

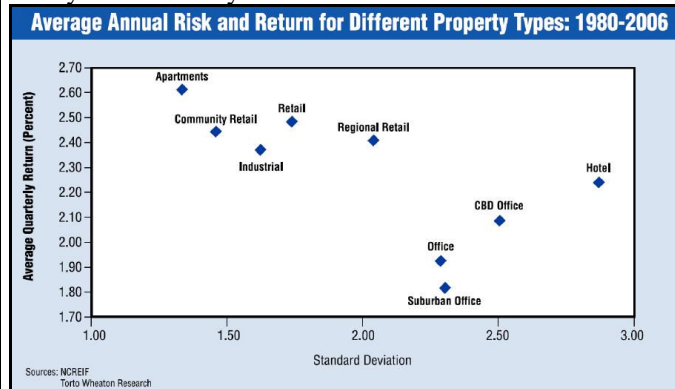
# Real Estate Investments Are Cyclical

## What Asset Classes Will Perform Best in the Next Few Years?

Office, Industrial, Multi-Family and Retail make up the "Four Basic Food Groups" of real estate asset classes. They don't always follow the same economic cycle plus some are more cyclical than others. Investors need to factor in important sub-groups such as hotel, student housing, senior housing, self-storage, healthcare and restaurants. So, which asset class is near the top of its cycle and which asset class still has upside potential in 2008 going forward?

If you are an investor that is primarily concerned with durability and consistency of income you really need to consider the risk/reward profile of potential investments. Although higher initial cash flow is seductive, make sure you have the right risk tolerance because, generally, the higher the cash flow the higher the risk.

Take a look at the following chart and you will see that the best overall returns (cash flow, appreciation and amortization) and least cyclical asset class has been multi-family. The most cyclical asset class has been hotel.



**We feel that on a risk adjusted basis multi-family and health care are the best bets going forward in 2008.** As the economy expanded from 2002 to 2006 office and retail did very well but we see a strong probability that they are currently at the top of their cycles.

It is becoming evident that the contraction of the subprime market will affect not only the housing and mortgage markets, but may also have implications for the commercial real estate markets, the commercial lending and finance industry and the broader US economy.

Homeowners took out \$709 billion cash out of their homes annually at the peak of the housing boom in 2005. These cash proceeds were not saved or invested, but rather were largely consumed. The depreciation in housing

prices and the contraction of the credit markets has served to constrain the use of home equity credit and significantly impaired disposable wealth and income.

***Retail will suffer as consumers reign in their spending.*** This reduced spending capacity coupled with higher gasoline and energy costs will probably curtail discretionary retail spending. This will probably result in higher retail vacancy rates and make rent growth problematic in the retail sector.

***Office performance is generally tied to the economy.*** Vacancies have dropped significantly from 18% in 2002 to approximately 13% at the end of 2007. Vacancies rise when the economy goes into recession. Contraction of the workforce in the housing and housing finance industries as well as a general economic slowdown (or an actual recession) should result in reductions in near-term demand driving up vacancies. ***This leads us to believe that office is at the top or perhaps just past the top of its cycle.***

***These office vacancies take time to resolve*** because office is also prone to high costs and a time lag in the process of "re-tenanting" a building. Tenants negotiate fiercely for expensive tenant improvement, brokers earn lucrative leasing commissions plus historical averages indicates a longer "lease up" period that can span months or years.

You can see in the following chart that retail, and particularly office, have had extraordinary returns over the last three years and they are probably poised to enter a period of cyclicity that will challenge their ability to provide an acceptable return over the next few years.

	Annual Returns				Std Deviation		
	3 Yrs	5 Yrs	10 Yrs	20 Yrs	Since 1978	Since 1978	
Apartments	16.4%	13.7%	12.8%	10.3%	12.1%	4.7%	5.7%
Industrial	17.6%	13.9%	13.2%	9.3%	10.7%	6.9%	6.3%
Office	19.1%	13.5%	13.2%	7.3%	9.5%	9.3%	9.3%
Retail	18.0%	17.6%	13.6%	9.6%	10.5%	6.6%	5.8%
<b>Average</b>	<b>18.0%</b>	<b>14.4%</b>	<b>13.1%</b>	<b>8.7%</b>	<b>10.2%</b>	<b>6.8%</b>	<b>6.5%</b>

Index returns start in 1978

**Multi-family is poised to take advantage of the sub-prime and credit markets melt-down.**

The result of the residential market downturn will likely be an increased demand for apartments. The combined effect of the halt in home price appreciation, increases in foreclosures, along with the increased difficulty in obtaining financing should result in a number of homeowners and prospective homeowners electing to rent.

They will want a reasonably nice lifestyle which bodes well for larger, "amenity rich" apartment complexes. When you combine these housing factors with the approximate 75 million "echo boomers," which are approaching the prime rental age it is easy to see that demand for multi-family will be strong for many years to come.

***Supply of multi-family product has not kept pace with this demand.*** Over the past several years many existing rental properties have been converted to condo and home development has far outpaced the development of rental properties. Many communities have placed barriers to further development of apartments, land has become scarce and building costs have skyrocketed. Any new apartments will have substantially higher costs than five years ago. Therefore, rents will need to be significantly higher.

***Put this increase in demand together with the scarcity of supply and this should mean increased valuations for multi-family investors.***

***Multi-family is also a lower risk investment*** since when one tenant moves out of a large project, it has little effect on the overall income. Also, a new tenant can move-in in a shorter period of time and for a lot less expense than in an office or retail building. Also, since leases are usually for six to twelve months you have the ability to raise the rent more often at renewal or when a new lease is signed.

***The Multi-Family Asset Class Offers Significantly Higher Depreciation*** than Office, Retail and Industrial therefore, multi-family has the potential to put more after tax money in your pocket. Multi Family is depreciated over 27.5 years. Office, Retail and Industrial is depreciated over 39 years. Therefore Multi-family enjoys approximately 42% more depreciation and tax shelter than office, retail and industrial.

***Healthcare will benefit from the aging demographic of the US.*** Over the past 10 years, the 55-plus population has increased an average of 1.8% annually and is expected to accelerate 2.3% annually over the next 10 years. Today, people over 65, who make up about 12% of the population, use more than half of America's healthcare resources. Healthcare expenditures are projected to rise from under 13% of the nation's GDP in 1990 to over 20% by 2015.

***Institutional investors are making healthcare a major core holding of their portfolios.*** A recent survey of institutional plan sponsors (pension funds, insurance

companies etc.) ranks healthcare investments second in its relative attractiveness as a real estate investment type (behind multi-family). The sheer scale of the industry, solid fundamentals and growing demographic demand for its services are undeniable forces that should drive valuations upward. Investors point to three basic pillars of strength for this sector:

- Healthcare is always needed.
- Healthcare is largely recession proof.
- The aging of America, a robustly growing demographic trend.

***There are two basic types of facilities,*** the Outpatient (or Medical Office Buildings) and Inpatient (or hospitals, assisted living facilities and skilled nursing facilities).

- ***Outpatient facilities*** are similar to offices but enjoy higher occupancy rates as doctors are generally reluctant to move once they have established their practice. Heavy tenant build-out requirements and the need to be near hospitals that physicians "affiliate with" are strong inducements to stay. The lease structure will typically carry longer terms and have attractive triple-net stipulations.
- ***Inpatient Facilities*** are heavily regulated by states and local governments. On one hand this complexity is beneficial because it limits competition. On the other hand it also means that the operator of the facility better be experienced and competent since it makes all the difference in the property's success. One bad survey or highly publicized episode can tarnish the reputation of an asset within its community and require months, or years, to recover.

***Real Estate Cycles can be your friend!*** We suggest that you take advantage of the cycles and position yourself for maximum gains with reasonable risk mitigation. Invest where the smart money is investing, follow demographic trends (***Please ask us for our special report on Demographic Investing***) and improve your chances for success. Let us show you how.

## Specialized Properties Inc.

Jeff Sangster, MBA

Real Estate Broker  
FINRA Registered Representative

419 Main Street #444  
Huntington Beach, CA 92648

Phone: 714 848-3707  
Toll Free: 888 543-2103  
jeff@specializedprop.com

[www.specializedprop.com](http://www.specializedprop.com)