CAPITAL AND INVESTMENT TRENDS

WINTER 1995/1996 • SURVEY OF TEXAS REAL ESTATE MARKETS

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OBSERVATIONS FROM THE EDITOR

In 324 A.D., the Emperor Constantine "relocated" the seat of The Holy Roman Empire from Rome to a city on the Bosporus. This was a place where "east met west" across a narrow channel connecting the Black Sea with the Mediterranean. He renamed it Constantinople, we know it today as Istanbul.

Nearly 1650 years later, Erik Jonnson and Amon Carter, the leaders of two neighboring cities agreed to create a new kind of port on the North American continent. Opening in 1974, Dallas/Fort Worth International Airport is now the second busiest airport in the world.

To many these two events bear no relationship but to others with foresight and a clear view of the future there is a direct parallel.

In ancient times, communication was limited to face-to-face contact. The news that came to the Emperor was brought by travelers or messengers who traveled by the use of beasts of burden, sailing ships or walking. It sometimes took months for news to come from the far reaches of the known world such as England and France. Constantine realized that he was relocating Rome to a crossroads of travel where he might control both communication and trade. He would be at the center of the world (as it was then known in 324 AD). From there, his army could reach a majority of the Empire within a few weeks. They could travel either overland or by sea and bring the riches of the world back to Constantinople to be stored in warehouses or traded to gain influence and power. In the ensuing 1650 years human invention and technology has changed the way mankind communicates with one another and how they travel, trade and ship goods. The use of satellites allows instant voice and video links with people in the remotest areas of the world. Any place with a sufficiently sized runway and nonstop service can be only hours from another point on the globe. People, services and goods weighing thousands of pounds can be sent within hours of request from modern airports.

Trade is global where the natural resources of one continent are matched with the labor of another and the finished products are sold to people living on yet another continent. In such a world the ability to ship goods and people to as many different places and conversely to import them is critical to the commerce and wealth of an area. In such an environment, having the port facility along with the land for expansion and the central mid-continent location clearly makes Dallas/Fort Worth the growth market for the next century.

After the Romans, the Byzantine and Ottomans ruled an empire stretching from Austria to Persia, from this port on the Bosporus, their influence lasted until World War I. In contrast, Dallas/Fort Worth's importance in world trade is just beginning.

Today, when business leaders are re-evaluating the cheapest most efficient way to operate, they inevitably find the need to locate some, if not all, of their operations in Dallas. This market is located in the center of the largest economy in the world. Over time, if for no other reason than its mid continental location and great airport, Dallas/Fort Worth, will overtake even Atlanta in its prominence as a business address in North America.

Therefore, as 1996 begins we have a clear focus of the underlying and essential reasons to expect that investments in real estate in this region will benefit from an increasing demand. New jobs beget new homes and apartments, require new services and consume products and food. New jobs require offices in which to work and warehouses from which to stock and ship products.

Low mortgage rates combined with lower costs of operating facilities will continue to push values higher. The sustainable job growth ranging between 50,000 and 75,000 new jobs per year will push the outer reaches of the Dallas/Fort Worth metroplex further north and provide demand for all types of real estate.

WINTER 1995 - 96 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 219 transactions totalling $1.16 billion 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 stabilized throughout the state for all property types but office and retail which have increased by 8% and 20% respectively from one year ago.

Following are the estimates of new constructions cost as reported by our Group:

PROPERTY TYPE	COST OF CONSTRUCTION
Apartments (per unit)	$53,500
Suburban Office (per SF)	110.00
Shopping Center (per SF)	79.00
Distribution Warehouse (per SF)	29.50
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 extremely limited but is occurring 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.

Property Type	Effective Income		Non-Reimbursed Expenses	
	Winter 199596	Range	Winter 199596	Range
Apartments	$1.01/sf/mo	$0.90-1.10/sf/mo	$3.55/sf/yr	$3.20-4.10/sf/yr
Office (suburban)	20.00	18.00-23.00	6.25	5.50-7.00
Retail (inline space)	14.50	12.50-15.00	2.50	1.83-3.00
Retail (anchor)	9.40	7.00-10.00	1.80	1.75-2.50
Industrial Warehouse	3.80	3.25-5.00	1.50	0.75-2.00
Industrial Flex	$7.25	$5.50-10.00	$2.40	$2.00-2.80

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 decreased allowing for substantial positive leverage after financing. This has brought new investors to the market looking for higher yields and existing investors more cash flow through refinancing at lower rates.

Over 65% of The Group reported that new real estate investments show lower proforma returns than those of one year ago, but the lower borrowing costs have offset the more competitive environment. Most have reported little change with their major investment assumptions. However, the duration of the investment has increased slightly. Land is normally held for three to five years but the improved properties were being held for seven to twelve years.

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)? Forty percent of the group reported annualized returns ranging from 20% to 125% on recent real estate sales. The average return was over 50% per year. These results are a good barometer of the Texas market's strength, responding to new liquidity and strong growth.

REAL ESTATE YIELDS

Interest rates peaked about one year ago and since then they have dropped by nearly 150 basis points. The five and seven year treasuries which are the benchmark for many fixed rate lenders, provide for mortgage rates in the 7.0% to 7.5% range for the best investment grade properties. These rates result in mortgage constants of .085 to .089 and allow significant positive leverage. A 75% loan with a 25 year amortization will create an equity return of nearly 10.6% if it was purchased on a 9% cap rate.

CAP RATES

	Stablized		Reversions	
	Spring 1995	Winter 1995-96	Spring 1995	Winter 1995-96
Apartments	10.10%	9.34%	10.44%	9.64%
Office	10.59	8.90	10.61	9.29
Retail	10.58	10.30	10.70	10.46
Industrial	10.21	9.50	10.63	9.80
Hotel	11.56%	10.63%	11.86%	11.00%

As a result, yields have declined and most cap rates are below 10% for investment grade properties. Even hotels which carry the perceived additional risk of management have broken below 11% in their cap rates.

REITs, whose typical cost of equity capital is well below 10%, can refinance and acquire new properties in this environment producing significant returns. We would expect them to be very active purchasing Texas real estate during 1996.

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. The current discount rates being used in the Texas Markets are seen on the table which follows.

DISCOUNT RATES

	Weighted Avg. Spring 1995	Low	Weighted Avg. Winter 1995-96	High	Change From Spring 1995
Apartments	10.7%	10.0%	11.2%	13.0%	+50 pts.
Office	12.8	8.0	11.7	15.0	-110
Retail	12.1	8.0	12.0	16.0	-10
Industrial	12.3	11.0	12.1	15.0	-20
Hotel	14.0	12.0	12.8	16.0	-120
Groundlease	10.4%	10.0%	10.25%	11.0%	-15

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 10.0% next year and 10.0% the next year. This is a 60% increase from a year 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 6.10% up from 5.67% one year ago and 4.52% two years ago. This represents a 16% annual compound increase in income from 1993. 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 Income	Next Year Expenses	Following Year Income	Following Year Expenses
Apartments	4.0%	3.8%	4.1%	4.0%
Office	10.0	4.0	10.0	4.5
Retail	5.0	3.7	4.3	4.0
Industrial	5.5	4.1	4.8	4.0
Hotel	6.0	4.3	5.0	4.0
Average	6.1%	4.0%	5.6%	4.1%

Below are the current lending criteria for real estate loans made on Texas properties. Rates are 1.43 basis points lower 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
Winter 199596	7.92%	72.0	25	5.8	1.25x	1.20
Spring 1995	9.35%	73.7	24	6.3	1.23x	1.15

Reasonable Marketing Time

When estimating market values, participants must consider what marketing time is reasonable when putting a property up for sale. 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 several cases, the Group thought the Class A Properties would sell in less than six months.

Summary

The year 1996 has begun with economic conditions that are highly favorable to real estate including: sustainable strong job growth, low interest rates, and dynamic demand for all property types. These conditions should continue throughout the year creating numerous opportunities for new development and strong appreciation from rising rents. Most owners of commercial property should consider refinancing rather than selling at this point in the cycle. For the more timid, buying shares in REITs owning Texas property should yield nice returns.

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