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Chapter chair message: Revisiting the case for real estate

February 09, 2012 - Appraisal & Consulting

After last month's Fed announcement it seems the case for real estate became stronger. The Fed statement - that short term interest rates will likely be kept near zero at least through 2014 - has implications across asset classes. Lower interest rates create challenges for savers but should be a positive influence on assets with dividend income and cash flow. Commercial real estate falls into this category. Although most in the real estate industry are already "believers" in the asset class, the recent Fed declaration warrants a reflection on real estate in the multi-asset class portfolio.

Even though real estate comprises a significant portion of the "Global Market Portfolio," debate continues on its appropriate allocation among institutional investors. By some estimates, global real estate value exceeds 40% of the world investment value yet institutions struggle with a 0-10% allocation. Major pension funds continue to use long-term actuarial assumptions of 7-8%. Given expected historically low fixed income returns over at least the next 2-4 years, real estate can be part of the solution to achieving targeted portfolio objectives through its stable income (generated from in-place cash flows) along with gradual appreciation.

Given current economic conditions a focus on in-place cash flows is important given slow expected job growth. Even though cap rates for real estate feel uncomfortably (aka "historically") low, spreads over long term rates reflect a wider margin than history would imply (both on an absolute and percentage basis).

Economic history would lead us to believe that low rates and slow growth will eventually yield to demand and inflation. Even with low cap rates, most quality real estate is trading below replacement cost. Ongoing deleveraging of the global economy will continue to constrain new construction and result in gradual real estate appreciation. This positions real estate to capture increased income over the long term against a backdrop of limited interim additional supply.

What does all this mean for our industry? Commercial real estate will be one of the few investment areas that can provide income and total return to meet investment objectives. Demand for quality real estate will likely increase as the reality of low mid-term interest rates permeate global investment markets. As demand for real estate increases we must continue to focus on in-place cash flows and realistic mid-term assumptions (i.e. limited growth). Solid fundamental underwriting will reward investors over the long term.

Stay disciplined, my friends!

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