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Peaked performance?

Markets for income-producing properties in large Texas cities continue to strengthen, following a trend that began in the early 1990s. However, some markets, particularly those for apartment and retailing properties, appear to be topping out. While the Texas and national economies continue to grow, two recent major events in commercial property markets have had a negative influence.

Compiled by the Research Staff

Commercial market recovery reaches plateau

Event one: credit crunch hits commercial real estate. In recent years, debt financing of real estate properties has become more securitized. In effect, commercial mortgage credit has been following residential credit's conversion from private to public sources, resulting in the market's vitality being tied closely to national capital markets. While this development frees real estate markets from regional and periodic disruptions, it exposes them to factors influencing capital supply and price, many of which have little to do with real estate or local economies.

So when Asian economies faltered and the Russians looked like they might default on international loans, the bond markets got defensive. As a consequence, risk premiums grew rapidly, adding to the cost of everything more risky than U.S. treasuries. Fortunately, the federal budget surplus allowed the Treasury to avoid entering the market with a lot of new issues, or the problem might have been worse. As it was, some well publicized failures occurred in the commercial real estate loan pipeline.

In mid-1999, the problem was more basic. Demand for credit continued to rise, but new supplies of funds declined. On the demand side, real estate investment trusts (REITs) became larger debtors as

Vacancy Rates for Selected Texas Markets (Second quarter, 1999)

Market Area	CBD Office	Suburban Office	Industrial
Austin	4.8	7.9	3.8
Dallas-Fort Worth	32.0	15.6	7.1
Houston	10.0	11.3	-
U.S. average	9.1	10.1	6.8

Source: CB Richard Ellis Global Research and Consulting

share prices dropped. There were some reports of corporations pre-funding short-term credit needs early in 1999 to avoid potential disruptions from the Y2K problem. On the supply side, expectations of higher interest rates increasingly caused investors to be unwilling to commit to long-term assets As a result, some investors may have found it difficult to finance property acquisitions during 1999.

Event two: REITs retreat. While the debt markets were becoming more skittish, the supply of equity capital also suffered a setback as REITs slowed their acquisition programs. The REITs have been the major buyers of real property for many years. Their ability to pay dividends at attractive yields made them stars in the booming stock market of the mid-1990s. As the money poured in, managers had to add more properties to their portfolios (REITs have to invest a high proportion of their portfolio in real estate to retain favorable tax status). Not only did the REITs have ambitious acquisition programs, they also tended to out-bid everyone else for investment-grade properties.

Several years have passed since the REIT boom in the stock market, and the inflow of funds has greatly diminished. Today, acquisition programs primarily are dependent on debt financing, and there are reports of REITs selling off their poorer performing assets.

So far, Texas markets have shown minimal effect, suggesting a plateau rather than a cyclical peak followed by a sharp decline. The loss of public debt and equity infusions has not left the markets without recourse. Life insurance companies and pension funds largely filled in the credit void left by the conduits (although pension fund acquisitions slumped in mid-1999). Private investors will return to the equity markets when prices readjust. In the short term, there are key factors to monitor.

- **Interest rate spreads.** This is the difference between mortgage and corporate bond rates over mid-term treasury yields. If this spread returns to its historical mean of 125 basis points, it could signal that the bond markets have calmed down and realize that Russian loans have no effect on Houston office buildings.
- **REIT returns.** News of outstanding values in REIT stocks would signal a return to expansion mode for these important property buyers. While this could help property valuations improve, it might be beneficial for the markets to take some time for the fundamentals to catch up before embarking on another expansion.

Some reading these comments might wonder about the role of fundamental value in these markets. True, prices can be affected in the short term by institutional changes in supply of debt and equity funds. Eventually, the properties have to perform to justify these valuations. In other words, the basic demand for improved space underlies the behavior of rents and prices. And, in this regard, there have been significant changes in the way real property is used.

- The **technological revolution** running through the business world will affect the need for office, industrial and warehouse space. Businesses are reassessing old assumptions about the amount and design of the office space they use. Advances in communications will change the appearance and location of business property, as well as the amount demanded.
- Success of **low inventory strategies** by manufacturers and distributors will determine how retail and wholesale facilities are used. These strategies continue to be experimental as the Internet influences how products are marketed and sold.
- Continuing **prosperity** and **aging** of the population will affect the demand for rental housing. Older households are willing to scale down their space needs for more convenience and less maintenance responsibilities, but may not opt out of homeownership, even though federal tax law allows them to sell without reinvesting. Unlike previous times, it is not so much investment and tax considerations that attach people to ownership, but the greater sense of control over their environment afforded by homeownership. Look for the return of the luxury condominium.

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