2007 Retail Investment Forecast
Midwestern and Southern Retail Properties
http://www.dumesfalk.com

The market for retail investment properties softened somewhat in 2006 while remaining near historic peaks. While we do not expect the market to return to the heights achieved in 2004 – 2005, we expect the market to remain favorable to sellers in 2007. The brokerage team founded by Stanton Falk and Joel Dumes is among the most active and accomplished groups in the Midwest and South. Since the two joined forces in early 2005, they have brokered over $128,000,000 of investment properties from Michigan to Mississippi. The following analysis is culled from their experience in the marketplace as well as Marcus and Millichap's up-to-the-minute internal tracking data.

PRIMARY FACTORS IMPACTING VALUE

It is our opinion that the market value of retail investment properties in 2007 will be primarily determined by the following four factors.

1. Effective Marketing
2. Direction of Interest Rates
3. Health of the Retail Sector of Economy
4. Retail Property vs. Alternative Investment

Each will be examined briefly.

EFFECTIVE MARKETING

We have chosen to discuss marketing before all other factors for a very simple reason. It is impossible to achieve premium pricing unless a marketing campaign is able to target the most aggressive money in the marketplace. As we have seen over the last several years, the most aggressive money targeting Midwestern and Southern retail in 2007 will continue to come from California, and to a lesser degree, Florida and the Northeast. Over 74% of the deals brokered by The Dumes Falk Group were sold to buyers in these markets. The remaining 26% were largely management intensive, value-added opportunities rather than the types of stabilized, low-management investments favored by out-of-area investors. Due to Marcus and Millichap's heavy concentration of offices and depths of relationships in these coastal markets, we have an unparalleled ability to access this pool of investment capital.

The key to a successful marketing campaign is the ability to target the most aggressive capital with an ability to create a market place on a national level.

INTEREST RATES

In 2006, the Ten-year Treasury note fluctuated 97 Basis Points from its low of 4.28% in late January and rose to its high 5.25% In July. As the leading index in commercial lending, we will focus on the Ten-Year as a general barometer for the direction of interest rates. In our observations, few expect the Ten-Year to fall below 4.00% or rise above 5.25% in 2007. Rising interest rates in the middle part of 2006 caused a large number of deals to fall out of contract during due diligence. As rates rose, many buyers attempted to re-trade in an effort to preserve anticipated yields while sellers refused to settle for reduced selling prices.

The effect of rising interest rates was mitigated somewhat by increased competition among lenders. Reduced transaction volume and re-financing activity led to an oversupply of capital relative to the number new loans in the market. In the summer of 2006, The Dumes and Falk Group sourced a conduit loan at 108 basis points over the Ten-year for the buyer of an outlet mall in Savannah, GA. In 2005, we would have expected the most aggressive lenders to quotes rates of at least 150 bps over the Ten-year for the same deal.

Fortunately, the Ten-year bond has retreated since its peak in July. This has had the effect of preserving, and oftentimes enhancing, a buyer's anticipated cash-flow during the due diligence period. This led to a higher probability of closing once a deal went under contract in the latter part of the year.

While it is difficult to predict the movement of interest rates, there is some basis for making modest predictions. Mixed economic indicators and the downturn in the housing markets are likely to keep fluctuation in the Ten-year Bond to stay in the mid-four's to low five's in 2007. This will result in interest rates to borrowers in the high fives to mid-six percent range for most of the investment real estate. While signs of sustained economic growth or a rebound in the housing market may be good for the overall economy, these will have a negative impact on sellers if it triggers a commensurate rise in interest rates. The primary effect will be a reduced probability of closing, rather than increased cap rates due to the fact that sellers will be more likely to let a deal die than accept a lower price for their property.

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RETAIL HEALTH

In recent years the retail sector of the economy was buttressed by the "wealth effect" produced in the housing markets. Record home prices and re-financing activity created windfalls for many home owners. This kept consumer spending strong in an otherwise weak economy. Many predicted that a downturn in the housing markets would result in reduced levels of consumer spending, but this does not appear to be the case.

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Holiday spending in 2006 was up 3.2% which is suggests consumer spending is holding firm.

Healthy levels of retail spending will bolster the confidence of retail investors and support current pricing levels in the near term since there is little reason to predict dramatic movement in levels of consumer spending. Over the long-term, however, there is a very real risk that a reduction in consumer spending could have cascading effect on retail real estate. High levels of consumer spending have led to soaring levels of retail development. This has created the risk of oversupply in many Midwestern and Southern markets. A significant drop in consumer spending could lead to high levels of vacancy, reduced rents, and increased loan defaults. While this scenario is not on the horizon for 2007, it does pose a real long-term risk for landlords in many over-built markets.

In 2007, retail investments will finally begin to fall from the tip of the bell curve. Consumer spending will remain active, but will pull back as well. We will see the real winning and losing retail concepts show their faces in 2007.

RETAIL PROPERTY vs. ALTERNATIVE INVESTMENTS

In 2006, we saw a relative softening of the retail sector of the marketplace that was manifested in reduced offer activity and longer market times. While it remained strong in historical terms, we do not expect a return to its 2005 peak in 2007. While retail will remain a desirable asset class for real estate investors, increasing numbers of investors will begin to target non-retail assets. Many felt that retail has reached its peak and that better values can be found in other asset classes. For example, in 2006 the apartment market throughout the Midwest and South rebounded after several soft years. As the housing markets cooled and apartment rental markets heated up, investors that would have been candidates for retail investments increasingly targeted apartments over retail. This was due to a perception that retail had to be purchased at the top of the market, while apartments could still be acquired near the bottom.

The markets for office and industrial properties have seen increasing levels of investor interest as well, though not to the same degree as the apartment market. Investors with a bullish outlook on the economy targeted these properties in 2006. In recent years, many markets throughout the Midwest and South saw as many as Ten sq/ft of new retail developed for every square foot of speculative office or industrial. Many believe that sustained economic growth will lead to reduced vacancy rates and upward rental trends as existing space is absorbed.

In addition, the solid performance of the stock market has had a negative impact on investment real estate in general. Prior to 2006, capital flowed into the real estate markets as a perceived "safe haven" after the fallout from the various corporate accounting scandals, the bursting of the technology bubble, and the specter of market disruptions caused by terrorism.

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Investor confidence which has made the liquidity, passive ownership, and anticipated returns of the stock market attractive to many investors who otherwise might have wanted "something I can touch."

The primary reason investors will target retail is that it continues to offer a broad range of risks and rewards. Investors seeking passive and predictable income streams will continue to target stabilized shopping centers and net leased retail. More aggressive investors will target under-performing retail properties with the goal of creating equity through aggressive management. While retail may not be the darling of the real estate market that it had been in 2003 - 2005, it is still the asset class of choice for a sizeable portion of the market.

Investment capital that has been earmarked for retail will continue to flow into alternative investments such as apartments, office property, stocks and bonds in 2007. We expect this to continue to have an impact in offer activity for retail properties with little effect on value for A properties. B and C properties will feel this in a greater decrease in value considering the amount of supply currently overpriced and on the market.

CONCLUSIONS

We expect the first quarter of 2007 to transition out of a sellers market into an uncertain market. It will be hard to generalize whether the market is a "buyers" or "sellers" because 2007 will be very deal specific. 1031 Capital will be raging in the beginning of the year due to all of the year end closings. All asset classes in commercial real estate will be earmarked in early 2007. This influx of capital will once again stimulate aggressive pricing until middle to year end 2007. Transactions will be much harder to complete without bullet proof underwriting. Money coming in from the coastal markets will continue to diminish moving through 2007 as the residential boom continues to slow in these markets. This will, in-turn, have a slight impact on value considering California is responsible for this market to begin with.

Sellers will need brokered deals to ensure both maximum exposure and a targeted audience. There are very few brokerages and brokerage teams able to position assets in a transitioning environment.

Buyers will need sophisticated real estate agents to not only consult but to help guide real estate investment decisions.

Marcus & Millichap and the brokerage team headed up by Joel Dumes & Stanton Falk have a proven track record of effectively marketing to the most aggressive money in the marketplace. We look forward to the opportunity to create value for you as a seller in the event you are considering the disposition of a retail, office or industrial property in 2007.

Please contact us directly if we can be of any assistance.

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