

Predictions of `Bubble' in High-Flying Office Investment Market Are Premature, New Study Concludes

Grubb & Ellis, PNC Real Estate Finance and Real Capital Analytics Forecast Leasing Market Will Not Regain Balance Until 2007

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Office building sale prices have risen while occupancy rates have fallen. But despite industry buzz that this divergent trend is pumping a "bubble" in the office investment market, this activity is no more than "rational exuberance" on the part of investors, concludes a year-end research report by Grubb & Ellis Company, PNC Real Estate Finance, a member of The PNC Financial Services Group, Inc., and Real Capital Analytics.

(Photo: <http://www.newscom.com/cgi-bin/prnh/20021218/PHW013>)

In fact, the co-authors concluded, the headline-grabbing activity is limited to a small set of investors buying the best properties in a handful of markets - it is not a widespread problem. One investment broker included in the study responded: "For every investor who thinks there's a bubble, five others outbid him."

The co-authors of the report are: Bob Bach, National Director of Market Analysis for Grubb & Ellis; Nicholas Buss, Group Manager, and Elizabeth Ptacek, Senior Analyst, both from Market Research at PNC Real Estate Finance; and Bob White, President of Real Capital Analytics. Their national study includes transaction data, leasing data as well as investor and lender interviews with leading players within the commercial real estate industry.

The co-authors concluded that a "bubble," defined as price appreciation that is both unjustifiable and unsustainable, does not exist in the office market and the occurrence of one appears unlikely.

"Our findings clearly indicate that investors are exhibiting rational exuberance as they consider investment options, choosing to buy the best assets in the best markets for high prices in order to avoid market risk," Bach said. "This is a rational response to historically low mortgage rates, the lack of compelling investment alternatives, and the willingness of investors to trade lower yields for lower risk in the post-bubble, post-Enron era."

PNC's Buss noted: "To quote one respondent - 'fear is outweighing greed and no one wants to screw up.' If they are wrong, investors want to be wrong on the upside and they are willing to accept -- and pay for -- a lower yield in order to take on less risk."

The reasons for the continuing trend are relatively straightforward, Buss said. "Based on unattractive investment alternatives, real estate clearly looks to be the best of the worst. Real estate is a hard, tangible asset that has historically thrown off a 7-9 percent income return (in the form of current cash flow) and, in terms of total return, has outperformed most other major asset classes over the last one-, three-, five-, and

10-year investment horizons," he noted.

With interest rates falling to historic lows, Buss added, the spread between finance rates and cash yields is the widest it has been in many years. The result, paying higher prices for properties with stable or (marginally) declining cash flows can be justified in terms of the total risk-adjusted yield.

Tale of Two Markets

The study found that the District of Columbia, midtown Manhattan and southern California top the list of primary markets where investors are willing to bid aggressively for the right assets. The District of Columbia may be the last market where the opportunity play is alive and well as buyers bid aggressively for Class B and C properties as well as Class A.

White of Real Capital Analytics said the study tells "a tale of two markets," contrasting the stable Class A properties with the vast universe of other properties more subject to leasing risk. This latter category includes Class B or poorly located properties in primary markets and the vast majority of properties in secondary markets.

"There is some migration along the risk curve as buyers excluded from the first tier take on riskier properties simply to get their money placed in real estate. But there is little evidence to suggest that this is happening on a systemic basis," White said. "On the contrary, there still appears to be a gap between buyer and seller expectations for second tier properties and secondary markets, with sellers choosing to refinance rather than sell into a cautious market."

White noted there is anecdotal evidence of properties generating positive cash flow with occupancies as low as 50 percent, a sign of both low mortgage rates and the conservative loan-to-value ratios initially placed (or forced) on these properties by lenders.

New Year's Prediction

Going forward, the study's co-authors expect some of today's more aggressive investors, notably those using floating rate debt and not anticipating a long-term hold, to experience some discomfort when the capital markets become less friendly to real estate. This could happen when the economy gains momentum causing interest rates to rise and other investment categories (stocks and bonds) to look more appealing.

"Because the capital markets shift more rapidly than the leasing markets, these owners will not be able to offset rising interest rates with rising rental rates soon enough to avoid deterioration in their cash flows," PNC's Ptacek said. "This could result in some distressed properties coming to market in 2003 and 2004, but nowhere near the volume that capsized values in the early 1990s following the last recession. Most investors appear to be buying with their eyes open."

Leasing markets will recover slowly. "Office leasing activity is expected to pick up in late-2003, early-2004,"

Bach said, "But the office market is unlikely to see a 10 percent vacancy rate until 2007, thus keeping the lid on rents for the near-term."

[TO SEE THE REPORT: A summary is available online at www.pncrealestatefinance.com/REMarketResearch.htm or <http://www.grubb-ellis.com/>]

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