

## 2003 Outlook

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# Market Perspective

### Introduction

At the start of 2002, we were hopeful that the year would bring some relief from the economic and geopolitical uncertainty that complicated all short-term predictions for the US economy and real estate markets. A year later, however, there are few signs that the economy or world is noticeably closer to the more familiar “normal” order that existed prior to the recession and the terrorist attacks in 2001. In fact, many of the sources of anxiety in the markets and world affairs that were at work at the start of last year – terrorism at home and abroad, tensions in the Middle East and weak domestic and foreign economies – remain firmly in place and, in some cases, have worsened.

Clearly certain aspects of the current environment have changed from a year ago, but many features of the broader economic landscape seem relatively unchanged. GDP growth is still sporadic; interest rates remain at historic lows; and the stock market continues to be extremely volatile as the parade of corporate malfeasance and lackluster earnings releases marches on. Perhaps most importantly, as far as the US economy is concerned, the fundamental problem continues to be the wide gap between the consumer and business segments, a familiar feature that has been good for consumer-driven sectors like housing and retail, and bad for business-driven sectors like manufacturing, technology and, with a few exceptions, employment.

The environment in the US real estate market at the start of 2003 closely parallels that of the broader economy. Certain features have changed in the past year. New legislation for terrorism insurance, for example, should help alleviate some of the uncertainty in the real estate debt markets.

But like the broader economy, many of the same dynamics that were in force last year remain largely in place. Low interest rates have kept the cost of capital at historic lows for many segments of the industry, although not for all property types or markets. Equity and debt capital flows to real estate have remained strong, mostly because of the relative attractiveness of real estate returns versus other asset classes. But property market fundamentals have continued to deteriorate amid weak tenant demand, particularly in property types that depend on business, like offices and hotels.

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While it seems clear that property market fundamentals will not begin to improve materially until the business sector has enough confidence to begin investing in equipment and workers again, it is not yet clear when this will occur or even what it will mean for real estate investments in the short to medium term. Typically, a strengthening economy causes real estate market fundamentals to improve, making cash flows safer while providing some opportunity for income growth and asset appreciation. Such an outcome depends heavily on the timing of the recovery, the speed with which businesses begin to reinvest and, at the property level, the timing of lease rollovers. The longer the corporate sector takes to recover and begin investing again, the less likely this scenario becomes.

Alternatively, a strengthening economy could adversely affect real estate in the short term. With continued strong capital flows and further deterioration in property market fundamentals last year, the disconnect between the real estate capital markets and property markets widened in 2002. Cap rates in certain market segments continued to trend downward even as vacancies increased and rents fell. The degree to which capital flows and interest rates are supporting the property markets is difficult to measure, and the spreads between cap rates and interest rates are still very wide. However, if interest rates and/or capital flows are providing more support than we currently believe, a broad economic recovery could cause both to change relatively quickly. In such a scenario, we could see a reversal of the current trend, with cap rates rising as vacancies fall and market rents stabilize.

While it is hard to predict where we actually will fall between these two admittedly extreme scenarios, we remain optimistic that the economic recovery will gain strength as corporate confidence recovers in 2003 and that property market fundamentals will stabilize and perhaps begin to improve in the second half of the year. This year, however, it is harder than it has been in the past to generalize about the outlook for real estate investments, as the risks have increased in most property types and markets. In the following discussion, we offer some thoughts on the current dynamics in the real estate property and capital markets and the opportunities and risks they present in the year ahead.

### **The Debt Markets**

Another year of historically low interest rates and continued turmoil in the corporate fixed income markets combined to make 2002 another busy year in the real estate debt markets. A year ago, we expected lenders would become more selective in 2002 as property market fundamentals weakened. Instead, debt capital became more readily available for many segments of the real estate market as new and traditional sources of debt capital converged on the industry in search of transparency, safety and yields.

Although lenders continue to favor property types that benefit from the strong consumer economy, namely retail and multifamily, competition for deals has caused mortgage spreads to narrow and forced lenders to consider a broader menu of investment options to satisfy their appetites. Commercial banks, for example, appear to be more willing today to make construction loans than they were a year ago, and a significant amount of mezzanine capital remains eager to fill gaps between the equity and senior debt positions of a broad array of deals. The increased competition in the debt markets has intensified the struggle between those charged with originating loans and those responsible for maintaining underwriting standards. While this

struggle is not new, the current market dynamics appear to have shifted the balance of power to the origination side of the equation for the moment, increasing the risk that too much debt capital could flow into real estate.

So far, delinquencies and defaults in most institutional loan portfolios and CMBS pools have remained low. According to ACLI data, delinquencies in life insurance loan portfolios remained near historic lows through the first half of 2002, while average loan-to-value ratios declined and debt service coverage ratios increased. Although the credit quality of some outstanding CMBS issues has deteriorated somewhat as loan-to-value ratios and delinquency rates have increased, the health care and lodging sectors continue to be the source of most of the problems. At some point, we expect the continued deterioration in the office and multifamily markets will begin to show up in rising CMBS delinquency rates, but so far the public debt markets have been spared.

The weakening market fundamentals did little to slow the pace of new CMBS issuance in 2002. Although the total volume last year fell short of the record \$97 billion in 2001, CMBS issuance remained strong and even accelerated in the fourth quarter. According to *Commercial Mortgage Alert*, total new CMBS issuance in 2002 was \$95 billion, which included \$28.6 billion of loans secured by collateral outside the US. The brisk pace of loan originations in the final months of 2002 suggests that new issuance could remain strong in the first half of 2003. Investor appetite for new CMBS issues in 2003 may provide some indication of the market's perception of risk in the real estate sector and the relative attractiveness of other asset classes.

Last year, investor demand was strong enough to cause spreads to narrow throughout the year on most tranches, despite the robust pace of new supply. Spreads on senior-rated tranches of CMBS tightened further in December and remain well below spreads for comparably rated corporate bonds. Some of this pressure on spreads can be attributed to the voracious appetite of Freddie Mac for the senior pieces of any issue comprised of at least 30% multifamily loans. Spreads on the lower tranches, however, widened in December, perhaps in response to the rich pricing levels achieved earlier in the year as more players entered the B-piece market. Although these investors continue to impose discipline on the market through their ability to kick out any loans in a CMBS pool that do not meet their underwriting criteria, declining loan kick outs and tighter spreads suggest the B-piece buyers may be losing some of their leverage.

The availability of debt capital for the real estate sector in 2003 will depend on what happens in the broader economy and with interest rates. The Fed likely will refrain from raising interest rates until the economy is clearly on a sound footing. However, with deficits looming at the city, state and federal levels, the public sector could begin issuing significant amounts of new debt in 2003 and beyond. In theory, this should put upward pressure on long-term rates, making the yield curve even steeper. Any increase in borrowing costs, particularly if combined with a recovery in the corporate sector, could make real estate relatively less attractive and cause spreads to widen. Although certain market segments would suffer more than others if debt capital becomes more constrained in 2003, some reduction in the amount of capital available for real estate could ease some of the pressures in the market and shut off the slow drip of new supply.

## The REIT Market

The REIT market extended its streak as one of the few bright spots (on a relative basis) in an otherwise dismal stock market by outperforming most broader market indices for a third straight year. The Morgan Stanley REIT Index (RMS) finished the year with a 3.6% total return, well off the 12.8% and 26.8% total returns in 2001 and 2000, respectively. While the sector's total return in 2002 was still very attractive when compared with broader market indices like the NASDAQ (-31%), S&P 500 (-22%), and Dow Jones Industrial Average (-15%), the margin by which equity REITs outperformed these other benchmarks narrowed in the second half of the year. After peaking in April 2002, the RMS finished the second quarter with a total return of about 13.5%. The Index then fell nearly 9% in the third quarter as REIT stocks suffered along with the rest of the stock market. When the broader equity market rallied in October, however, equity REITs were largely left out as widespread downward earnings revisions and a handful of dividend cuts in the REIT sector together with an improving outlook for the broader market caused investors to rotate out of REIT stocks.

Most of the weakness in the REIT market last year came from the multifamily and office sectors, where performance turned negative. According to NAREIT, retail REITs continued to ride the wave of consumer spending in 2002, delivering the best performance by property type with an average total return of more than 21%. Industrial REITs also performed well. The average total return for the industrial sector exceeded 17% in 2002, as the modest recovery in the manufacturing sector in the first half of the year and the sector's attractive defensive characteristics continued to attract investors. But performance among office and apartment REITs was disappointing, with both sectors finishing the year with average total returns of about -6%. Companies specializing in both property types were forced to revise their earnings estimates downward and, in the case of a few apartment REITs, cut dividends.

Although we expect the office and apartment property markets will remain challenging in 2003, sector bets will be more likely to deliver inferior results in 2003 than in previous years. With greater variation in the performance of individual real estate companies within and across property sectors, investors need to identify the strongest companies with the best management teams to outperform indices like NAREIT and the RMS. Outperforming broader market indices will be more difficult, particularly since REITs historically have been highly sensitive to stock market rotations as investors shift between value and growth stocks.

The weaker property market fundamentals and potential risk of capital outflows may be offset somewhat by a few positive attributes that generally remain in force for many REITs. First, most REITs appear to have managed their balance sheets well while the sector has been in favor, keeping leverage ratios in check while taking advantage of cheap debt to lower their overall cost of capital. Few companies took advantage of the strong REIT market in 2001 and the first half of 2002 to raise new capital for the sake of raising capital. Instead, most of the \$20 billion in new capital raised last year was in the form of unsecured debt and was related to specific deals.

REITs should also continue to benefit from their high dividend yields. The average dividend yield on equity REITs at year end was about 7%, versus less than 2% for companies in the S&P 500. Although REIT dividends are not as safe as they were a year ago, REITs are currently paying out about 65% of their funds from operations (FFO), which should provide ample

protection for dividends even if earnings weaken further. Several REITs, however, are currently paying out a very high percentage of their cash flows, and a few REITs are paying out dividends that *exceed* their funds available for distribution. These companies will have trouble attracting investors in 2003, particularly if dividend safety becomes a differentiating factor in the REIT market.

Even for companies whose dividends are safe, however, the recent Bush administration proposal to eliminate personal taxes on dividends paid by C-corporations could weaken perceptions of one of the most touted advantages of REITs. How much of an impact the proposal will have on REITs will depend on the final terms of the stimulus package, of course. If the proposal is implemented and corporations decide to increase dividends because the tax status of *some* of their investors – namely, taxable investors – has changed, then the REIT industry could suffer severe consequences, at least among that constituency. However, a significant amount of the capital in the broader equities market and in the REIT market is tax exempt, so it seems unlikely that companies would substantially change their dividend policies to appeal to one segment of the market. Moreover, because the spread between REIT dividend yields and those for the broader market is so wide, REITs should still offer a yield advantage to most other sectors even on an after-tax basis. However, any change in the tax treatment of dividends could be a distraction for income-oriented investors, particularly since Wall Street will respond to whatever changes are made with a flurry of new products designed to exploit the change.

If 2003 proves to be a year in which the performance of individual companies varies widely, we could see an increase in M&A activity, most likely in the form of mergers between public companies and possibly a few instances of public companies being taken private. Last year, most of the \$22 billion in M&A activity was concentrated in the retail sector, although the most intriguing retail deal, Simon's hostile takeover bid for Taubman, was only launched in December. The looming struggle between these two stalwarts of retail real estate seems likely to invite more intense scrutiny of REIT corporate governance as allegations fly of misaligned interests between the managements and shareholders of both companies.

Clearly there are more risks to the outlook for REITs now than a year ago. While many of these risks are specific to certain property types, most REITs now face the same pricing power dilemma that has plagued the rest of corporate America as expenses and rents continue to move in opposite directions. Perhaps the biggest risk that REITs face at this point in the economic and real estate cycle is that they may be forced to revise earnings estimates further downward and possibly cut dividends just as the outlook for other sectors of the economy begins to improve.

Capital flows into REIT mutual funds slowed in the second half of 2002, and several closed-end funds that were launched late in the year received a lukewarm reception from investors. It is too early to tell whether the slowdown in capital flows is a pause or is the beginning of a sector rotation. But if capital flows turn against REITs, the sector will have fewer winners. While we expect the REIT market will deliver total returns in the mid-single digits in 2003, the downside risks have increased, and individual company performance will likely be mixed.

## The Property Markets

Falling cap rates and deteriorating market fundamentals were recurring themes in the US real estate markets in 2002, although not all property types or markets participated equally in either. Certain sectors, like apartments and retail, had no trouble attracting capital despite weakening market fundamentals, causing cap rates to fall further. Other sectors, like offices and hotels, could attract capital only if the asset offered an attractive, safe yield. This left most hotels out of the transactions market but led to unprecedented pricing in some markets for well-leased office properties with credit-quality tenants and long-term leases.

Private buyers continued to dominate the transactions market, taking full advantage of the historically low interest rates to increase returns on equity. Transaction volumes for institutional investors, however, were off by as much as 30% to 50% due, in part, to increased competition from private buyers taking advantage of low interest rates and the limited inventory for sale. Many institutional investors became net sellers in 2002 to take advantage of the high levels of liquidity in certain market segments.

Recently, we have heard from several brokers that RFPs for property sales increased in the final months of the year, which could mean that more properties will make their way to the market in the first half of 2003. Although some owners may be more interested in testing the market receptiveness to their properties than they are in selling, more product in the market could help ease some of the pressure on cap rates and narrow the gap between bids and asking prices.

Most of the deterioration in property market fundamentals continues to be driven by extremely weak tenant demand, particularly in the hotel and office sectors. New construction has fallen sharply in almost every sector, with the notable exceptions of multifamily, where the pace of new supply seems to have accelerated rather than slowed, and retail, where retailers help drive the supply pipeline often without much regard for space market fundamentals.

Unfortunately, the slowdown in construction has yet to improve the short-term outlook in the hotel sector. Although leisure travel and convention business have reportedly recovered somewhat from their post-9/11 lows, demand from business travelers remains very weak. According to Smith Travel Research, new hotel supply has fallen to an annual growth rate of about 1.7%, its lowest level since 1995, but demand growth remains even more anemic and only slightly positive at around 0.3%.

Not surprisingly, hotel revenue per available room (RevPAR) has continued to trend downward as occupancy rates remain flat, and the business traveler has yet to return in force. As long as corporations continue to focus on cutting costs rather than on growing revenues, which will persist until businesses have more pricing power, hotels will struggle along with the rest of the economy. However, when business confidence does return, hotels should feel the effects of the recovery much more quickly than other property types. For investors with a stomach for short-term volatility, the hotel sector may provide an opportunity to acquire assets at attractive prices in advance of the economic recovery. But as we've noted before, the capital-intensive nature of lodging properties makes it very difficult to manage these assets through extended periods of market weakness, since most hotel properties require frequent capital infusions to keep them competitive.

The weakness in tenant demand is most severe in the office sector. According to Torto Wheaton Research, the average office vacancy rate increased from about 14% at the start of the year to more than 16% by year end. Vacancy rates are still much higher in suburban markets, where the average vacancy rate is now about 20%, but have continued to climb in CBD markets as well. CBD office vacancy rates increased from slightly less than 11% at the end of 2001 to about 13% by year-end 2002.

Although the sharp increase in vacancy rates in the past two years has surprised virtually everyone in the industry, the overhang of space in the market today is a legacy of the speculative demand bubble that accompanied the robust years of economic growth in the late 90s, and is the real estate manifestation of the excess capacity that built up in the bull market economy.

Despite the virtual cessation of new office construction, working through the excess capacity will take time. Moreover, questions remain about how much “shadow” space, or leased but underutilized space, is in the market today. According to a recent survey by CoreNet Global, a trade group representing corporate real estate executives, more than 50% of the companies surveyed expect to reduce the amount of office space their companies occupy over the next six months. Property owners could, therefore, face a situation in which their existing tenants demand concessions – capital expenditures and/or reduced or flat rental rates – just to remain in *less* space when their leases roll over, while at the same time some of the vacant-but-rent-paying sublease space turns over to vacant non-rent-paying space.

Until the outlook for job growth improves, the US office market will remain weak. Although distressed sales have been relatively few so far, most of the office transactions that have been completed involve a fairly narrow segment of the market, namely well-leased, stabilized Class A properties with credit tenants and long-term leases. In many cases, the competitive bidding process for these properties has produced spectacular results. However, if market rents continue to slide and demand remains weak, investors could see more opportunities to acquire distressed office assets in 2003, particularly if interest rates begin to rise.

Conditions in the apartment sector, where the disconnect between pricing and fundamentals remains widest, changed relatively little over the course of last year. Although occupancies improved slightly in the first half of 2002, weak job growth and high homeownership rates have continued to depress demand, and expenses and rent concessions are on the rise. Still, equity and debt capital abound for multifamily properties. With low interest rates allowing developers and lenders to underwrite to lower stabilized occupancy rates, and with an eager transaction market, all the incentives to keep developing remain in place.

As long as these dynamics persist, the current environment provides a good opportunity to selectively sell multifamily assets in secondary markets to take advantage of the sector’s liquidity. At some point, however, pricing and market fundamentals must move back into alignment. Interestingly, while private market investors have remained bullish on the apartment sector, the weak performance of many apartment REITs has left several public companies trading at discounts to net asset value. While this is not the first time that the public real estate markets have diverged from private market valuations, it underscores the severity of the disconnect in the private markets.

Investor appetite for industrial (warehouse) properties has also remained strong as the outlook for the general real estate market has weakened. Although average industrial vacancy rates have increased to more than 10% nationally and, according to PPR and Torto Wheaton, are expected to remain at similar levels through 2003, the sector's defensive characteristics continue to find favor with investors. The most prominent among these attributes is the short development period for warehouse properties, which keeps supply and demand closer to equilibrium than in other property types.

According to Census Bureau data for new construction put in place, new industrial development has slowed to its lowest levels in more than a decade. Much of the space that is now coming online consists of build-to-suit projects for owner-occupants. While this means that the new space is less likely to cause a rise in vacancy rates, it does little to resolve the soft tenant demand. Although we do not expect conditions in the warehouse market to weaken much further, the defensive characteristics of warehouse properties will be a drag on portfolio performance as market conditions in other property types stabilize and begin to improve.

Finally, with the consumer economy still in high gear, retail real estate enjoyed a return to grace among institutional investors. After years of disfavor, retail properties stood at the top of many investors' wish lists in 2002. The strong performance of malls, which after several noteworthy acquisitions this year are increasingly becoming the domain of public REITs, proved once again that the format can adapt to the changing spending patterns of consumers and the merchandising trends of retailers. While this is not true of all malls, dominant Class A regional malls have managed to increase revenues despite the ongoing struggle among department store anchors. With limited new mall development and further consolidation in mall ownership, dominant regional malls should continue to enjoy strong internal growth amid stable market fundamentals.

Power centers also regained favor last year among investors, who were attracted by the high cash yields and relative safety of income offered by select, top-tier power centers. Liquidity and pricing for good quality, well-leased power centers has improved significantly in the past two years as bankruptcies among big box tenants in previous years have eliminated many weaker tenants. But with a disappointing holiday retail season, the risks have increased that more retailers could file for bankruptcy protection this year. Kmart alone, which is already in bankruptcy, could return as much of 140 million square feet of space in more than 1,800 locations if the company decides to liquidate rather than reorganize. When combined with the substantial amounts of new space that retailers like Wal-Mart and Target will develop, this represents a tremendous amount of big box space for the market to digest.

Although the 2002 outlook improved for most segments of the retail sector, the risks for certain retail formats increased. With Wal-Mart and Target continuing their push into the grocery business and other retail formats encroaching on what was once the domain of traditional grocers, increased competition is putting pressure on already thin margins and forcing further consolidation in the industry. While this trend increases the risks for any grocery-anchored retail center that does not have the number one or two grocer in the local market, it is particularly troubling for the smaller, "garden variety" community shopping center where the grocer-anchor is the primary driver of traffic.

The powerful cross currents in the economy and in the real estate markets make our annual forecast of the NCREIF index returns challenging again this year. In 2001, the total return for the NCREIF Index was 7.4%, which was well off the 12.3% return in 2000. Through the third quarter of 2002, the one-year return had fallen to 5.6%, as value declines continued to depress total returns. With income returns of roughly 2% per quarter and further property declines likely before market fundamentals begin to improve, we expect total returns for NCREIF in 2003 will be in the 5% to 7% range. Like the REIT market, however, the opportunities in the private transaction market next year will be driven less by sectors and markets and more by the characteristics of individual assets and specific deals.

## **Conclusion**

With conditions in the economy and real estate markets at the start of 2003 seemingly unchanged from a year ago, the current environment has a certain “Waiting for Godot” quality as we await some catalyst to move the economy and real estate markets in a definitive direction. Although many of the dynamics that existed in the real estate market a year ago – low interest rates, the relative attractiveness of real estate investments versus other asset classes and deteriorating property market conditions – remain, it would be a mistake to assume that nothing has changed or that there is “nothing to be done,” as Beckett’s characters conclude.

Some things clearly have changed. Perhaps most importantly, over the course of the past year a significant amount of economic activity has taken place and continues to take place in the course of everyday life, even as we wait for some concrete evidence that the economic weakness is behind us. At the end of the last US recession, there was a similar pronounced lull as economic fundamentals gradually but steadily improved until it was apparent to almost everyone that a broad cross section of the US economy was booming. Yet looking back, no obvious catalyst triggered the recovery – Godot never arrived.

As we look ahead to 2003, we remain optimistic that the US economy is in a similar phase of quiet recovery today and that the seeds of the recovery have already taken root. For real estate investors, the changes in the economy and real estate markets over the past year mean that simply overweighting the real estate sector is more likely to produce disappointing results than in recent years, as risks remain in all property types and markets. In both the public and the private real estate markets, investment selection, execution and management will be critical to achieving target returns while managing risk.





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