Is Commercial Property Still a Good Investment?

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These are blissful times for commercial real estate investors. Having fallen into a deep slump with the ending of the Internet boom, the market has come surging back. In 2004 alone, prices rose 26% for apartment complexes, 21% for industrial properties, 14% for retail properties and 6% for office buildings, according to Real Capital Analytics, a New York real estate research firm.

And the market gives no sign of slackening. "We're not seeing any slowdown at all," says Steven Dunn, chief economist for CB Richard Ellis, a big commercial real estate services company based in Los Angeles. "The numbers are great, not just for sales but for leasing, too."

But not everyone is so confident. Over the past few months, a number of major institutional and private investors have been selling off large chunks of their portfolios of prime commercial real estate. These investors, which include Calpers, the $186 billion pension fund, have been taking advantage of what they see as a frothy market. They are putting the sale proceeds into less expensive real estate or into other assets entirely.

The Rubenstein Company, a Philadelphia-based real estate firm, is one investor that has pulled its money out of real estate with the expectation that prices will come back down. Last year, the company sold nearly all of its office buildings for about $1 billion. "We thought the markets weren't going to get much better and had a chance to get considerably worse," says CEO David Rubenstein.

To be sure, for every seller there is a buyer, and other investors have rushed forward to buy these properties, often at record prices. But as the consensus builds that the housing market has become seriously overvalued, some are asking whether the same might be true of commercial property. The answer matters not just to the individual and institutional investors who are committing ever-greater sums to real estate, but also to the growing number of companies who are using their valuable property to obtain cheap financing.

A Flood of Capital

Several forces are driving commercial real estate's revival. Most obviously, the economy is improving and businesses are growing once more. As they expand their operations and hire new employees they need additional space. But real estate pricing has recovered faster than the economy itself. Indeed, while prices have rebounded nicely, rents have been sluggish: The average rent today is $15.42 a foot, down from $28.92 in 2000. A more important reason for real estate's rise has been a flood of new investment capital. Some of this comes from individuals seeking better returns than they can achieve in the debt or equity markets. These investors have channeled great sums to investment vehicles such as REITs and TICs (tenants-in-common).

The big money has come from institutions. Spooked by their losses after the dotcom bust and drawn to the reliable cash flows offered by property, these investors are now paying closer attention to commercial real estate. One is TIAA-CREF, a national financial services company with over $340 billion in assets under management. "We see this asset class as a great addition to our portfolio," says Tom Garbutt, the company's managing director and head of real estate. "It's a nice diversifier, has a current income stream

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and a potential for appreciation." The company now owns $14 billion of real estate properties.

The resulting upswing in prices for the best properties has been a boon for the owners. In fact, a growing number of corporations are taking the opportunity to use their real estate as a financing tool. Through sale-leasebacks, companies can sell their property to an investor who will agree to lease it back to the company for a specified period. Many find this as attractive as issuing debt, since property values are high but rents remain affordable. Some of these deals have been gargantuan. Last year, Bank of America did a $770 million leaseback for most of its bank branches. McDonald's (which has historically been an owner of property) also did one, valued at $340 million. Companies are using the money for different purposes, ranging from balance sheet improvement to acquisitions.

Few Signs of Trouble

How sustainable are today's high prices? Not very, argue some. "We feel that properties are overvalued," says David Harris, a research analyst who covers REITs for Lehman Brothers. Harris notes that the "euphoria" of bidding on certain commercial properties should give investors pause, especially since rising interest rates may soon make real estate a less attractive investment.

Another potential concern is that yields on property ownership are falling. Also known as capitalization rates ("cap rates" for short), yields have dropped over the past three years to near-historic lows. While this is the natural outcome of higher prices -- cap rates are the ratio of a property's yearly income to purchase price -- it can also indicate that operating income hasn't kept pace with the higher prices. This can make real estate less attractive to investors primarily interested in the cash stream.

But there are good reasons to believe that the market is actually quite strong. One is that the fundamentals are improving. Metropolitan office vacancies, for example, have fallen from 16.8% during the first quarter of 2004 to 15.4% today. Dunn points to San Francisco as an example of an area where the improvement has been substantial: In eight quarters, vacancies in that market have fallen from 23% to just 15%.

And improving occupancy levels mean higher income. "People often forget that income goes up faster than occupancy," says Peter Linneman, a professor of real estate at Wharton. "That's because as occupancy picks up you can boost your rents a little and you pick up more ancillary income from things such as parking and health clubs. I think this year will be good in terms of income for commercial properties, and next year will be great."

Furthermore, the market does not suffer from excess construction. "There was huge overbuilding in the late 1980s which really hurt the market when we had a recession," says Joseph Gyourko, also a professor of real estate at Wharton. "But for the most part real estate did not get overbuilt before the last downturn." Nor do developers' plans seem excessive. One reason is that banks have become more conservative in their lending, requiring developers to show that their buildings will be fully leased. Another is that the soaring price for concrete and steel (a product of China's massive construction boom) has made new construction costly. The result, of course, is limited supply at a time of growing demand, which suggests that prices have further to rise.

Ultimately, say many experts, investors should be asking how commercial real estate compares with other investments. And next to stocks and bonds, it remains attractive. "If you do CAPM or other risk pricing models, you find that real estate remains 15 to 35% underpriced based on its cash stream and its risk profile relative to other alternatives," says Linneman. In other words, not only does real estate give investors a better current income than debt or equity, but it's safer.

The reason is simple: commercial real estate is a lease claim on the same companies that make up the S&P 500. If a company runs out of cash, it will always pay its rent before it pays a dividend and will

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usually pay rent before it makes debt payments. "Real estate has a risk profile closer to bonds, but it's trading as if it's equity," says Linneman.

Largely because of this comparatively attractive income stream, the institutional investors are unlikely to abandon the market. This may be true even if cap rates fall farther. Because institutional investors often pay with cash, they can accept lower cap rates: Without interest payments, their effective yields are higher that those of more leveraged buyers. Garbutt says that TIAA-CREF has no plans to reduce its exposure to real estate. "We don't play the short game. For us, the question is, 'What makes sense for our participants?' And the answer is to stay well diversified and active in all markets."

What about interest rates? While higher rates can dampen the real estate market by raising borrowing costs, rates remain at historic lows. The Federal Reserve has signaled its intention to increase rates gradually, about a quarter point per quarter, but this may not be enough to ward off buyers. "If we saw a 200 basis point uplift in the 10-year treasury over a year, that would have some effect on real estate pricing," comments Garbutt. "But remember that an abrupt jump in interest rates and the 10-year would affect other asset classes, too."

Buyer Beware

None of this is to say that some real estate isn't perilously overpriced. In particular, speculation appears to be driving the prices of many apartment buildings and condominiums to unsustainable levels. "There some people who are being wildly aggressive when it comes to pricing cash streams for apartment buildings," says Linneman. "They are looking at a building with 45% vacancy and saying 'I'm going to buy it as if it's 90% occupied.'" Similarly, condominiums -- which offer virtually no income stream since they are owned, not leased -- are looking shaky. Between 50% and 60% are now being presold to investors who don't plan to live in them. Once buyers stop showing up to the presales, the prices will tumble.

David Rubenstein also sees weakness in certain office markets, especially in the suburbs of Washington, D.C., and in southern California. In those markets leasing costs are rising, net operating income is falling (due to leases that tenants signed five years ago but are now up for renewal, at lower rents), and investors are taking on what he considers excessive leverage. That should produce lower prices for some properties.

And there's always the risk of some broader meltdown that would bring down the real estate market along with stocks and bonds. Linneman argues that in this case, an investor would be wise to be in the asset that's the least overvalued to begin with: commercial real estate.

Barring a calamity, investors should expect solid, if not spectacular, returns, says Gyourko. He predicts that while the real estate market will continue to do well, the days of double-digit appreciation are over. "Relative to historic pricing, real estate is pretty expensive, and that's something that should make everyone think hard," he says. "Does it mean that prices are going to fall? No it doesn't. But it almost certainly means that the returns will be lower going forward. The million dollar question is this: Will you be disappointed relative to other things you could have done with your money?"

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