

# TRENDS

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## METHODS CHANGE—PRINCIPLES ENDURE



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To many, the concept of representing clients headquartered in cities hundreds or even thousands of miles away (whose real estate needs possess a corresponding disparity of geographic and functional characteristics) would appear difficult at best and downright mind boggling at its worst. There are times, having for 20 years pursued just this course as a profession, that I would have to agree. But in many respects the seemingly impossible nature of what I do helps me see clearly the fundamentals that apply to successfully representing clients no matter where they are and what their needs might be.

The commercial real estate industry nationwide is by most accounts in its third year of a down cycle. For many who have joined the real estate profession within the last 10 years this is the first real down cycle they have experienced. The go-go days of recent years have (especially in the national corporate arena) literally spoiled some. They spent their days riding the wave of expansion - assignments seemed to fall magically from the ceiling into their waiting hands. Everything fit into an orderly pattern and the problems at hand were related to finding enough space to fill the insatiable appetite of the “new economy”. And then, slowly but surely, reality began to settle in like the coming of the seasons for some, but like a terrifying stranger to others.

In my traveling and meetings across the nation it has become very evident that the competition is falling into two distinct categories. Those that have the good sense and dedication to pay very close attention to the real world needs of their clients and those that are unwilling or unable to hunker down and perform the tasks at hand regardless of difficulty. I am finding there are many of the latter category. Those of us within the profession have a tremendous opportunity to utilize this period to evaluate what our role in the industry truly is, as well as what our clients expect from us. We can use these somewhat difficult times to discover some things that will add tremendous value to our services hence our value to our clients.

At **Henry S. Miller Commercial** we are blessed to have access (regardless of our individual specialization) to a platform of services and a cadre of experienced professionals of the same mindset working under the same banner that has flown for nearing 90 years. Our motto *is* our mindset- “**Methods Change - Principles Endure**”. Also, we are proud to point to the following statement - “**Service and Integrity since 1914**”. It is in the components of these simple but poignant statements where we find the fundamentals that are vital to delivering truly valuable services to our clients. In this current climate of putting portfolios under the magnifying glass, and scrutinizing the related relationships, we focus more closely than ever on our firm’s beliefs. It is the commitment to enduring principles and the dedication to service and integrity that will sustain the value of a relationship no matter the level of scrutiny and examination.

In recent years it has become popular for corporate real estate service providers to attempt to instill a sense of awe in the client by delivering razzle-dazzle presentations touting innovation and unique approaches that will somehow transform the client’s world into a model of efficiency and economic wonder. The reality is much less caviar and champagne and a lot more meat and potatoes. What clients really want, need, and deserve are three simple but powerful things. They need a partner who can *listen, understand and execute*.

Everyone has heard the old adages that stress the importance of **listening**. No one doubts the truth of these time-honored statements, but few give this practice the vital attention it deserves. It is absolutely critical to cultivate the art of listening to the client’s needs-not just hearing the words they speak. Listening involves perspectives that the client is relaying as well as hearing perspectives that the client themselves may not yet fully realize. By listening one formulates an accurate

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picture of what the client needs, and sets the course for a successful plan to provide excellent service. If a service provider is more adept at telling the client how their system works than they are listening to what the client needs, they are misguided in what their role is in the process. Our function is to service the needs of the client—not to make the client's needs somehow fit our service.

Experience (as well as listening) plays a key role in **understanding** the client's needs. Having been involved in hundreds of transactions on behalf of my clients over the years, I have a wide range of valuable experiences to draw from. By applying what I have learned in the past, I can leverage this experience to explore all possible avenues to achieve the desired final result. Methods do change to deal effectively with situations and provide practical solutions. My value to the client is sharing the cumulative experience I receive from my dedication to performing my best for all that I represent. The leveraged effect of performing and learning- learning and performing creates an exponential flow of productivity that benefits all in its path.

Understanding not only market nuances and the mechanics of commercial real estate, but also the short-term and long-term objectives of the client are crucial to creating solutions to difficult problems. A 'one size fits all' methodology simply will not work in all phases of the cycle. As a real estate service provider it is important to understand what one is looking at, what approach has worked for this particular type of situation in the past, and what it is that the client is ultimately trying to achieve.

The person or people involved on the client's behalf must be willing to apply themselves, their resources and experience, and **execute** to their fullest ability. Simply accepting an assignment and hoping for the best is not acceptable-executing with a keen focus on solutions and results is key to successfully completing an assignment. In simple terms, it is plain old work ethic-believing in the principle that a job worth doing is worth doing right- the customer is king- taking pride in knowing that you did all you could do on behalf of someone who has placed their confidence in you as a professional.

There will be a day when the economy will turn and the challenges for all of us involved in commercial and corporate real estate will be of a less tedious nature. A time when our day to day will involve a pattern of growth and timelines for completion as opposed to the complex issues of disposition or finding tenants for a sea of empty space. A day when those in the corporate arena are working hard to find space for the new employees to fill the new jobs created by a robust economy and enjoying the satisfaction of that moment when the lights are on, desks are filled, the phones are ringing. In the meantime, for those of us

who earn our keep by assisting our clients no matter what their situation might be, now more than ever we will endeavor ourselves to fundamentals that are a common thread for sound practice in all business cycles. Like our motto says-“Methods Change-Principles Endure”.

*By Dan Polanchyck  
Executive Vice President  
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**TRENDS** - The information contained herein is the result of a survey of participants in the commercial real estate markets of North Texas for the second half of 2002. The respondents include local and national developers, asset managers, loan officers in local and national lending institutions, brokers, as well as consultants, mortgage bankers and individual investors. Some of the data reported reflects a weighted average using the transactions and total dollar amounts as the basis. Thus, the respondents that were the most active within the period had more influence on the data reported.

The responding group as a whole participated in 263 transactions totaling approximately \$585 million during the second half of 2002. Of the respondents 3.7% were lenders, 7.4% were investors, 74.1% were brokers and 14.8% were other real estate professionals.

**"Who are the active buyers in today's market?"** The following chart reflects the actual buyers, based on the number of transactions, according to the respondents.

## ACTIVE BUYERS

|                        |       |
|------------------------|-------|
| End Users              | 19.5% |
| Out-of-State Investors | 20.2  |
| Local Investors        | 59.1  |
| Other                  | 1.2   |

The following table shows the sources of funds used in the transactions (based on the dollar amount of the transactions).

## SOURCES OF FUNDS

|                                     |       |
|-------------------------------------|-------|
| Local Lender                        | 47.9% |
| Non-Texas Bank                      | 31.5  |
| Individual/Cash                     | 11.7  |
| Other (Owner-Financed, Gov't, etc.) | 7.6   |
| Insurance                           | 1.0   |
| Pension                             | 0.3   |



Direct capitalization, expressed as a rate, converts a single year's net operating income into a value. The market recognizes three types of "Cap Rates." The "going-in" rate is based on the investor's analysis of the current income at time of purchase. The "stabilized rate" is based on the investment's typical operating year at a stabilized occupancy. The "reversion rate" is the capitalization rate anticipated by investors at the time of resale.

## CAPITALIZATION RATES

| Property Type | Going-In |           | Stablized |           | Reversion |           |
|---------------|----------|-----------|-----------|-----------|-----------|-----------|
|               | Avg      | Range     | Avg       | Range     | Avg       | Range     |
| Apartments    | 8.2%     | 7.0-11.0% | 8.7%      | 7.5-11.0% | 9.2%      | 8.5-11.0% |
| Office        | 9.1      | 7.0-10.5  | 9.6       | 8.0-11.0  | 10.2      | 9.5-12.0  |
| Retail        | 9.5      | 9.0-10.5  | 10.0      | 9.0-11.0  | 10.1      | 9.0-12.0  |
| Industrial    | 8.9      | 7.0-11.0  | 9.3       | 8.0-10.0  | 10.0      | 9.0-12.0  |
| Hotel         | 10.5     | 9.5-11.0  | 11.4      | 10.5-12.0 | 11.3      | 11.0-12.0 |

The capitalization rates reported are more reflective of Class A and B type properties and are broken out as follows: Class A – 41.8%, Class B – 43.1% and Class C – 12.4% and all types – 2.7%.

A discount rate (interest rate to the lender, yield to the investor) is the rate that equates the property's present value to its future income over a period of years and eventual resale. The following table presents the range and the average discount rates, as compared to year-end 2001. The discount rates presented in the table were allocated by property as follows: Class A – 45.5%, Class B – 36.9% and Class C – 14.0% and all types – 3.7%.

## DISCOUNT RATES

| Property Type | Year-End 2001 Average | Year-End 2002 Average | Year-End 2002 Low | Year-End 2002 High |
|---------------|-----------------------|-----------------------|-------------------|--------------------|
| Apartments    | 11.2%                 | <b>10.8%</b>          | 7.0%              | 15.0%              |
| Office        | 11.6                  | <b>10.3</b>           | 8.0               | 12.0               |
| Retail        | 11.1                  | <b>10.6</b>           | 9.0               | 12.0               |
| Industrial    | 11.0                  | <b>9.8</b>            | 9.0               | 11.5               |
| Hotel         | 13.8                  | <b>12.3</b>           | 11.0              | 14.0               |
| Ground Leases | 9.2                   | <b>8.9</b>            | 8.0               | 10.0               |

We asked the respondents to estimate changes in revenue and expenses by property type, which is demonstrated in the following table.

## REVENUE AND EXPENSE EXPECTATIONS

| Property Type | YEAR 1 |       | YEAR 2 |       | THEREAFTER |       |
|---------------|--------|-------|--------|-------|------------|-------|
|               | Rev.   | Exp.  | Rev.   | Exp.  | Rev.       | Exp.  |
| Apartments    | 0.67%  | 2.78% | 2.67%  | 2.44% | 3.33%      | 2.98% |
| Office        | 0.17   | 2.63  | 1.75   | 2.81  | 2.25       | 2.88  |
| Retail        | 1.21   | 2.61  | 2.61   | 2.78  | 2.61       | 2.89  |
| Industrial    | 2.75   | 2.93  | 2.33   | 2.42  | 2.17       | 2.17  |
| Hotel         | 1.20   | 3.00  | 2.40   | 2.90  | 3.00       | 3.00  |

When asked what would be a reasonable exposure time for a property to sell in the open market, the respondents answered as follows:

## REASONABLE EXPOSURE TIME (MONTHS)

| Property Type    | Months | Property Type    | Months |
|------------------|--------|------------------|--------|
| Apartments:      |        | Land:            |        |
| Class A          | 6.1    | Leased Fee Sites | 8.8    |
| Class B          | 6.6    |                  |        |
| Other            | 7.0    |                  |        |
| Office:          |        | Industrial       |        |
| High Rise        | 9.3    | Bulk Warehouse   | 7.9    |
| Class A Suburban | 9.8    | Office/Warehouse | 7.6    |
| Class B          | 9.8    | Tech Flex        | 10.1   |
| Other            | 7.7    |                  |        |
| Retail           |        | Hotels:          |        |
| Regional         | 9.0    | Full Service     | 12.9   |
| Community        | 7.0    | Limited Service  | 12.6   |
| Neighborhood     | 6.3    | Economy          | 12.6   |
| Unanchored       | 7.8    |                  |        |

The following table reflects the anticipated term of ownership (from acquisition to resale) for certain property types.

## HOLDING PERIOD (YEARS)

| Property Type | Average | Range    | Mode |
|---------------|---------|----------|------|
| Apartments    | 4.8     | 1.0-7.0  | 5.0  |
| Office        | 6.4     | 2.5-10.0 | 5.0  |
| Retail        | 5.1     | 1.5-9.0  | 5.0  |
| Industrial    | 5.6     | 1.0-10.0 | 5.0  |
| Hotels        | 6.0     | 4.0-10.0 | 5.0  |
| Ground Lease  | 9.2     | 5.0-12.5 | 10.0 |



## Investment Opportunity in 2002

Industrial properties were viewed as being the best investment opportunity, followed by apartment, retail, land, office and hotel properties. The participants were asked to provide their forecast for 2003: 4.2% said great, 16.7% think good, 58.3% say stable and 20.8% anticipate a decline.

The following table reflects market averages and ranges for finish-out in office, industrial and retail properties. These are shown on a per square foot basis. Please note that the ranges for industrial reflect both bulk and flex type space. The upper end reflects flex space, with the lower end being more representative of warehouse or bulk type space, which is usually only applied to the office portion.

### FINISH-OUT

|                | Office  | Industrial | Retail  |
|----------------|---------|------------|---------|
| <u>New</u>     |         |            |         |
| Average        | \$18.38 | \$5.61     | \$16.20 |
| Low            | 10.00   | 2.00       | 11.00   |
| High           | 30.00   | 10.00      | 20.00   |
| <u>Renewal</u> |         |            |         |
| Average        | \$9.56  | \$2.81     | \$7.70  |
| Low            | 5.00    | 0.50       | 5.00    |
| High           | 17.00   | 6.50       | 15.00   |
| <u>Shell</u>   |         |            |         |
| Average        | \$25.38 | \$9.54     | \$19.20 |
| Low            | 12.00   | 2.75       | 16.00   |
| High           | 30.00   | 30.00      | 25.00   |

We asked the investment community about their acceptable returns when investing in land. The following yield rates reflect primarily unleveraged returns.

### YIELDS FOR LAND

| Property Type               | Average | Low  | High |
|-----------------------------|---------|------|------|
| Pad Site                    | N/A     | N/A  | N/A  |
| Industrial                  | N/A     | N/A  | N/A  |
| Residential Lot Development | 22.7    | 20.0 | 28.0 |
| Speculative Land Purchase   | 23.3    | 13.0 | 30.0 |

We asked the respondents what they used for a stabilized vacancy and collection loss when analyzing different property types. The following table summarizes their responses, presenting both the average and the mode.

## VACANCY & COLLECTION LOSS (AVG & MODE)

| Multi-Tenant       | Loss (%)    | Single Tenant      | Loss (%)   |
|--------------------|-------------|--------------------|------------|
| <u>Retail:</u>     |             | <u>Retail:</u>     |            |
| Strip Center       | 8.8 / 10.0  | Credit             | 3.6 / 5.0  |
| Neighborhood       | 7.8 / 7.0   | Non-Credit         | 7.1 / 10.0 |
| Anchored           | 6.1 / 5.0   |                    |            |
| Multi-anchor       | 6.1 / 5.0   |                    |            |
| <u>Office:</u>     |             | <u>Industrial:</u> |            |
| Class A            | 9.5 / 10.0  | Credit             | 4.1 / 5.0  |
| Class B            | 10.2 / 10.0 | Non-Credit         | 7.8 / 10.0 |
| Garden (Class C)   | 10.5 / 10.0 |                    |            |
| Small              | 9.6 / 10.0  |                    |            |
| <u>Industrial:</u> |             | <u>Office:</u>     |            |
| Bulk               | 6.0 / 5.0   | Credit             | 4.4 / 5.0  |
| Flex               | 8.9 / 10.0  | Non-Credit         | 8.1 / 10.0 |
| <u>Apartments:</u> |             |                    |            |
| Class A            | 8.5 / 8.0   |                    |            |
| Class B            | 9.0 / 10.0  |                    |            |
| Class C            | 9.2 / 10.0  |                    |            |

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