

Apartments: Steady and Strong Rent Growth

Apartment rents are the only one of the four property types to grow in real terms over time. They are also the least volatile, which turns theoretical notions about risk/return tradeoffs on their heads. They're great income generators, with very little year-to-year variation, and property values tend to rise gradually but consistently. This stability makes apartment investments particularly appropriate for core portfolios.

Apartment Rents Outpace Inflation



Source: Reis; CBRE Investors

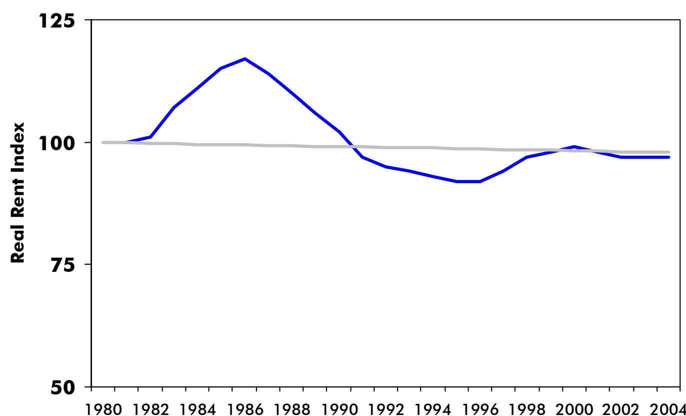
Structural trends point to continued solid long-term performance for apartments. The long-term structural drivers of apartment demand are strong. The "echo boom" generation (the children of the baby boomers) are just entering the prime renter age group. The urban renaissance in several central cities is attracting many young professionals and empty nesters to these dynamic locations.

The downsides to investing in apartments are more cyclical in nature. First of all, current pricing is high. Apartments have had the biggest cap rate compression over the past few years, and there are no shortages of buyers. Finding attractive yields in strong markets is challenging. Second, supply is a concern in many – generally non-coastal – markets with weak fundamentals. Even vacancy rates in the double digits in some markets aren't enough to squelch development capital. Higher interest rates will hopefully tamp down some of this construction and allow imbalanced markets to find their footing, but until that occurs, new building will prolong the period of soft rental rates and sub-par occupancies.

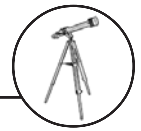
Retail Stays the Course

Retail rent growth is essentially a mean reverting trend; that is, retail rents tend to track inflation fairly closely. Retail rents in inflation adjusted terms are virtually the same now as they were in 1980. This steady performance makes retail well-suited to core portfolios. Retail also serves as an exceptional portfolio diversifier. Rents for retail properties behave differently from industrial and, especially, office. As a part of a large portfolio, a retail component will typically enhance overall risk-adjusted returns.

Retail Rents Track Inflation



Source: CBRE Torto Wheaton Research; CBRE Investors



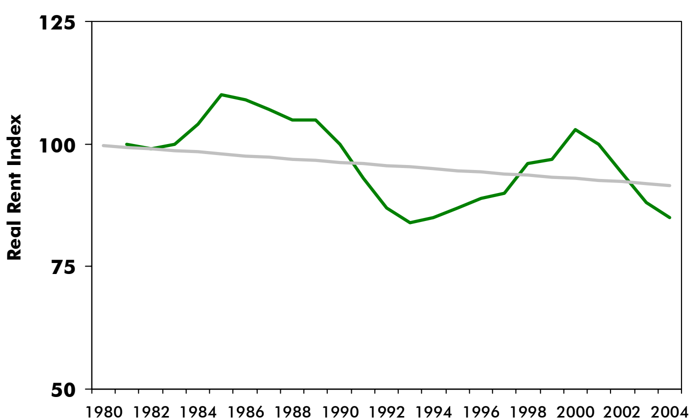
Retail does have its challenges. For one thing, retail properties are exceptionally heterogeneous. It's quite likely that a portfolio of ten shopping centers diversified geographically and by tenant type will perform about the same as the "average" retail property, but any single asset will most likely perform much better – or much worse – than average. Tenant mix, property-specific attributes and micro-location is far more important for retail centers than for any of the other major property types, making it challenging to choose the best performers.

Retail is also coming off a three-year period when returns have been as much as double the NCREIF average. The sustainability of these returns, particularly when recent rent growth has been solid but not spectacular, is tenuous. Compounding the risk is the shaky position of retail spending; consumers are shouldering significant debt loads, and if they rein in their spending even by a little over the next few years, many retail centers will feel the impact.

Industrial Straddles the Line between Core and Value Added

Industrial, one of the two business investment-driven property types, reflects some of the volatility of its underlying demand source. Neither the downward trend nor the volatility is as high as they are for office properties, but there is more cyclicality than in the consumer-driven retail and apartment sectors. This makes industrial something of a dual-strategy property type for both core and value added investors.

Industrial Rents Trend Lower



Source: CBRE Torto Wheaton Research; CBRE Investors

On the core side, industrial properties generate great income returns when they're leased. Management costs are generally low, especially when there is only one tenant. Leases tend to be triple net, meaning only a minimal proportion of cash flow needs to be reinvested in physical upgrades. Re-tenanting is usually inexpensive, since tenants are typically responsible for all or most of the improvements. These advantages make functional, well-located industrial properties attractive to core investors.

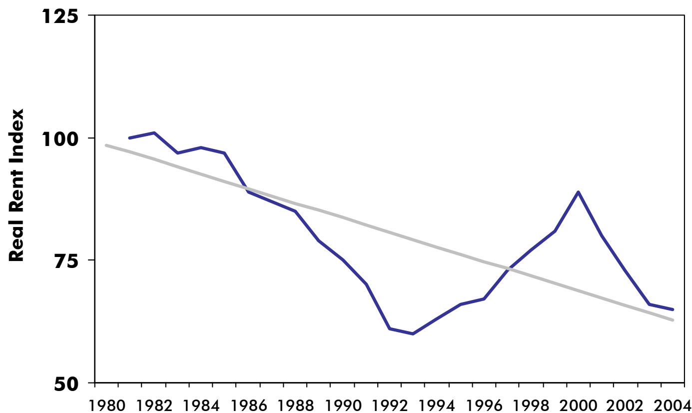
On the value added side, it's possible for investors to capitalize on cycles. Business investment in warehouse, distribution and manufacturing space waxes and wanes along with the business cycle, making periods of undersupply and overbuilding fairly common. Although over the long term industrial rents trend moderately lower, there is significant cyclical variation around that trend. For instance, from 1993 to 2000 industrial rents increased by 22% on a real basis, better than either retail or apartments over the period. Leasing into improving market fundamentals can generate high returns.

While the nation's gateway markets consistently outperform smaller, local-serving metro areas in terms of supply and demand fundamentals, pricing levels are high and yields low in these top markets. In general, low vacancy rates and positive rent growth are reflected by intense bidding and compressed cap rates. Core buyers looking for double-digit returns often come up short in the strongest industrial markets.

Functional obsolescence poses another risk for prospective investors. This risk is limited not only to dilapidated properties, but even some newer ones. Especially in smaller markets or those without supply constraints, newer state-of-the-art industrial buildings often cause rents to fall in less functional ones, even though in some cases these lower quality buildings were built only 20 or even 10 years ago.

Long-Term Rent Trends (cont.)

Office Rents Are Highly Cyclical



Source: CBRE Torto Wheaton Research; CBRE Investors

Office Offers Cyclical Opportunities

A quick glance at office rent trends makes two first impressions: they are highly volatile, and in real terms they decline over the long run. The slope of the annual rent change index is the steepest of the four major property types, both on the downslides and upswings. Note that the index line is never flat – when the office market turns, it turns quickly. That was certainly bad news in 2001, but welcome in the mid-1990s when nominal rent growth rocketed up by more than 10% in some years.

The extreme cyclicality in rents means that office assets, by their very nature, should always be actively managed investments. They are most appropriate for value added strategies. Office investments offer the best opportunity to capture rising market rents; although office returns are the weakest of the four property types over the long term, office has had the highest one-year returns. From 1996 through 2000, NCREIF returns were in the double-digits in every year, with a total five-year cumulative return of 104%! But market timing and a disciplined exit strategy are essential, as demonstrated in the period from 1990 to 1993 when returns were negative in every year, and the value of office properties tracked by NCREIF dropped by 42%.

The largest risk of office investments is that over longer time periods, office rents do not keep pace with inflation. Not coincidentally, over the last two decades, office values have declined *in nominal terms*, so it would be unwise for investors to expect appreciation of buy-and-hold assets. This risk is heightened in the current cycle, since prices have in many cases surpassed 2000 levels even though vacancies have skyrocketed and rents have dropped sharply. This currently makes buying properties for value added strategies particularly difficult.

Finally, there are trends including offshoring that are causing office space to be used more efficiently or, in some cases, not at all. While sensationalistic media portrayals significantly overstate the impact of offshoring on office tenant demand, it is true that office employment growth rates will likely be lower in the next decade than they were in the 1990s. This is part of an on-going trend, as office employment growth rates in the 1990s were lower than they were in the 1980s, which in turn was lower than growth in the 1970s. Combine lower office employment growth rates with more efficient use of space, including smaller offices and open floorplans, and it becomes clear that office space demand will grow at a slower rate than in prior decades.

Long-Term Thinking

The only good thing about the property market meltdown after 2000 is that it allows us to look at two full property market cycles since 1980, making it possible to analyze truly meaningful long-term trends. Consumer-driven property types have both stronger and more stable rent growth, making them more appropriate for core investments, while the more volatile rent trends in business-driven property types provides value added investors with the ability to capitalize on cycles.

There are plenty of exceptions to these broad brush observations; for example, there are certainly office investments that are highly appropriate for core investors, and some apartment properties offer the potential for value added or even opportunistic returns. But from a portfolio design perspective, these long term trends are enlightening and provocative, and they have substantial implications for investment strategy. ■

Globalization: Capitalizing on the Winners

The U.S. has the world's dominant economy—copied, reviled, envied and feared around the globe. Yet, Americans themselves are generally ambivalent at best, and often apprehensive about, the country's global role. Globalization is part of a dynamic process that clearly results in winners and losers. The losers get a lot of publicity, especially in a politicized atmosphere. From shuttered textile mills in the Carolinas to unemployed call center workers in Nebraska, the short-term downsides of globalization are evident. A lot of American workers, businesses and regions are suffering from the effects of an increasingly globalized economy.

But the structural effects of globalization reach well beyond today's often alarmist headlines. Globalization generally benefits top-line productivity and output in the world and U.S. economies. There are many winners in the dynamic process it unleashes; many American industries, workers and metro regions benefit from it. Identifying the beneficiaries and their real estate needs is a crucial part of creating a property investment portfolio that will perform strongly in an increasingly globalized environment.

Globalization reinforces the nation's income bifurcation, the growth of international gateway markets and the importance of knowledge industries. These by-products of globalization have important implications for consumer-driven sectors including retail and multi-family and the business-driven office and industrial sectors.

Income Bifurcation

Globalization reinforces the nation's income bifurcation. The negative fallout of globalization eliminates many easily automated jobs. Less obvious is that it benefits high income households by driving up the wages of skilled workers, while increasing the wealth of stockholders. The greater prosperity of upper income people also contributes to surging job growth in many support service industries.

The U.S. is a hotbed of knowledge industries that generate the products and services that the rest of a growing world wants. America creates a diverse range of cutting edge products, from software and entertainment to aircraft and agriculture. Its know-how in finance, development and logistics are readily exportable. Education at U.S. universities and treatment at U.S. hospitals are highly prized. These globally competitive industries and services require skilled, highly educated employees. As firms that supply these services and products expand, their demand for skilled workers will outstrip the supply. This will continue a long-term trend of outsized wage gains for college educated and technically proficient employees.

Lower skilled workers will see their wages continue to lag. Many jobs can be broken down to a series of repetitive rules, requiring little judgment or interpretation. These jobs are at risk to automation or shifting to low cost locations, often offshore. Globalization is the latest step in a long term trend toward mechanization and relocation. The trend makes the world economy more efficient and productive overall, but clearly dislocates many workers, industries and regions. Lower middle income, blue collar workers are generally the most pinched by the trend. Simultaneously, a great many jobs are being created in service industries that require a physical presence — from waiters to gardeners to personal trainers. Some of these are specialized skilled occupations that will see real income gains. But most of these are low skilled positions, readily supplied with workers being pushed out of blue collar jobs and by new immigrants.

Another group of big beneficiaries of globalization are multinational corporations. They successfully export products and services around the world. They also "rationalize" their operations to the most cost effective locations. The profits of multinational corporations have surged recently. Surging profits clearly benefit multinationals' executives, but they more importantly reward their stockholders. And stocks are disproportionately held by high income households — J.P. Morgan Chase estimates that the top 20% of households by income hold 75% of stocks. In this way, already high income individuals benefit directly from the wealth effect of globalization.

Globalization (cont.)

Consumer-Driven Sectors

The surging prosperity of affluent households and the increased income disparity have clear implications for real estate investment. This is particularly true for the retail and residential sectors driven by consumer demand.

Affluent trade areas are attractive environments for **retail** investment. The real income and wealth gains of residents of upscale neighborhoods translate into real retail sales growth. High income trade areas are also often mature or master-planned communities where additional shopping center development is constrained, providing some predictability of competitive supply.

Retail formats that meet the needs and desires of affluent residents will be strong performers. Higher income households desire brand name goods in a convenient, attractive environment. Affluent shoppers don't have a lot of time for shopping or food preparation, yet want the best quality and natural products. The well-to-do spend disproportionately on experiential activities, including dining out, health clubs, travel and entertainment. Retail formats that address these needs and desires include lifestyle villages, neighborhood centers anchored by a dominant or upscale specialty supermarket, and 24/7 CBD (Central Business District) shopping districts.

The booming residential market has been characterized by the proliferation of mini mansions across the landscape. The surge in affluent households has also been reflected in the **multi-family** sector. There has been a "Europeanization" of American cities. Young professionals, many employed in knowledge industries, have moved into central cities in force. They are being joined by empty nesters, many of them affluent enough to have a second home close to the action. In the suburbs, the affluent are looking for multi-family communities with resort amenities but without single family homeownership responsibilities. And beaches, deserts and mountains are experiencing burgeoning demand for retirement and getaway residences. Multi-family residential formats that satisfy these demand sources include apartments and condominiums in upscale urban towers and lofts, lifestyle low-rise communities and townhouses, and seasonal properties.

Globally Competitive Gateway Economies

The effects of globalization are not limited to workers and households. They also vary geographically. Metro areas with concentrations of industries providing exportable products and services clearly benefit from globalization. Gateway markets with seaports and major international airports benefit from burgeoning import and export activity.

The world is hungry for many American-made products and services. Their production is generally concentrated in key metro areas, ones that have an "agglomeration" of one or more globally competitive industries. These industries are often knowledge based, and require a deep pool of specialized skilled professionals and support services. Examples include the entertainment industry in Los Angeles, financial services in New York City, and technology in the San Francisco Bay Area. Washington, DC increasingly functions as the capital of the world, not just the U.S. Although domestic oil production stagnates, Houston exports energy services globally. American ingenuity is also evident as international visitors flock to amusement parks in Orlando and gaming venues in Las Vegas.

Globally competitive local economies are characterized by American know-how, but they also have an international orientation. This includes an ability to attract the best and the brightest talent from around the world. Many new immigrants also maintain close ties to their mother countries, giving a local American region direct access to an emerging source of low cost talent and production. These internationally oriented metro areas are often located along the coast, with a seaport. They can also be focused on a major international airport.

Business-Driven Sectors

An international orientation and a globally competitive economy are important determinants of a metro area's income levels and demographics, driving retail and residential demand. They are particularly crucial drivers of the long-term health of sectors driven by business demand including industrial and office.

Gateway markets are positioned to capture a disproportionately large share of **industrial** demand. Los Angeles/Long Beach and New York/New Jersey are the preeminent ports of entry for the U.S., garnering massive import flows. They are also proximate to the nation's largest consumer markets, making them key distribution staging areas. Other major national distribution centers benefit from their international airports and nexus of highways and railroads. Corporate America continues to concentrate warehousing activities into fewer, but more strategic, locations like Atlanta, Chicago and Dallas.

Metro areas with an agglomeration of exportable knowledge industries will experience substantial long-term **office** demand. Office markets in cities like New York, San Francisco and Washington, DC are more oriented to worldwide trends than local economic conditions. And within metro areas, knowledge industries tend to concentrate in highly amenitized CBD and Edge City submarkets.

Embracing the Inevitable

There are clearly winners and losers in a globalized world. Real estate investment portfolios should be designed to avoid losing demographic groups, industries and regions, while capitalizing on the winners.

But America shouldn't write the losers off. Effective initiatives that foster education, research and infrastructure can make more workers, industries and regions globally competitive. By embracing globalization in a way that widens its benefits, America can create a wider pool of real estate investment opportunities. ■

Overview

Tenant demand for all property types turned positive in 2004 for the first time since 2000. The economic expansion has added jobs in every month for over a year, fueling net absorption in both the consumer- and business-driven sectors. While the upward momentum is encouraging, substantial challenges remain: vacancies remain high in the office, industrial and apartment sectors, and retail spending growth is slowing. The outlook is for a sustained, yet protracted, recovery over the next few years.

The economic expansion is on track, although there are a few warning signs about the durability of the recovery. The transition to an investment-driven economy is underway, with rising business spending on equipment, hiring and, increasingly, office and industrial space. While current job growth in itself is not robust enough to sustain the recovery, the most likely scenario is that labor markets will regain momentum, driving tenant demand higher for commercial real estate.

The capital markets are being driven by voracious investor demand. Cap rates have fallen across all property types, although the compression has been particularly marked in the consumer-driven retail and apartment sectors. Despite the absolute drop in cap rates, real estate yields remain competitive compared with other income producing alternatives. While cap rates will shift higher as interest rates rise, they are not likely to return to their mid-1990s levels.

The consumer-driven property types – retail and apartments – are poised to perform best over the near-term. Demand for apartments is responding to positive net job gains, and will further benefit from higher mortgage rates. Driven by resilient consumer spending, retail demand never turned negative. The retail outlook varies considerably by product segment, with the most promising opportunities in formats that cater to affluent shoppers.

Office and industrial properties are just beginning to benefit from resurgent business spending. While industrial availabilities are still near record levels, they have finally begun to improve. Gateway industrial markets will continue to be the strongest performers, while the cyclical turnaround in regional distribution centers will provide opportunities to capitalize on the market recovery. Office demand is also on the mend, and the national vacancy rate has fallen for five consecutive quarters.

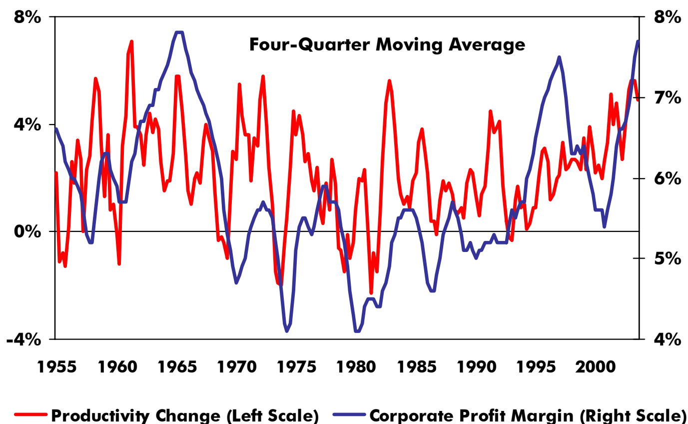
The economy and property markets have passed their nadirs. While a few questions remain, it is clear that the recovery is underway, and investors can expect gradual improvement from here forward. ■

Economy

The U.S. economy is transitioning from a consumer- to business-led expansion. The resurgent driver of growth entering 2005 will be corporate investment. While there are some warning signs of the sustainability of the current expansion – specifically, employment growth has softened recently, and high oil prices pose a threat to consumer spending and manufacturing output – the most likely forecast is for continued economic growth and stronger job gains.

Productivity and profitability are important indicators of the nation's economic health. Productivity has improved at a historically unprecedented pace since the early 1990s, even sustaining positive growth during the 2001 recession. This productivity has lifted average real wages, sustained output higher than it would have been during a difficult economic period, and more recently has driven corporate profit margins to near-record levels. These profits are driving business investment higher; this spending is necessary if the current expansion is to remain on track.

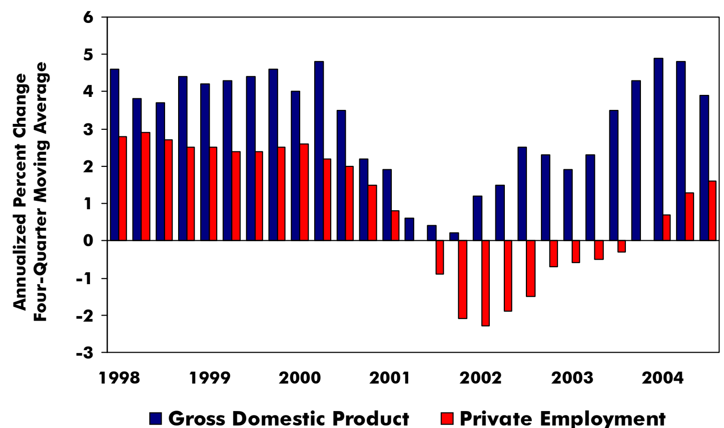
Profits and Productivity Are Near Historic Peaks



Source: Bureau of Economic Analysis; Bureau of Labor Statistics; CBRE Investors

Firms' improving profitability has also induced them to renew their hiring activity. Since 2001, employment growth has lagged significantly behind GDP. Indeed, more jobs were lost after the 2001 recession than during it. Yet the situation has improved markedly over the past year; robust GDP growth finally began to translate into net hiring in the second half of 2003, and into stronger job gains in 2004.

Healthy GDP Gains Are Finally Driving Job Growth



Source: Bureau of Economic Analysis; Bureau of Labor Statistics; CBRE Investors

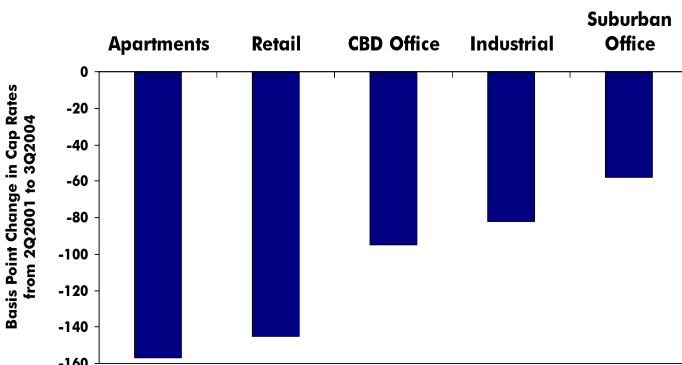
Economic and, in particular, job growth drive tenant demand. The economy is on track to remain in an expansionary mode, driving improvement in the labor markets. The business-driven property types – office and industrial – will experience significant improvement, as demand for these property types is most connected to business investment. As corporate spending rises, net absorption for these two property types will rebound, driving vacancy rates lower and rents higher. The consumer-driven property types – apartments and retail – will continue to benefit from increasing household formations and growing incomes, especially among the affluent. ■

Capital Markets

While tenant demand for commercial real estate has only recently shown signs of improvement, investor demand for properties began the decade strong and has only gotten stronger. Even though the number of properties on the market has increased considerably in 2004, investor demand has grown even faster, especially for well-leased, high quality assets. It is too early to tell whether this is the result of a permanent downward shift in return expectations or that a pricing correction is imminent, since there is evidence to support both scenarios.

Cap rates have fallen across all property types since 2001, and the compression has been especially marked in the consumer-driven property types. Cap rates have fallen fastest for apartments (down 157 basis points since mid-2001 and heading below 7%) and retail (down 145 basis points). These two property types are prized by investors for their income, and their exposure to the heretofore strongest sectors of the economy – consumer spending and residential demand– makes them particularly attractive now. Industrial and CBD office properties, despite generally unfavorable supply/ demand conditions, have attracted growing institutional investor interest, with prices hitting all-time peaks in many markets. Even the suburban office sector, which has been hard-hit by plunging tenant demand until recently, experienced a drop in cap rates over the past three years.

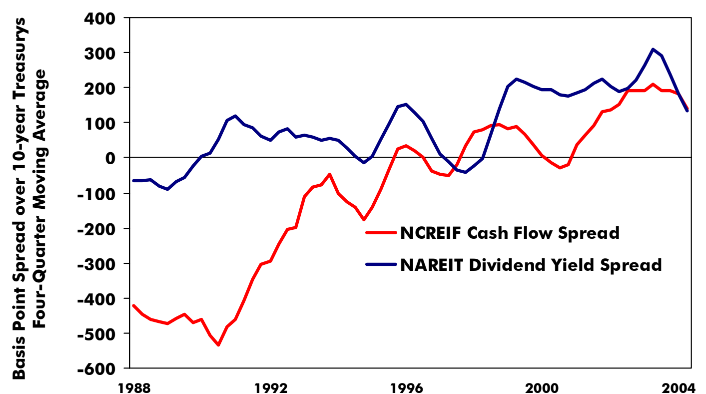
Cap Rates Have Fallen Fastest in Consumer-Driven Property Types



Source: Korpacz Real Estate Investor Survey; CBRE Investors

While the absolute drop in cap rates has been unprecedented, as compared with other income producing assets real estate yields remain very competitive. Spreads are very favorable, with real estate cash returns commanding more than a 100 basis point premium over 10-year Treasurys. This is in marked contrast to the early 1990s, when private real estate spreads were consistently negative. The risk premium for real estate over fixed-income bonds is appropriate, and demonstrates that real estate is competitively priced today relative to the alternatives.

Real Estate Income Spreads Are Positive



Source: NCREIF; NAREIT; Treasury Department; CBRE Investors

The concern now is that cap rates will rise as other income producing asset classes, including risk-free government bonds and high-quality corporates, offer higher yields. The question isn't whether cap rates will rise over the next few years – assuming the economic recovery remains on track and drives interest rates up, they almost certainly will – but rather what the magnitude of the rise will be. Cap rates will shift higher, but they are not likely to return to their mid-1990s levels. Real estate has proven its mettle as a legitimate asset class for institutional investors, and this level of acceptance combined with growing demand for income-producing investments will sustain demand for quality properties. ■

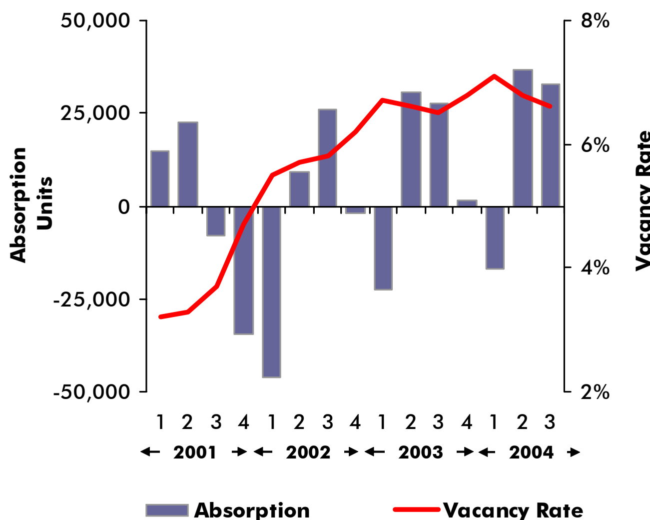
Apartments

The outlook for apartments is brightening. Since early 2001, apartment demand has been negatively impacted by two major factors. First, it had to contend with major job losses. When people lose their job, they eventually end up moving back home or doubling up with friends. Second, generational low mortgage rates enticed higher-end apartment dwellers to finally move-up to homeownership.

In addition, apartments have had to deal with long-term unfavorable demographic trends, with the prime renter age group (age 20-29) having shrunk over the past two decades. All three of these forces now are poised for turnarounds as the economy rebounds, interest rates begin to head up, and the echo boomers come of age.

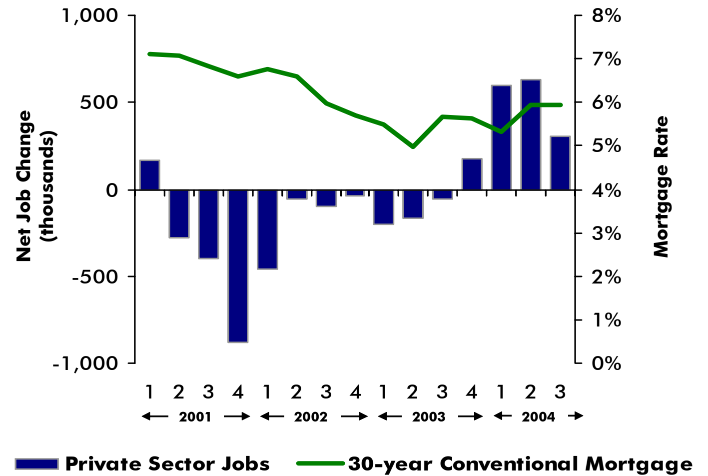
The poor economy and low interest rates caused apartment demand to turn negative in 2001 and 2002, the only down years since 1980. This negative absorption, along with continued construction, drove the apartment vacancy rate up from a very low 3.1% at year-end 2000 to a peak of 7.1% in the first quarter of 2004. However, it looks like conditions may be changing. Absorption was a strong 37,000 units in the second quarter of 2004 and 33,000 units in the third quarter. As a result, the vacancy rate fell to 6.6%.

Signs of Recovery for Apartments



Source: Reis; CBRE Investors

Demand Drivers Are Turning Around for Apartments



Source: Bureau of Labor Statistics; Freddie Mac; CBRE Investors

This recent reversal is due to a rebound in the drivers of apartment absorption. In the last three quarters, the nation finally experienced strong sustained employment growth, following ten quarters of job losses. Job gains quickly translate into increased apartment demand, as evidenced by the strong absorption in the second quarter. Interest rates are also higher than they were a year ago, although the upward trend has been more volatile than expected. Going forward, mortgage rates are projected to resume their climb. This will slow the transition to homeownership. It should also eventually slow the construction of new units.

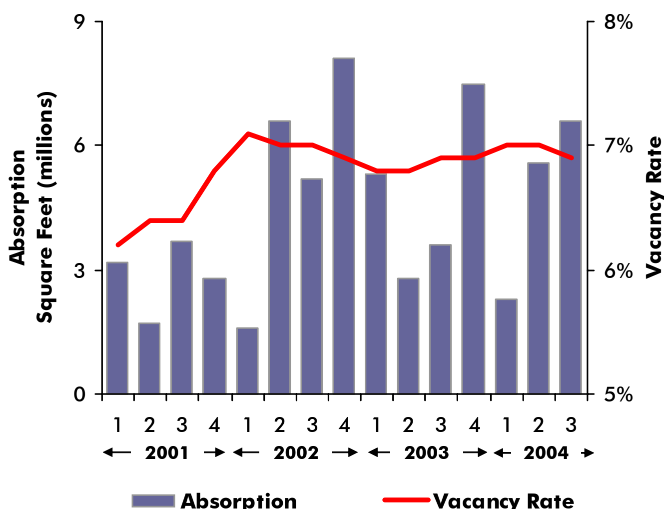
The turnaround in the key drivers of apartment demand will significantly boost absorption in 2005 and beyond. Construction should also begin to slow. As a result, the apartment vacancy will peak at year-end 2004, and then begin to slowly correct downwards. Major metropolitan areas with supply constraints and low housing affordability are still the best long-term bets for multi-family housing.■

Retail

Retail has been the best performing property type since 2000. In stark contrast to other sectors, retail absorption has been consistently positive, driven by resilient consumer spending and the rapid expansion of key retailers. Stores that are thriving in today's environment are generally clustered at the low- and high-ends. Although the top-line retail outlook is positive, performance by retailer and shopping format will vary considerably.

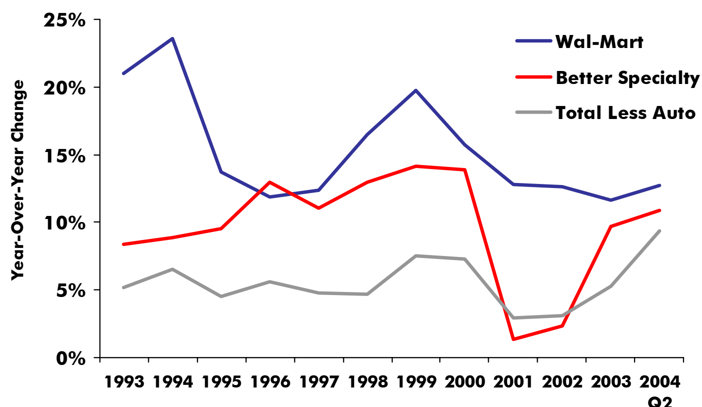
Retail sales growth is the prime driver of demand for shopping center space. Though it slowed down during the recent economic downturn, it was nowhere near the low levels typically seen in a recession. Consumers continued to spend because low mortgage rates allowed them to refinance and lower their monthly payments, as well as take out money for remodeling and other big expenditures. Tax cuts also increased take-home pay. This continued spending, along with relatively tame construction and rapid expansion by some national retailers, kept the shopping center vacancy rates low while preventing rent declines.

Retail Demand Has Been Healthy



Source: Reis; CBRE Investors

Retail Sales Growth Is Bifurcated



Source: U.S. Department of Commerce; CBRE Investors

In an overall strong environment, changing income distribution, demographics and consumer preferences mean that retail sales growth has been bifurcated. The strong segments are at the low- and high-ends, as the middle struggles. The accompanying exhibit illustrates these trends. Representing the low discount end, Wal-Mart's growth has been very strong over the past 11 years, and even with a recent slowdown remains in the double-digits. Better specialty stores including Pottery Barn, Neiman Marcus and Gap, have also been very strong, growing at almost twice the total. However, the higher end retailers are more susceptible to a weak economy and fashion trends; their sales dipped below the total in 2001 and 2002 before rebounding in 2003. Long-term income, demographic and preference trends indicate this bifurcation favoring the low- and high-ends is here to stay.

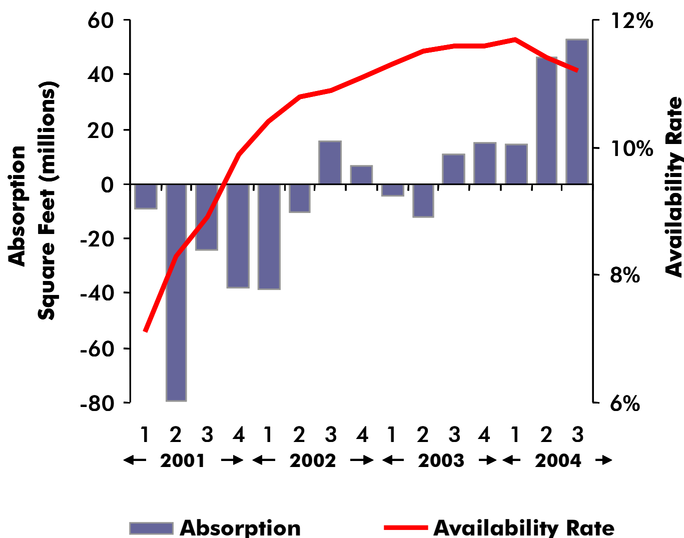
Going forward, the positive effects of lower mortgage rates and tax cuts will wane, but stronger job growth will maintain retail sales gains. Fortunately, retail vacancy is low enough to weather a moderate increase in construction, maintaining positive rent growth. Retailers that execute effectively at either end of the price spectrum will continue to outperform. Shopping centers and districts that provide attractive and convenient locations for these retailers and their customers are positioned to be desirable investments. ■

Industrial

The performance of the national industrial market is finally turning positive, but the road to recovery will be protracted. The business investment pullback beginning in 2001 devastated demand; net absorption turned sharply negative, availabilities rose and rents fell for nearly three years. Availabilities are still near record levels, and are especially high in unconstrained, local-serving markets. Regional markets are just now regaining their footing. Gateway markets are comparatively healthy, and will be the strongest performers going forward.

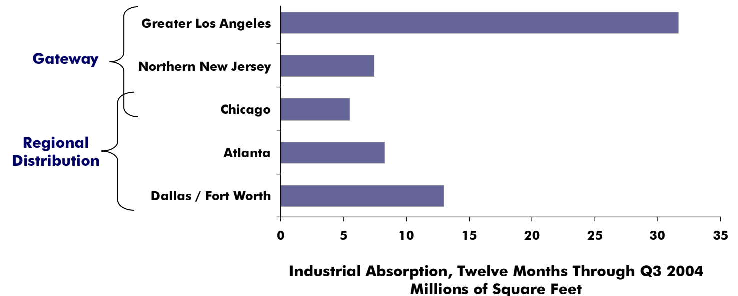
After a rough recessionary period in 2001 and uninspiring performance in 2002 and 2003, the industrial market finally showed firm signs of improvement in 2004. The availability rate fell in the second quarter of 2004 for the first time in 14 quarters, and ticked down further in the third quarter. Net absorption rebounded strongly, fueled by rising business investment and strong growth in inventory levels. A variety of indicators – including surveys of manufacturing activity, surging international trade and rising orders for new equipment – signal the recent improvement in industrial space demand is sustainable going forward.

Industrial Takes a Turn for the Better



Source: CBRE Torto Wheaton Research; CBRE Investors

Gateway Markets Lead the Pack, Regional Markets Rebound



Source: CBRE Torto Wheaton Research; CBRE Investors

While industrial performance has generally been middling over the past two years, this macro picture obscures the clear out-performance of globally-oriented markets. The nation's two largest gateway markets, Greater Los Angeles and Northern New Jersey, have experienced consistently strong net absorption since 2001, even as demand at the national level stagnated. Net absorption over the past twelve months has been particularly strong in Greater Los Angeles, but two other major regional centers, Atlanta and Dallas / Fort Worth, have also recently rebounded.

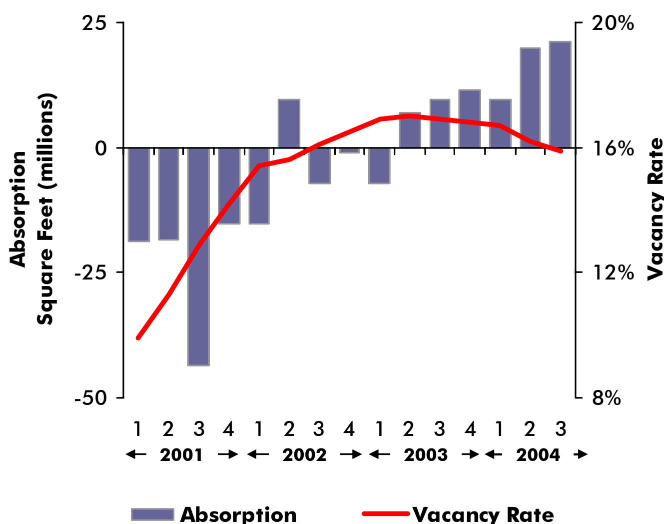
The national availability rate is still not low enough to drive a rebound in rental rates, but rents have at least stabilized at the national level. Going forward, tenant demand will be strongest in the nation's largest metro areas, as trade flows swell and the trend towards consolidation of smaller local-serving facilities into larger big box regional distribution centers accelerates. Gateway markets will continue to lead the pack given their substantial structural advantages, but the cyclical turnaround in major regional distribution centers presents opportunities to investors looking to capitalize on the market recovery. ■

Office

After suffering from the most severe reversal of fortune of the four major property types, the office market has notably improved in the last year. The direct leasing market is gradually recovering, but the dramatic drop in sublease space is even more responsible for falling vacancy rates and stabilizing rents. Although many markets remain saddled with very high vacancy rates, and market rents are well below in-place rents in most properties, the prospects for the office market are brighter than they have been for years.

The U.S. office market has been on the mend for over a year. In both the second and third quarters of 2004, the market absorbed more than 20 million square feet, the best levels since 2000. This brings the consecutive streak of quarters with positive absorption to more than six. The flood of space made available for sublease by overextended tenants – a major contributor to the sector's dismal performance in 2001-02 – is ebbing as businesses shift from cost cutting to planning for future expansion. The surge in demand caused vacancy to decline to 15.9%, clearly marking the end of the downturn.

The Office Market Is on the Mend



Source: CBRE Torto Wheaton Research; CBRE Investors

Recent Office Absorption Has Been Concentrated

Top Ten Absorption Markets, Twelve Months Through Q3 2004

Source: CBRE Torto Wheaton Research; CBRE Investors

Over the past year, absorption was highly concentrated along the nation's coasts. (The blue bars on the U.S. map are scaled to reflect the relative level of net absorption.) Ten metro areas, mostly in the Northeast and California, accounted for 55% of net demand in the U.S. The bi-coastal nature of the office demand recovery parallels the resurgence of financial, business, entertainment and technology oriented metro economies that are benefiting from the improving global economy. Many of these metro areas are also gaining from surging defense spending.

Going forward, office fundamentals will continue their gradual improvement. Construction levels are low in most markets, so even moderate levels of positive net absorption will translate into improving vacancy rates. As vacancies fall from today's high levels, rent growth will pick up steam. Most markets will experience improving office demand, but centers of knowledge industries in particular will be the strongest performers over both the near and longer term. ■

INVESTMENT RESEARCH REPORT

CB RICHARD ELLIS INVESTORS
INVESTMENT RESEARCH DEPARTMENT

Doug Herzbrun
Senior Managing Director
dherzbrun@cbreinvestors.com

Jane Dorrel
Senior Director
jdorrel@cbreinvestors.com

Lee Menifee
Senior Director
lmenifee@cbreinvestors.com

Shubhra Jha
Associate
sjha@cbreinvestors.com

CB RICHARD ELLIS INVESTORS
GLOBAL OFFICES

LOS ANGELES
865 South Figueroa Street, Suite 3500
Los Angeles, CA 90017
TEL +1 213 683 4200 FAX +1 213 683 4301

SAN FRANCISCO
2730 Sand Hill Road, Suite 280
Menlo Park, CA 94025
TEL +1 650 233 3600 FAX +1 650 233 3601

NEW YORK
140 Broadway, 8th Floor
New York, NY 10005
TEL +1 212 803 6170 FAX +1 212 803 6175

BOSTON
800 Boylston Street, Suite 1475
Boston, MA 02199
TEL +1 617 425 2800 FAX +1 617 425 2801

LONDON
64 North Row, 5th Floor
London UK W1K 7DA
TEL +44 207 882 8100 FAX +44 207 882 8683

PARIS
223 rue Saint-Honore, 75001
Paris, France
TEL +33 1 5862 5555 FAX +33 1 5862 5556

MILAN
Via Santa Maria Segreta 6, 20123
Milan, Italy
TEL +39 02 72 73 70 01 FAX +39 02 655 67050

BERLIN
Taubenstrasse 19, Am Gendarmenmarkt
10 117 Berlin, Germany
TEL +49 307 261 540 FAX +49 307 261 54

TOKYO
Izumi Garden Tower 29th Floor, 1-6-1 Roppongi, Minato-ku
Tokyo, Japan 106-6029
TEL +81 3 6229 3800 FAX +81 3 6229 3801

www.cbreinvestors.com

December 2004

04:100