Reprinted from the issue of January 29, 2001

BANKER & TRADESMAN

THE REAL ESTATE, BANKING AND COMMERCIAL WEEKLY FOR MASSACHUSETTS *ESTABLISHED 1872*

▶ FORECAST

Will the New England Economy See a Hard or Soft Landing?

By Dana C. Rowan

As the dot-com bust plays itself out and the national economy starts to lose a little altitude, speculative discussions among real estate investors invariably turn to the pressing question of whether or not the New England economy will ultimately suffer a hard or soft landing. Though memories of the real estate collapse of the early 1990's still run deep, there is compelling evidence that we will not see a repeat of that brutal downturn.

Real Estate INVESTMENT

At the close of the 1980s, severe recession started to grip the industry. Prices were soaring and investment cap rates were at all-time lows due to the flood of Japanese capital. In fact, these declining cap rates had masked declining NOI's in many properties from 1986 to 1989 as rising vacancies from aggressive overbuilding plagued many markets. Then, as tenant demand fell off abruptly with the onset of the recession, construction already underway compounded rising vacancy problems with even more latent supply.

The result: rents collapsed, so did price, and cap rates jumped more than 300 basis points. Vacancies in downtown Boston hit the mid-teens and suburban vacancies soared to over 20 percent in most markets. To make matters worse, an onslaught of real estate debt write-downs, which eroded the capital base of most highly leveraged New England banks, then forced these institutions to ration their remaining capital to only the strongest corporate credits. This put the economy into a tailspin and put a further squeeze on tenant demand.

DANA C. ROWAN *is senior vice president and director of asset management for the New Boston Fund, a real estate investment firm based in Boston. Rowan is a former president of the National Association of Industrial and Office Properties.*

Today and Tomorrow

Today, in stark contrast, new construction is proceeding at only a modest pace. Vacancies are at a 20-year low and rents have spiked to new highs, but are still not much more than the inflation adjusted peaks of the 1980s. Greater market transparency demanded by REIT analysts, investors and rating agencies, combined with readily accessible market data from electronic intermediaries continue to impart a capital markets discipline on the supply side.

Today, the dominant large property owners are the REITs, followed by private opportunity funds and some offshore owners. The REITs have modestly leveraged capital structures and depressed stock prices have kept many of these companies out of the market. Most private investment firms are yield constrained and thus remain price sensitive, especially as they view the latest run-up in rents as unsustainable. There is a price-per-pound mentality among buyers in the market that imposes a ceiling on price and now fuels a widening bid-ask spread. Meanwhile, sellers believe they're entitled to receive fair value for the leases they've put in place and are, effectively imposing a floor on cap rate derived pricing.

Average U.S. Rental Growth Rates By Property Type

Property Type	Actual 2000	Projected 2001 (soft landing)	Projected 2001 (hard landing)
Office	12.0%	5.5%	4.25%
Industrial	12.0%	6.0%	4.0%
Residential	4.0%	4.5%	4.25%
Retail	4.25%	4.0%	1.5%

Source: Torto Whearon Research

Widening bid-ask spreads and rising anxiety over the current direction of the economy have pushed some buyers to the sidelines. Other idle buyers believe that a pricing shakeout is imminent and are keeping their powder dry for what they believe will be better pricing and higher product quality in the third and fourth quarters of 2001. Investment sale brokers who used to consistently see fifteen buyers pursuing each prospect, now see five buyers. And there is far greater attention given to a buyers' ability to close rather than focusing primarily on the offer price.

Momentum-oriented markets that used to allow short-term investors to confidently exit deals at comfortable spreads with little perceived risk are now seeing market pricing shed some value. Without a reliable exit strategy for prospective new entrants, and rents now starting to come off their highs, speculative momentum is dissipating. Sellers that must exit are increasingly accepting higher cap rates. Underwriting for offers these days discount peak rents by 5 to 10 percent and treat these spikes more as aberrations than as benchmarks for future leasing activity and a baseline for sustained rental growth. The days of applying a four to five percent growth rate on cur-

continued on reverse side

rent market rents are gone. Heady rent comparables from the second quarter to the fourth quarter of 2000 are frequently relied on by investment sales brokers to promote deals, but are usually dismissed by buyers as being far less indicative of future near-term performance.

Well capitalized, value-oriented investment funds, such as New Boston Fund, will continue to seek out attractively priced properties that offer strong cash flow returns. These buyers are finding a new level of respect for their discipline in the market as sellers, who increasingly value a buyer's ability to close, will often accept a slightly lower offer for the added comfort of knowing the deal will get done. "One of the surest ways to meet yield objectives these days is to buy right," says Bill McAvoy, chief investment officer for New Boston Fund. "Overpaying for deals in overheated markets is a risky strategy especially when fundamentals start to shift." Bill has also completed a number of deals this past year with sellers that have come back to him after failing to close a string of back-up offers, either due to lack of equity or lenders simply refusing to support the underwriting of aggressive, thinly capitalized deals.

In spite of the economic uncertainty looming on the horizon, Torto Wheaton Research expects real estate investments to deliver healthy returns through 2004. Office investments are expected to outperform other product types with a projected five-year average yield across the US of 14.0%, followed by industrial at 10.3%, residential at 9.4% and retail at 8.5%. These yields are predicated on moderate, but healthy rental rate increases with a slightly less favorable outcome expected if the US economy suffers a hard landing.

TWR's projections bode well for real estate as rental rates are expected to increase even with a hard landing. As one would expect, industrial and retail rents are anticipated to be the most sensitive to a hard landing. In this scenario, inventories are expected to shrink and wary consumers put off purchases.

One other positive trend facing the industry is declining interest rates. Though lenders have used declining interest rates recently as an opportunity to widen their spreads, a substantial portion of the rate drop is being passed along to borrowers. We are now entering a capital market environment where cap rates are rising and interest rates are falling, translating into increasingly attractive yields for leveraged buyers that can still find product at the right price. ■