CAPITAL AND INVESTMENT TRENDS

FALL 1997 • SURVEY OF TEXAS REAL ESTATE MARKETS

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OBSERVATIONS FROM THE EDITOR

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Real Estate is part of the capital markets and nowhere is this more clear than in the stock market, where analysts point out that REIT stocks suffered far less in the October 1997 correction than did the S & P 500 (-6.9%). Claiming REITs a safe haven, their proponents are urging small investors and large funds alike to increase their REIT holdings.

Those that follow these markets know that REITs were a favorite investment vehicle in the early '70s only to go out of favor in the mid '70s with disastrous results. They remained on the sidelines thru the eighties bull market. However, beginning with a tax law change in 1993, which allowed institutions to own REIT shares, they have come roaring back.

Today, they dominate the commercial real estate markets. By acquiring as much property as they can, the REITs grow by issuing new shares and taking on more debt for the next wave of buying. Mergers are common. Locally, Columbus Realty Trust was acquired by Atlanta based Post Properties to allow the combined firm to improve their borrowing power by paying less interest on the same debt.

The REIT's cost of capital is lower than most other types of institutional real estate owners and therefore they can afford to pay more for the same office building or shopping center than an individual investor or limited partnership. Therefore, today they drive the market and compete with one another when large commercial properties are placed on the market.

This picture of the real estate market sounds too good to be true. Just buy REIT stock through your life insurance, IRA or company pension and as rents go up you can take early retirement! There must be some catch; but, what is it? Where is it? I believe that it begins and ends with our perception of how things are going. Today most of us see growth and prosperity and our investments increasing over the long term. This rosy picture can change if enough of us start seeing the investment environment glass as half-empty rather than half-full.

To wit, in October 1997, in just two days, sellers of market shares drowned the buyers when the Dow Jones Average fell nearly 800 points only to come bouncing back. But, what happens if interest rates start going up and companies with investments in Asia or Latin America start missing profit projections? Fund managers see this and start selling to increase their cash position and protect their gains. All of these things can turn our perception of that rosy glass to being murky and then we become uncertain and tentative.

On a more local level, REITs who are now building office buildings could find that the expansion at these companies, who were going to occupy the new space, slows down and new hiring decisions are put off. Production slated for a new plant in Fort

Worth is shifted to another site leaving home builders targeting the workers, who were to move in 1998, without a market and new retail developers without tenants.

Then the unspeakable happens, the market has another correction and certain REITs who had borrowed close to their statutory limited (50% of their market capitalization) find they are over their borrowing limit.

These events are hypothetical and could never happen; or could they? I have always been told that real estate is a cyclical industry and that, at any given moment, we are somewhere on the cycle. As real estate becomes more closely aligned with the main stream capital markets through the REIT ownership and securitized mortgages, real estate will be subject to the vagaries of these public markets.

We have no crystal ball here; but, we have seen tremendous growth in Texas from the depths of the last real estate depression beginning around 1990. We have clearly arrived at a point high on the cycle as there is new construction occurring in every major market and almost every property type. Thus, it is much easier for one to see slow downs occurring in the economy and fewer jobs being created or relocated to the Texas markets than it is for one to see this boom continuing indefinitely. This is not a time for the faint of heart because at the top of the cycle many fortunes are made and many are lost. My one homily for those in the Texas real estate markets is "know the risks that you take and prepare accordingly. Have a clearly defined exit strategy."

FALL 1997 RESULTS

This publication is a result of a survey of active participants in the real estate markets in Texas including Investors, Lenders, Mortgage Bankers, Brokers, Portfolio Managers, Appraisers and Title Company Executives. The Group reported completing 182 transactions totaling $1.54 billion during the past year.

TEXAS NEW CONSTRUCTION FOCUS

Our Group of Respondents were active in all major Texas markets; Austin, Dallas, Ft. Worth, Houston and San Antonio. More than half of them had participated in a new construction project in Texas during the past six months. Therefore, we asked The Group "what do you believe it will cost to build the following property type in Texas during the next six months?" Their answers reveal that the cost to build new properties has increased throughout the state for all property types from six months ago.

Following are the estimates of new construction costs as reported by our Group:

PROPERTY TYPE	Avg. Cost of Construction Fall 1997	Avg. Cost of Construction Fall 1996
Apartments (per unit)	$60,000	$55,870
Suburban Office (per SF)	119.00	118.00
Shopping Center (per SF)	84.00	81.00
Distribution Warehouse (per SF)	31.00	30.15
Limited Service Hotel (per room)	$63,000	$50,000

New construction is occurring today in all Texas cities in the apartment, industrial, retail, hotel, and mini-storage markets. Office construction is widespread in the larger cities and includes many speculative buildings where there is no major anchor tenant. In the chart below is the consensus opinion of what income (effective rent, net of vacancy) and (landlord's share of) expenses would be used in a new property proforma today.

Property Type	Effective Income		Non-Reimbursed Expenses	
	Fall 1997	Range	Fall 1997	Range
Apartments	$1.03/sf/mo	$0.90-1.15/sf/mo	$4.40/sf/yr	$4.00-4.75/sf/yr
Office (suburban)*	21.50	18.00-23.00	6.55	5.50-7.50
Retail (inline space)	15.50	14.00-18.00	2.65	2.50-3.00
Retail (anchor)	6.30	5.00-8.00	1.85	1.75-2.20
Industrial Warehouse	3.80	3.50-4.20	1.40	1.15-1.65
Industrial Flex	$7.10	6.75-7.50	2.40	2.25-3.00

*Plus electricity

Investment Targets

During the past year, we asked The Group about how they look at real estate investments in Texas. Most investors had gone into such acquisitions with a specific time frame in mind and an exit strategy. In our last issue we found that many of the acquisitions were based on a three to five year resale. Interest rates have continued to decrease allowing for substantial positive leverage after financing. This has brought new investors to the market looking for higher yields and existing investors cash through the ability to resell properties purchased during the 1990-1995 time frame.

A majority of The Group reported that new real estate investments show lower proforma returns than those of one year ago, but that the lower borrowing costs and strong growth have attracted more investors into the state. Most have reported little change with their major investment assumptions. However, the expected returns have decreased due to the more competitive environment.

Investment Returns

We asked The Group whether they had sold any property purchased within the last three years and if so, what was their annualized return (as a percent)? Those that sold properties reported annualized returns ranging from 22% to 40% on recent real estate sales. The average return was nearly 30% per year. These results reflect in many cases the resale of properties purchased from the RTC and FDIC, at depressed prices.

Real Estate Yields

The recent slowing of the world economy and lack of significant inflation has caused the long-term treasuries to decrease. This in turn has assisted the real estate markets by lowering mortgage rates by nearly 75 basis points. Lower mortgage rates allow positive leverage and higher returns to the equity investors. Thus, it is no surprise to see cap rates and yields continuing to decline on properties throughout the state.

As a result, yields have declined and most cap rates are below 10% for investment-grade properties. Hotels, which carry the perceived additional risk of management, have continued to stay below 11% in their cap rates.

REITs, who are the most aggressive buyers, have pushed cap rates lower competing with one another for the ability to grow their asset base (see lead article).

CAP RATES

	Stablized		Reversions	
	Fall 1996	Fall 1997	Fall 1996	Fall 1997
Apartments	9.25%	9.18%	9.63%	9.50%
Office	8.75	8.68	9.03	8.88
Retail	10.25	9.93	10.47	10.20
Industrial	9.43	9.60	9.86	9.65
Hotel	10.75%	10.50%	11.05%	10.60%

Discount rates, also known as free and clear equity returns, have generally changed to the same degree as the cap rates from those rates of one year ago. The current discount rates being used in the Texas Markets are seen on the table which follows:

DISCOUNT RATES

	Weighted Avg. Fall 1996	Low	Weighted Avg. Fall 1997	High	Change From Fall 1996
Apartments	11.30%	11.0%	11.25%	12.0%	-05 pts
Office	11.11	10.5	11.20	12.0	+09
Retail	11.93	10.5	11.35	12.0	-58
Industrial	11.47	11.0	11.57	12.5	+10
Hotel	12.58	11.5	12.00	13.0	-58
Groundlease	10.75%	9.0%	9.80%	11.0%	-95

With the purchase of most real estate one is buying future income. Therefore, one of the critical assumptions with regard to any investment is its ability to pay net income. Our Group had become extremely bullish regarding rent increases. During the last two years many of the respondents were looking for double digit increases in their markets; however, their optimism has subsided and expected increases have gotten smaller.

The office sector is the strongest and our Group believes that office rents will increase by nearly 7.6% next year and more than 7.0% the next year. With very little of the new office construction completed and most suburban markets very tight, landlords have boldly raised rents by 15% to 30% over the last two years.

Many of the other sectors are not performing quite as well. Therefore, the anticipated increase in income for all property types is only 4.9% for next year. Office and hotel sectors are the only ones where income growth is expected to be above 5%. This market performance represents a slight decrease from the prior year which probably reflects the increase in office, industrial and hotel construction which will help keep rents in check.

Below are the estimates of our Group concerning increases in income and expenses for the major property types over the next two years.

	Next Year		Following Year	
	Income	Expenses	Income	Expenses
Apartments	3.7%	3.6%	3.8%	3.6%
Office	7.6	4.3	7.0	4.4
Retail	3.8	3.8	3.8	4.0
Industrial	3.6	3.6	3.4	3.8
Hotel	5.9	4.3	4.5	3.8
Average	4.9%	3.9%	4.5%	3.9%

Below are the current lending criteria for real estate loans made on Texas properties. Rates are 37 basis points lower than our survey one year ago and represent both acquisition and development loans as well as permanent loans.

CURRENT LENDING CRITERIA

	Interest Rate	LTV Ratio	Term in Years	Balloon in Years	DCR	Points
Fall 1997	7.76%	75.0	25	9.0	1.25x	1.00
Fall 1996	8.13%	71.5	20	7.0	1.30x	1.00

SUMMARY

This year, 1997, will be remembered as the year of the REIT. They drove the market, pushing up prices and driving down yields. Dallas and Houston saw significant job growth and economic expansion while weakness appeared in the Austin and San Antonio job markets. Office buildings and hotels will continue to out perform the rest of the market in 1998. As interest rates are near 30 year lows, real estate continues to attract significant capital and provide excellent yields when compared to other investments.

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