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Positive indicators and well-priced capital allow for a solid second half

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If the record attendance at IMN's U.S. Real Estate Opportunity & Private Fund Conference held late June in New York was any barometer, there is still plenty of capital trying to find a way into quality real estate investments. What constantly amazes most industry professionals with gray or graying hair is the shear number of players presently involved in the real estate capital markets. Not too long ago there were only two sources, life companies and domestic banks, in this space. Today, we have pension funds, opportunity funds, hedge funds, REITS, private investors, a few remaining direct investment life companies, and foreign and domestic banks all elbowing each other for the next transaction.

The competitive model of new entrants to the real estate capital markets is to carve out a specific slice of the capital stack, market segment, asset class, or region and focus to differentiate their programs from the masses. The clear winner from this process is the borrower or user of capital. By selectively focusing on a specific traunch of the market, real estate investors are now able to price their capital at a unique point along the risk/reward continuum. As a result, capital has never been priced more efficiently.

The preponderance of existing and ever increasing providers of capital has created a new dilemma for borrowers: the selection process. Unless a real estate development or management company has dedicated staff to constantly scan the marketplace and identify the best source, then today more than ever, borrowers should consider engaging a real estate investment banker. The historic terms of mortgage banker and mortgage broker have fallen out of vogue as a larger percentage of real estate capitalizations are now highly structured including mezzanine and preferred equity components.

In terms of current conditions, the recent rise in interest rates has created a slowdown in the for-sale housing market. In fact, some national marketsare experiencing a pull-back. In spite of this slowdown, it is important to consider that the for-sale housing market has carried the real estate industry for the last several years. For-sale housing was the primary catalyst of the industry driven by the construction boom in condominiums and single family tracks to the conversion of apartment, office, and other commercial space to residential condos. During this climate, a large number of lenders, construction companies, brokers, and developers redeployed assets to meet the massive demand. Now these assets, both human and capital, are being reallocated on a more balanced basis across other property types. While for-sale housing is presently struggling, no responsible economist is projecting a wide scale "real estate bubble." Notably, some over-built markets will suffer some retrenchment, but those are in markets that gained the most and have more to give back.

The real "real estate industry" news is beyond for-sale housing. Fundamentals are the best they have been in years in the major food groups: office, retail, industrial, and multifamily. The latter sector is benefiting from the very problem hurting for-sale housing: higher interest rates have caused renting to be more economical, in some cases, boosting occupancies and net income for multifamily assets nationally. The retail sector has directly benefited from the for-sale housing boom as demand increases for an abundance of services from new housing developments. The sluggish for-sale housing markets in south Florida and Nevada have some of the strongest new retail markets in the country following the residential build up.

The last quarter numbers indicate that the economy is cooling as high energy costs and increasing interest rates impact activity. In a speech on June 15th in Chicago, fed chairman Bernanke stressed that higher energy costs are here to stay, but that the fed will work to control inflation and ensure that these costs are not passed on in the form of higher wages or the prices for goods and services. Strong job numbers combined with solid industry balance sheets are expected to continue payroll additions. The net effect of this is a continued demand for office space. This demand coupled with constrained supply nationally will continue the trend of positive net office absorption this year.

In terms of overall market values, during the last several years real estate value creation was generated mostly from "cap rate compression." This is the phenomenon whereby values go up despite flat or ever declining income solely due to the macro effect of falling interest rates. Today the opposite is true. Despite the current rising rate environment, real estate fundamentals in most sectors are improving at such a pace that values are continuing to rise. We are witnessing a series of factors assisting this event. First, there is the generally improving economy as manifested in the resurgence of the stock markets. This improvement drives demand for all asset classes of real estate.

Next, there is the explosion of construction costs driven by the "Katrina Effect" and the consumption of materials from China and India. Increased construction costs have led to a shift in replacement cost analysis benefiting existing real estate assets and causing further downward pressure on cap rates.

In addition to the macro economic factors improving values, we should not overlook the "institutionalization" of the real estate industry. The recent institutional popularity of real estate is not a fleeting occurrence, since many of these new investors are pension funds that infrequently adjust their allocations. All this new capital chasing real estate investments is having a dampening effect on cap rates. Thus, the historical difference between real rates and real estate capitalization rates is at historic lows in the U.S. What is interesting is that our current cap rate/interest rate ratio is actually more in-line with other developed economies across the globe. This has led leading economists to predict that in our present global economy the current cap rates are the new paradigm.

The prospects for the real estate industry are optimistic at mid-year 2006, unless your primary focus is for-sale housing which continues to be a micro economic play. Otherwise, there are positive indicators for this sector and significant well-priced capital to allow for a solid second half of the year.

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