Prudential Real Estate Investors

Taking Advantage of Long-Term Trends

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Pinehurst

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Institutional and individual investors face daunting challenges as the aging U.S. population places more strain on the retirement system. As real estate investors know, abundant liquidity in the global capital markets has compressed yields and risk premiums across asset classes and countries, making attractive opportunities increasingly scarce and harder to win. The low-return environment only compounds the more serious problems for individual investors and for the U.S. retirement system. Under the most optimistic scenarios, the U.S. system is inadequate to meet the needs of the aging population. Personal savings rates are very low, and Social Security and employment-based retirement plans probably cannot continue paying the level of benefits they have provided without substantive reform and, potentially, significant additional funding.

Accordingly, this year's Pinehurst Real Estate Seminar examined the changes in the retirement industry, especially the ongoing shift from corporate defined benefit (DB) to defined contribution (DC) plans, and explored the difficult task of identifying attractive real estate investment opportunities. Two common themes emerged. First, the more obvious and, perhaps, popular approaches to solving the pension industry's woes or to finding higher yielding assets may be riskier in the long run than they now appear. Second, and not unrelated, creativity and innovation will be critical in confronting the challenges and managing the risks on both fronts.

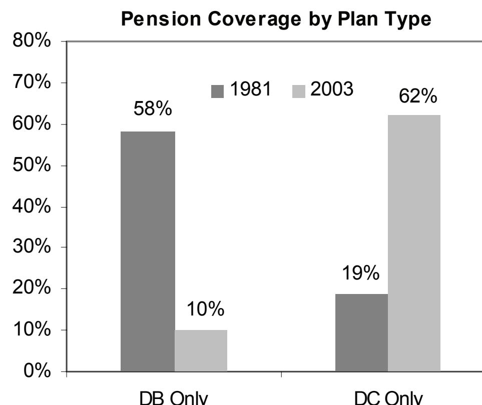
Changing Retirement Marketplace

The corporate retirement marketplace has undergone considerable change over the past 25 years. Since the introduction of 401k plans in the early 1980s, DC plans have proliferated, while the number of traditional DB plans has dwindled. DB plan *assets* still compose a sizeable share of the U.S. retirement market. But far fewer workers today are covered by traditional corporate DB plans. From 1981 to 2003, the share of workers who were covered by an employment-based retirement plan and had *only* a DB plan declined from 58% to just 10%, while those with *only* a DC plan soared from 19% to 62% (see **Exhibit 1**).

A confluence of forces has contributed to the increasing popularity of DC plans and to corporations' growing reluctance to offer traditional DB plans. A significant contributing factor has been the demographic reality of the aging baby-boom generation. The oldest

baby boomers will turn 65 in 2011 and the youngest in 2029. Between now and then, the U.S. population age 65 and older will more than double, causing its share of the total to jump from about 12.5% today to more than 19%.[1] How the baby boomers will behave as they approach retirement age is hard to predict. But the potential costs of providing for a much larger retiree population, whose longevity (and medical needs) could be unprecedented, represent a liability that companies are growing increasingly reluctant to bear.

Exhibit 1: Growth of Defined Contribution Plans

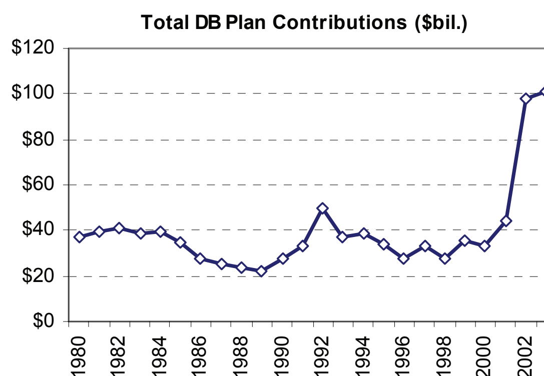


Source: Center for Retirement Research at Boston College

While demographics clearly have contributed to the shift from DB to DC plans, other factors have accelerated the trend in recent years, causing the future of traditional corporate DB plans to be at risk and highly unpredictable. Many of the corporate plans that are underfunded today reported surpluses during the bull market in stocks in the 1990s. Regrettably, those surpluses and excess fund returns encouraged plan sponsors to decrease or suspend contributions to their DB plans. When the stock market fell in 2000, employers were forced to significantly increase funding to their pension plans. Contributions to corporate DB plans spiked from an average of about $30 billion per year from 1980 to 2000 to about $100 billion per year in 2002 and 2003 (see **Exhibit 2**). Many companies now have no choice but to continue contributing substantial yearly sums to their pension plans or find alternative solutions. The current low-return environment, which not only reduces the expected rates of return for portfolios but also increases the present value of future liabilities, only exacerbates the problems plan sponsors face.

The impact of potential changes in the accounting rules for pension plans and legislation intended to protect retirees and to strengthen the Pension Benefit Guaranty Corp. (PBGC) may seal the fate of traditional corporate DB plans. Changes requiring mark-to-market accounting could seriously erode shareholders' equity, particularly in the airline and auto industries, and could sharply increase quarterly earnings volatility.

Exhibit 2: Soaring Plan Contributions



Source: Center for Retirement Research at Boston College

In addition, although the provisions of the new pension legislation have not yet been finalized, the reforms likely will not make it easier or less costly for corporations to continue offering traditional DB plans. Current proposals include tougher funding

[1] Moody's Economy.com (based on Census Bureau estimates). To put this into perspective, from 1980 to 2006, the share of the population age 65 and older increased only 120 basis points.

requirements, restrictions on extending new benefits for companies with underfunded plans and risk-based premiums for the PBGC that would increase the costs for plans that can least afford any additional expenses (i.e., underfunded plans).

From the corporate plan sponsor's perspective, DC plans seem like an obvious solution to many of the pension headaches that companies struggle with, especially as they face increasingly tough competition from foreign (and domestic) rivals who do not have similar liabilities. However, the DC plan solution has serious implications for retirees that many individual investors do not seem to appreciate fully. Most obviously, DC plans shift the burden of building an investment portfolio – one that can provide for a retiree's needs for a potentially long time – from the corporate plan sponsor to the individual. Many corporations match their employees' contributions to their DC accounts (usually with limits). But the responsibility for determining the appropriate level of savings and optimal asset allocation falls on the employees, who often are ill-prepared for making such decisions, relative to the investment professionals who manage corporate pension plans.

DC plans also transfer to individuals the responsibility for deciding whether and how to convert accumulated assets into retirement income, and for managing the accompanying risks. Difficulties individuals might face in managing these risks are compounded by factors such as longer life spans and rising healthcare costs.

While the shift from DB to DC plans affects only a portion of the U.S. retirement market, a sharp rise in the number of retirees who are increasingly reliant on insufficient levels of DC assets, along with Social Security and Medicare benefits, could have serious economic, fiscal and social repercussions. Pension reform legislation that includes provisions such as automatic enrollment would improve the DC plan model. However, the problem will require more creative solutions to provide the certainty of benefits that DB plans have promised. Educating employees will be an important part of any solution. But the market also requires innovative products that provide both the retirement returns and the distribution options needed to guarantee an income stream throughout retirement and, as importantly, products that appeal to individuals who have been reluctant to cede control of their retirement assets through traditional annuitization.

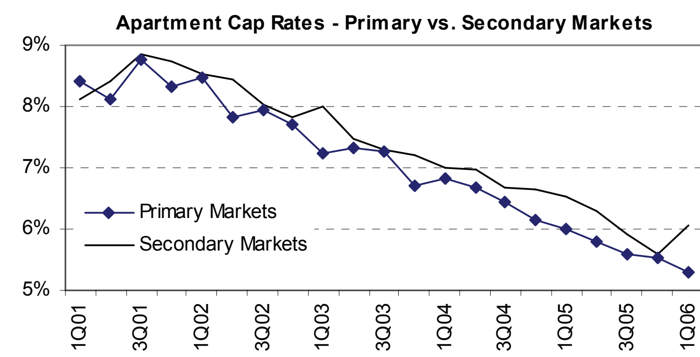
Real Estate Strategies and Tactics

Many of the factors confronting corporate plan sponsors today also affect the opportunities and risks in the real estate market. Perhaps the biggest near-term challenge is simply finding attractive investment opportunities. The low-return environment and global demand for yield has attracted significant capital flows to the asset class, causing yields to compress across property types and markets. Nowhere has the weight of capital been heavier than in the apartment sector. Condo fever, a product of low interest rates and the booming U.S. housing market, has pushed multifamily asset values to historically high levels in many markets. The strong demand for multifamily properties not only caused yields to fall, it also caused them to converge, leaving little (if any) premium for inferior assets and/or secondary markets (see **Exhibit 3**).

The most recent data suggests that yields in secondary markets may be rising, but the low yields and the lack of differentiation have complicated the difficult task of acquiring apartments. However, with apartment fundamentals improving and relatively little new supply of rental units

over the past few years, today's high asset values are creating attractive multifamily development opportunities in some markets.

Exhibit 3: Apartment Yields Have Fallen and Converged



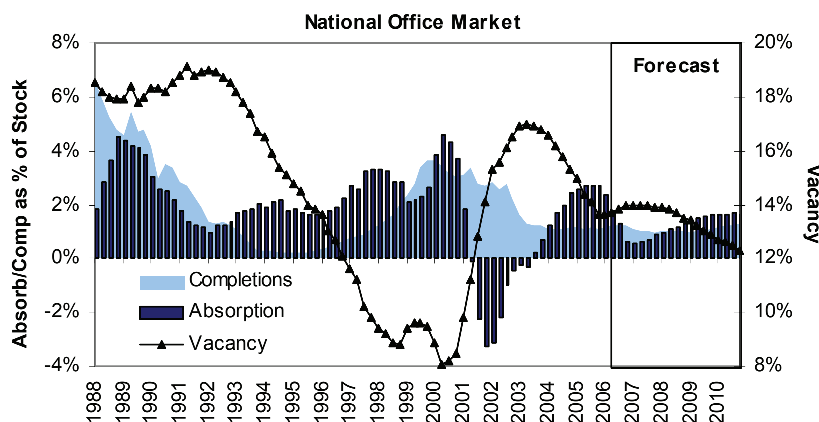
Source: Real Capital Analytics

As Stan Levy, chief operating officer of The Morgan Group, noted, after several years of strong home price appreciation, higher mortgage rates have pushed affordability beyond the reach of many households in a growing number of cities, especially on the coasts. In many of the markets with the most favorable population and job growth prospects, the high cost of homeownership has created a need for rental housing.

Finding development sites in cities with high homeownership costs and an expanding employment base requires (at least) as much art as science. Despite increasing signs of a slowdown in the condo market, competition for deals remains intense, especially in the bid-auction market. According to Mr. Levy, however, in supply-constrained markets where development is most attractive, investors usually can "manufacture" sites through redevelopment and still earn relatively attractive risk-adjusted returns. Although spreads between development and stabilized yields have narrowed, development allows investors to gain exposure to markets where demand-supply fundamentals have pushed pricing above replacement cost. Moreover, the narrow spreads must be weighed against the low yields in secondary markets or, for that matter, any market with few barriers to new supply. As the most recent cap rate data suggests, if apartment cap rates begin to rise, the upward trend most likely will appear first in markets where the outlook for rent growth is weakest.

Low yields and improving market fundamentals are also creating development opportunities in the office sector. Nationally, office vacancies have fallen dramatically since they peaked at about 17% in 2003, and new supply in most markets is still years away (see **Exhibit 4**).

Exhibit 4: Improving Office Market Fundamentals



Source: Torto Wheaton Research

While identifying markets that will be attractive for new development over the next cycle is critical to project success, Steve Van Amburgh, CEO of Koll Development, stressed the importance of understanding tenants' needs today. Mr. Van Amburgh described corporate America's space-planning decision matrix in the post-9/11 global economy as a "three-legged stool" built on people (employees), technology and cost.

Tenants' priorities today are neither surprising nor entirely new, but office properties that incorporate features and amenities that address these needs should have a distinct competitive advantage throughout the office market cycle. Koll's "Intellicenter-USA" concept, for example, is a "high-performance," LEED-certified design that incorporates environmentally friendly and energy-efficient elements that should appeal to tenants, investors and lenders.[2] The concept offers large, efficient floor plans that can be configured to maximize headcount to accommodate tenant growth or consolidation; raised access flooring for under-floor mechanical systems (air and cabling); abundant natural lighting; and other "green-building" elements that should improve operational efficiency and provide a healthier workplace. It remains to be seen whether LEED-certified buildings can deliver superior investment performance relative to their non-green peers, but public awareness of and tenant demand for these buildings has increased noticeably since energy prices soared. If energy prices remain elevated (or rise), the savings in operating costs alone could be a significant factor in attracting and retaining tenants.

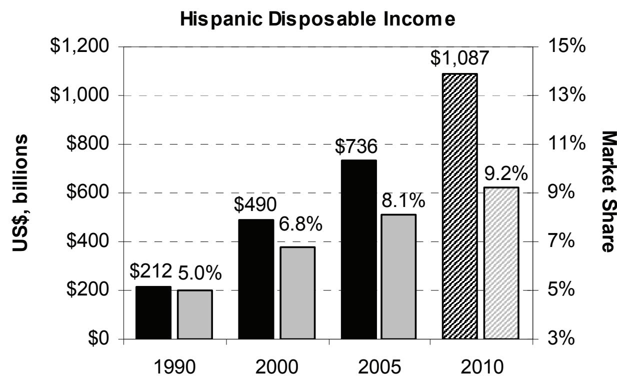
The retail market did not experience a sharp downturn in property market fundamentals after the tech bubble burst and the U.S. economy slipped briefly into recession. Instead, strong consumer spending continued to drive retail sales and to support demand for retail space throughout the slowdown in the corporate economy, keeping retail vacancy rates in check and rents stable. As in the apartment and office sectors, however, strong capital flows have created challenges for investors, particularly as the cooling housing market and higher energy prices threaten to take some of the momentum out of consumer spending. With initial yields already very low and a potential slowdown in retail sales, niche strategies with a more secular growth story, such as Hispanic retail, may offer the most attractive opportunities for retail investment.

The case for a Hispanic retail investment strategy is compelling. Hispanics constitute the largest and fastest growing minority population in the U.S. According to the Census Bureau, Hispanics compose more than 14% of the total population today, and are expected to account for 45% to 50% of U.S. births over the next decade or so. Their wealth is also increasing rapidly. Hispanic purchasing power in the U.S. increased at an 8.5% annual rate between 2000 and 2005, nearly twice as fast as that of non-Hispanics. By 2010, Hispanic disposable income is expected to reach nearly $1.1 trillion, or more than 9% of the U.S. total (see **Exhibit 5**).

[2] LEED (Leadership in Energy and Environmental Design) is a building rating system developed by the U.S. Green Building Council to "promote the design and construction of buildings that are environmentally responsible, profitable and healthy places to live and work." Buildings are evaluated in five categories: interior environmental quality; materials and resources; energy and atmosphere; water efficiency; and sustainable sites.

The growth and increasing affluence of the U.S. Hispanic population should create ample opportunities for retail development, not only in traditional gateway cities, such as Los Angeles, New York, Miami, Chicago and Houston, but also in markets like Phoenix and Orlando, which have experienced rapid growth in their Hispanic populations in recent years. However, as Arturo Sneider, a partner with Primestor Development, noted, to be successful, investors must know their customers. The Hispanic population differs in many ways from the non-Hispanic consumer that most retail developers and investors have previously targeted. Moreover, considerable differences exist between and within metropolitan areas and within the Hispanic population itself. Investors who take the time to understand these differences, however, have the opportunity to participate in one of the more dynamic segments of the U.S. retail real estate market.

Exhibit 5: Growing Hispanic Affluence Should Drive Consumption

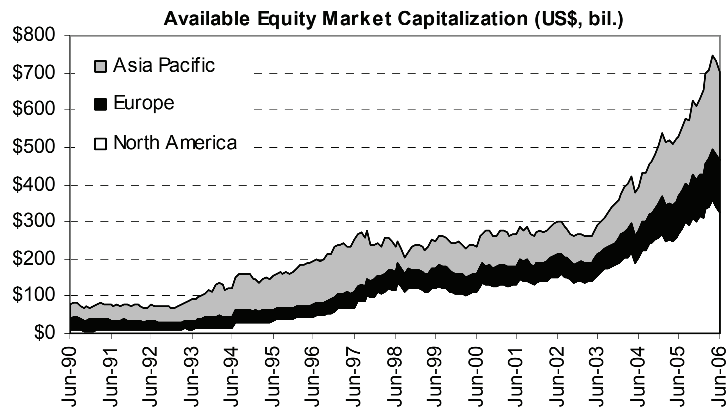


Source: Selig Center for Economic Growth (2005)

While the recent interest in real estate clearly has made finding attractive opportunities more difficult across all property types, it has also been a powerful catalyst for the proliferation of investment vehicles spanning all quadrants of the real estate capital markets. Most notably, the growth of securitized vehicles, such as real estate investments trusts (REITs), has greatly expanded individual and institutional investors' access to the asset class (see **Exhibit 6**). According to Scott Crowe, head of U.S. REITs and global strategist for UBS, over the course of the last decade, the number of countries with REIT legislation has increased from six to 18. The list now includes the UK, which adopted REIT legislation this year and should see the first REITs launched in 2007. Several other countries, including Germany, are also considering similar vehicles, presumably hoping to replicate the success of U.S. REITs and Australian listed property trusts (LPTs).

The dramatic growth of the global real estate securities market is an important development for the real estate industry and investors. From an industry perspective, better access to public capital markets not only alleviates the risk of a severe liquidity crisis, similar to what occurred in the early '90s, it also subjects the industry to the scrutiny of armies of public market analysts, rating agencies and others, thus improving transparency. For investors, the

Exhibit 6: Expanding Listed Property Markets



Source: S&P/Citigroup BMI Property Index (monthly data thru 6/1/06)

development of a global REIT market provides an opportunity to construct global portfolios of securities that offer many of the basic characteristics that make direct real estate investing attractive. As Bruce Eidelson, director of real estate advisory services with Russell Investment Group, noted, real estate securities offer significant diversification benefits in a portfolio of stocks and bonds and relatively attractive, stable yields. And, due to the local nature of property markets, a global portfolio of real estate securities offers superior diversification benefits compared with a global portfolio of non-real-estate stocks.

Although the growth of the global REIT market, along with healthy property market and economic fundamentals worldwide, should provide attractive opportunities for institutional and individual investors in the near term, REITs may play an even more important long-term role as the tsunami of baby boomers moves toward retirement. Commercial property (including multifamily) has proven a reliable source of stable income over the long term. Unfortunately, due to the large size and relatively illiquid nature of most assets, investing in real estate has been nearly impossible for most individuals. REITs are not a perfect substitute for direct real estate in the short term, but their long-term performance characteristics have been similar. Thus, if the shift to DC plans continues, REITs and other innovative real estate products designed for DC plans could become an important part of retirees' investment portfolios.

Closing Thoughts

The formidable challenges that investors face will not abate soon. They will probably become more acute as the baby boomers age and begin drawing on their retirement savings. With the future of traditional corporate DB plans uncertain and expected returns stubbornly low across all asset classes, plan sponsors and individual investors need the tools to build portfolios that will consistently deliver the returns and distribution options required to provide adequate income throughout retirement. Real estate alone won't meet the needs of most retirement portfolios, institutional or individual. But it certainly seems to deserve a place in a multi-asset portfolio, especially if the return objectives include stability and income. The increased interest in the asset class has eroded real estate's relative attractiveness over the last few years, but real estate historically has been a good source of stable, uncorrelated returns with a generous cash yield and capital growth at about the rate of inflation. Fortunately, real estate's new stature in the investment universe has also spawned a wide range of new investment opportunities, some of which will fare better than others. For investors with the expertise and creativity needed to identify and execute a strategy to take advantage of the long-term trends in the economy and society, real estate should continue to be a good source of attractive absolute and risk-adjusted returns.

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