CAPITAL AND INVESTMENT TRENDS

FALL 1996 • SURVEY OF TEXAS REAL ESTATE MARKETS

OBSERVATIONS FROM THE EDITOR

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Structural changes are occurring in the way information is "reaching the eyeballs" of the consumer due to the meteoric rise in the use of the internet. This will have a major impact on real estate in the way products are presented and shipped to the ultimate consumer. Retailing and distribution warehousing will be most impacted.

Andrew S. Grove, Chairman of Intel, in his book, *"Only the Paranoid Survive,"* put it succinctly when he stated that many products such as software, music CD's, and movies can be shipped via the Personal Computer to your home or office as bits of data. They will bypass the shelves of the neighborhood Blockbuster or the software store and be instantly accessible. As a result, much of the shelf space now holding nicely packaged boxes of software or CDs will be unnecessary. The storage and distribution system for these products and many more will become outdated and obsolete.

This is only the tip of the iceberg that we can see. Many other similar changes are simultaneously changing our businesses as we know them. Today, in little more than the blink of an eye, and at no more cost than a local phone call, I can ship a document containing hundreds of pages and color photos and charts across the country or to another continent using e-mail. Prior to this one had two choices, both more time consuming and costly: you could fax it, one page at a time, paying long distance charges, or you could ship it using Fed-Ex, Airborne, etc. at a cost of fees and time.

These changes in the way we communicate has allowed a growing number of people to work in their homes. "Telecommuting" reduces the need to live near an office and has created demand for housing in rural areas too far for a daily commute but close enough if one were to go to the office one or two days a week. Affordable, state-of-the-art computers, fax machines and printers have allowed thousands of people to create businesses that can be run out of home offices. Consequently, we see growing demand for new homes on ranchettes in areas twenty to forty miles from the metropolitan areas in towns like Krum, Brenham and Wimberley. However, these have also led some to feel separated from the face-to-face interactions of the central office. The need for social stimulus has led many to the inner city creating demand for housing near shops, restaurants, and office buildings. This demand is evidenced by the success of projects in the Uptown Neighborhood in Dallas.

As the difference between your PC and TV begins to blur and internet access becomes more user friendly, these changes will occur rapidly. Changing consumer demands (or lack there of) will require a recycling of buildings just as residential lofts are now occupying the prior home of the automobile and cotton gin factories and the flour mills in the central city. Think of the 40,000 SF building that formerly held the telephone switch that can now fit in a room of less than 1,000 SF or the series of microwave towers interrupting the horizon in west Texas that sit silent having been replaced by satellites in space.

As technology changes, the need for new professions arises. For example, at the beginning of the century, America was still an agrarian society transforming itself into an industrial age. Horses still were in wide use for transportation. In the 1900 census, two of the top twenty jobs in America were cottonmill workers and blacksmiths, while in the 1990 census it was computer programmers and medical technicians. Not only did these professions not even exist 60 years earlier; but, it was probably inconceivable to those alive then that a plastic screen could connect them to anyone on the planet through a system of satellites orbiting the earth. Nevertheless, the race to build faster and faster computers has given rise to thousands of jobs in Austin, Houston, and Dallas/Fort Worth with the likes of Dell, Compaq, TI and now Intel. The recently announced Intel microprocessing chip plant in Fort Worth will among other requirements create the need for highly trained technicians and scientists from the nearby universities.

In summary, demand for property (land and buildings) and their relative worth depends on whether there is a use for it. Today, one must consider what effect changes in computer, communication and transportation technology will have on the current use for a property. Land at the edge of the metropolitan area seems endless but geographical features and transportation corridors can make or break the demand for it. Land and older buildings in the inner city are a limited resource. A critical mass of new residential development can reverse the fortunes of an entire neighborhood creating demand for retail, offices and restaurants in what might have been a blighted area. Investors looking for opportunities in the Texas markets have a lot to consider before making a long-term investment.

FALL 1996 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 136 transactions totalling $631 million during the past six months.

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
Apartments (per unit)	$55,870
Suburban Office (per SF)	118.00
Shopping Center (per SF)	81.00
Distribution Warehouse (per SF)	30.15
Limited Service Hotel (per room)	$50,000

New construction is occurring today in all Texas cities in the apartment, industrial, retail, hotel, and mini-storage markets. Office construction is becoming more widespread but is occurring mostly where a building has been preleased with a major credit 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.

	Effective Income		Non-Reimbursed Expenses	
Property Type	Fall 1996	Range	Fall 1996	Range
Apartments	$0.93/sf/mo	$0.90-1.10/sf/mo	$4.10/sf/yr	$3.80-4.50/sf/yr
Office (suburban)	21.50	20.00-23.00	5.98	5.50-7.00
Retail (inline space)	15.50	14.00-18.00	2.93	1.83-3.00
Retail (anchor)	12.75	8.00-15.00	1.63	1.75-3.00
Industrial Warehouse	3.80	3.50-5.00	1.00	0.75-2.00
Industrial Flex	$5.80	$5.50-10.00	$2.69	$2.25-3.00

INVESTMENT TARGETS

During the past six months 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 decreased 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 1990-1994 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)? One-third of the group reported annualized returns ranging from 15% to 220% on recent real estate sales. The average return was nearly 60% 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 economy and lack of significant inflation has caused the long-term treasuries to decrease. This in turn has assisted the real estate markets by keeping mortgage rates in check. 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, whose typical cost of equity capital is well below 10%, have actively refinanced and acquired new properties in this environment producing significant returns. They have been very active purchasing Texas real estate during the past two years.

CAP RATES				
	Stablized		Reversions	
	Winter 1995	Fall 1996	Winter 1995	Fall 1996
Apartments	9.34%	9.25%	9.64%	9.63%
Office	8.90	8.75	9.29	9.03
Retail	10.30	10.25	10.46	10.47
Industrial	9.50	9.43	9.80	9.86
Hotel	10.63%	10.75%	11.00%	11.05%

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

DISCOUNT RATES					
	Weighted Avg. Winter 1995	Low	Weighted Avg. Fall 1996	High	Change From Winter 1995
Apartments	11.2%	10.5%	11.3%	12.0%	+10 pts.
Office	11.7	9.0	11.11	12.0	-59
Retail	12.0	11.5	11.93	12.5	-07
Industrial	12.1	10.5	11.47	12.5	-63
Hotel	12.8	11.5	12.58	14.0	-22
Groundlease	10.25%	10.0%	10.75%	11.0%	+50

Income and Expenses Expectations

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 has become extremely bullish regarding rent increases. Many of the respondents are looking for double digit increases in their markets. Office rents are expected to increase by nearly 9.0% next year and more than 8.0% the next year. This shows how rents are taking off in many of the office markets around the state. With very little new office construction and most suburban markets very tight, landlords are boldly raising rents by 15% to 20% in many cases. The average increase for all property types is 5.3% for next year and the following year. This represents a substantial increase from prior years. The largest component of this increase is in the office sector.

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

	Next Year		Following Year	
	Income	Expenses	Income	Expenses
Apartments	3.8%	3.8%	3.78%	3.78%
Office	8.95	3.93	8.09	4.75
Retail	4.15	3.95	5.06	4.28
Industrial	4.98	3.84	4.88	3.97
Hotel	4.40	3.93	4.75	4.33
Average	5.30%	3.90%	5.30%	4.20%

Below are the current lending criteria for real estate loans made on Texas properties. Rates are 21 basis points higher than six months 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 1996	8.13%	71.5	20	7.0	1.30x	1.00
Winter 1995	7.92%	72.0	25	5.8	1.25x	1.20

Reasonable Marketing Time

When estimating market values, participants must consider what marketing time is necessary to consummate a sale. Therefore, we asked the Group to estimate what a reasonable marketing period for the different property types would be in the Texas markets.

Without exception, the responses indicated that most properties would take less than a year for a sale to occur. In some cases, especially the Class A properties, the Group thought they would sell in less than six months.

Summary

This year, 1996, will be remembered as the year of the office. If you were a landlord you finally had a chance to make up for all those years of free rent. If you were a tenant you probably were hit with a rent increase equal to the increase on your health insurance rates. While this part of the market basked in the limelight, and fortunes were made by those who sold office buildings they purchased in the 1990-93 era, the hotel market also saw tremendous price increases. Revpar was increasing along with the number of buyers. Many hotels purchased in 1993-94 were being resold in 1996 at huge profits. Deals like that will be hard to replace in the coming years.

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