CAPITAL AND INVESTMENT TRENDS

SPRING 1995 • SURVEY OF TEXAS REAL ESTATE MARKETS

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OBSERVATIONS FROM THE EDITOR

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Five years ago Congress created the RTC. In our year end issue that year we asked our group of respondents "When will the multi-tenant office market see speculative new construction again?" Their consensus answer was 1995.

Were they accurate in their prediction? I believe from analyzing the results of our latest survey that speculative office construction (where less than 50% of the space is preleased prior to groundbreaking) will occur this year.

Last week, the managing director of one of the largest architectural firms in Texas confirmed that his firm is working on one such project along the Dallas North Tollway. Several sites have been put in play for new office development recently. So it appears only a matter of time before one of these deals comes to fruition.

The last speculative building was started in 1985, ten years ago. Thus if we see this type of development return to the market in either Austin, Houston, or Dallas, **it will mark the beginning of a new cycle in the Texas real estate market.** This signals the passing of an era punctuated by five major bank failures and the insolvency of scores of savings and loans causing widespread illiquidity and plummeting real estate prices. For those of you that lived through the last ten years, the return to a normal market was ten years too long.

The real estate market in Texas today is responding to strong growth in population and jobs in all of the major markets. Apartment and single family markets led the way out of the recession. Strong retail sales and rising household incomes have created a seemingly inexhaustible demand for new shopping centers and specialty stores. Similarly, their location, labor laws, skilled work force and low cost of living have made Dallas and Austin preferred places for new high tech industries. The other major cities like El Paso and San Antonio join Dallas in benefitting from their mid-continent location as major distribution centers. These cities have widespread industrial development occurring due to their proximity to Mexico or a world class airport. Due to the strong demand from the expansion or restructuring of corporate America, many of these new industrial buildings are being planned as speculative projects yet tenants are found before the ground breaking can take place.

We have observed here the effect of corporate capital in the recent growth of office buildings in Dallas. G.T.E., J.C.Penney, Oryx and many others have built millions of square feet over the last five years for their own use. To a lesser degree, this trend was evident in most of the major Texas markets. Only a large credit worthy user with special needs or a large ego would develop a new building when so many others could be purchased at a fraction of their replacement value.

Today however, that equation is changing. Rents in the most sought after markets are increasing exponentially. Larger tenants are finding few choices when their lease renews or they need to expand. Landlords are finally back in the driver's seat as certain sub-markets post 95% occupancies. Since the RTC days when Class A office space could be leased for $8 to $11/sf, rental rates for larger tenants are now over $14/sf and in many cases $18 to $20/sf is being paid. In our last issue we reported that new construction could be justified between $21 and $22/sf. **This leads us to the basis of our conclusion, and Our Group's 1990 prediction, that 1995 will see new speculative office construction.**

One last thought about 1995. So far this year, the economy has behaved and the Federal Reserve has left interest rates at prior levels. Should they remain level through the year, real estate transactions should increase dramatically as the year marches on. Title companies report strong Second Quarter closings. Many of the RTC assets will be resold at healthy profits. Half of the respondents reported reselling properties purchased during the last three years at an annual profit of over 75%. Additionally, over 80% of The Group has raised their asking price or paid more than anticipated on an acquisition so far in 1995.

Spring 1995 Results

This publication is a result of a survey of active participants in the real estate markets in Texas including Investors, Lenders, Brokers, Portfolio Managers, Appraisers and Title Company Executives. The Group reported completing 95 transactions totalling $277 million during the past three months.

Texas New Construction Focus

Our Group of Respondents were active in all major Texas markets; Austin, Dallas, Ft. Worth, Houston and San Antonio. Nearly 80% of them had participated in a new construction project in Texas during the past six months. We asked them "whether they found costs to be higher or lower than they had expected?" The Group agreed unanimously that construction costs were higher by nearly 12% over those of one year ago.

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 only in the retail and apartment markets are sales prices of existing buildings relatively close to construction costs. While the newest existing buildings are generally 8 to 10 years old today, they can still be purchased at 60 to 70% of their replacement value. The problem with many of these assets is not their age or condition but leaseholds which encumber the property with below market rents.

PROPERTY TYPE	COST OF CONSTRUCTION
Apartments	$51,250/Unit
Suburban Office	$102/SF
Shopping Center	$66/SF
Distribution Warehouse	$31/SF
Limited Service Hotel	$49,000/Room

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. Since then however, interest rates have increased and nearly a third of Our Group reported losing some of their investors to alternative safer investments that are now paying higher yields.

Over 65% of The Group reported that new real estate investments show lower proforma returns than those of one year ago. Nearly half of those surveyed have reported the need to be more aggressive with their major investment assumptions. This is true with investors and lenders alike. The duration of the investment has had to increase along with the acquisition price.

We surveyed The Group for their anticipated yield on new development in our last issue. Due to the underlying strength in the Texas markets, the yields shown below have all decreased whereby developers and syndicators do not have to pay as much for their capital. New syndications are being done based on much lower yields. Thus both debt and equity capital are willing to take less of a return just to be in a Texas deal. This has offset the increasing interest rates.

Below are the required returns from one year ago which now set the upper limit for the highest risk developments.

PROPERTY TYPE	REQUIRED ANNUAL RETURN
Retail Pad Site	19.0%
Industrial Building	13.3%
Residential Lot Development	27.0%
Speculative Land Purchase	33.5%

In the next issue we will revisit the required yields for projects listed above. No doubt, many of these investment targets will be much lower than in 1994.

Real Estate Yields

While interest rates did rise significantly during 1994, they have leveled as the national economy has cooled off. As a result, cap rates for all but hotels have increased since the first quarter of 1994. The Reversionary Rates have increased by an average of 39 basis points over last year, while Stabilized Rates have increased by an average of 40 basis points.

One would expect very little change in cap rates over the next few months as interest rates have begun to decline and inflation remains stable.

CAP RATES				
	Stablized		Reversions	
	1st Qtr. 1994	1st Qtr. 1995	1st Qtr. 1994	1st Qtr. 1995
Apartments	9.07%	10.10%	10.12%	10.44%
Office	9.94	10.59	10.24	10.61
Retail	10.18	10.58	10.29	10.70
Industrial	9.87	10.21	10.25	10.63
Hotel	12.00	11.56	11.40	11.86

Discount rates also known as free and clear equity returns have changed to the same degree as the cap rates from those rates of one year ago. While the recent trend for these rates has been up, these should stabilize during the remainder of the year. The current discount rates being used in the Texas Markets are on the table which follows.

DISCOUNT RATES					
	Weighted Average 1st Qtr. 1994	Low 1st Qtr. 1995	Weighted Average 1st Qtr. 1995	High 1st Qtr. 1995	Change From 1st Qtr. 1994
Apartments	11.2%	10.0%	10.7%	15.0%	-50 pts.
Office	12.2	9.0	12.8	17.0	+60
Retail	12.0	10.0	12.1	15.0	+10
Industrial	11.8	10.5	12.3	15.0	+50
Hotel	12.6	12.5	14.0	16.0	+140
Groundlease	10.4	10.0	10.4	11.0	0

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. The overall estimate of income increases hit an all time high this quarter. Many of the respondents are looking for double digit increases in their markets. Office rents are expected to increase by nearly 6.0% next year and 6.35% the next year. This is a 400 per cent increase from eighteen months ago and shows how rents are taking off in many of the office markets around the state. The average increase for all property types is 5.67% up from 4.52% one year ago representing a 25% increase.

As an indication of where the market has been, eighteen months ago The Group predicted that office income would only increase by 1.2% over the previous year. Today they believe that office rents will increase nearly 6% over last year, or nearly double that of inflation.

	Next Year		Following Year	
	Income	Expenses	Income	Expenses
Apartments	5.17%	4.46%	4.30%	4.09%
Office	5.96	4.71	6.35	4.31
Retail	5.62	4.41	5.70	4.19
Industrial	6.30	4.03	5.79	3.86
Hotel	5.29	4.20	5.20	4.20
Average	5.67%	4.36%	5.47%	4.13%

Below are the current lending criteria for real estate loans made on Texas properties. Rates are 60 basis points higher than 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
1st. Qtr. 1995	9.35%	73.7	24	6.3	1.23x	1.15
1st. Qtr. 1994	8.75%	73	23.4	6.1	1.20x	.92

Summary

The year has begun with widespread single-family, apartment, industrial and retail construction occurring throughout the major markets in the State. Office development is occurring on a specific build-to-suit basis for immediate use. By year's end, our Group of respondents believes that some speculative office projects will begin in some of the strongest suburban markets such as Richardson or the North Dallas Tollway in the Dallas area.

Hotel construction is occurring along high growth corridors but is mostly limited to two-story type suite or limited service properties. Generally, new full-service hotels make little sense as one can still purchase five year old properties at 60 to 70% of replacement cost.

Look for a dramatic increase in transactions throughout the State if interest rates remain stable for the next few months. Title companies report increased activity for Second Quarter closings. For those of you who made it through the 1985-95 period, congratulations, the next ten years should be your reward if you remember all the lessons that we learned!

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