

# FALCON

REAL ESTATE INVESTMENT COMPANY, LTD.



*Comprehensive Services for Investors in U.S. Real Estate*

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## 1991–2001 Falcon's Tenth Anniversary

Falcon Real Estate was formed ten years ago, in September 1991. We were then at the bottom of one of the worst real estate recessions that the United States had experienced since the Great Depression of the 1930's. But the U.S. real estate market recovered from that recession much more quickly than had been expected, and within a few years every measure of the health of the market—occupancy rates, rental rates and property values—were all rising.

During the past ten years Falcon has carried out over \$1 billion of transactions on behalf of our clients, and we currently provide asset management for in excess of \$650 million of real estate assets around the country. We now have offices in six cities—New York, Chicago, Washington D.C., Miami, Dallas and San Diego—and we have an experienced staff of professionals of whom we are justifiably proud. For a more complete description of Falcon, log on to our new web site – [www.falconreal.com](http://www.falconreal.com).

We began publishing newsletters such as this one shortly after Falcon was started, and we are outlining in this issue excerpts from the issues of the past ten years.

### *January, 1992* **The 1992 Outlook**

Tremendous over-building and a slow rental market due to the recession have resulted in high vacancies, declining rental rates, and plunging real estate values throughout the United States. The current recession in the real estate market is, in many ways, the worst in the last 50 years. But new construction has virtually stopped throughout the U.S., and occupancy rates will improve as the economy recovers. Since real estate prices have declined sharply, falling, in many cases, well below replacement costs, there is now for the astute, long-term investor *an historic buying opportunity*.

### *October, 1992* **The U.S. Dollar**

But for the foreign investor, U.S. real estate prices may be even more attractive, since the U.S. dollar continues to trade at near-record lows. Even after its recent rally, the dollar remains about 20% lower in

German mark terms than it was one year ago. For the foreign investor, an eventual recovery in the dollar could enhance the already attractive total returns available in the U.S. real estate market.

### *January, 1993* **The Start of the Recovery**

All of the elements are slowly falling into place for a sustained recovery in the U.S. commercial real estate market. The American economy is showing surprising strength and appears to be heading into a period of steady growth. This is leading to a slow pick-up in leasing activity, particularly in well-situated industrial buildings and suburban offices. With virtually no new construction taking place anywhere in the United States, vacancy rates in many markets have begun to creep down, and we expect this trend to continue. Real estate investors have had a tremendous buying opportunity over the past two years, and this window of opportunity should remain open during 1993.

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*October, 1994*

### **Favorable Supply/Demand Situation**

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The most important factors that indicate a continued increase in the value of commercial real estate on a long-term basis are supply and demand. Throughout the United States, more constraints have been placed on the development of well-located, quality real estate than at any time in history. At the same time, demand will continue to grow in line with the growth of population and the economy. *The result will be rising rental rates and increased values for high quality commercial properties through the end of the decade.*

*April, 1995*

### **No Speculative Construction**

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As demand for space has picked up, there continues to be a total absence of new speculative construction, with lending institutions remaining on the sidelines and existing rent levels being too low to justify new construction. This changing supply/demand situation is beginning to result in upward pressure on rental rates, a trend that is likely to continue for the next several years.

*January, 1996*

### **The RTC**

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On December 31, 1995 the Resolution Trust Corporation (the "RTC") closed its doors and went out of business. This was the U.S. Government agency that was formed in April 1989 to take over hundreds of savings and loan associations (the "S & L's") that had become insolvent due to bad real estate loans. The RTC ultimately took responsibility for almost \$500 billion of real estate assets that had been held by the S & L's, and it faced the daunting task of disposing of these assets in the midst of an economic and real estate recession. The fact that virtually all of these assets have now been sold, and that the RTC was able to go out of business, is clear evidence of the recovery that has been underway in the real estate industry for the last two and one-half years. On average, in selling the S & L's assets, the RTC was able to realize 85¢ on the dollar, which is a remarkable achievement considering the quality of assets involved.

*April, 1996*

### **The U.S. vs. the European Real Estate Markets**

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In comparing the U.S. real estate market with the major European markets, we believe that the U.S.

market is clearly the most attractive for the following reasons:

1. Yields, or capitalization rates, on prime properties are higher in the United States than in comparable markets in the United Kingdom, France or Germany.
2. Rents on existing properties in many European markets, such as the U.K., are above current market levels, which may result in lower rents and lower yields to the investor, when leases mature. The situation in the U.S. is exactly the opposite, with rents expected to rise as leases roll over.
3. The major real estate markets in Europe are considerably smaller than those of the United States, and are typically concentrated in a few major cities. In the U.K., for example, investment quality real estate is focused in the greater London area together with Manchester and Edinburgh. The French real estate market is basically dominated by Paris. The U.S., by contrast, has over 250 distinct real estate markets, of which 15 could be characterized as major markets.
4. Economic growth, which leads to demand for leaseable space, has been stronger in the U.S. than in countries such as Germany and France, and vacancy rates in the U.S. are declining more rapidly.

*October, 1996*

### **The Underlying Economic Expansion**

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The five-year expansion, which began in the final year of President Bush's administration, has had a major effect on the commercial real estate market throughout the country. As the economy has improved, demand for space—office, industrial and retail—has risen at a very rapid rate. Since there has been virtually no new construction in the United States during the past five years, the rising economy and the increasing requirement for space associated with that rise has resulted in declining vacancy rates and increasing rental rates. As a result, we have today, in most areas of the United States, one of the healthiest real estate markets that we have experienced since the 1970's.

*January, 1997*

### **Guide to Investing**

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The U.S. real estate market has been changing dramatically in recent years, as both U.S. institutional and foreign purchasers have re-entered the market. Properties can still be purchased at yields or capitalization rates that are quite high by historical standards,

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and many properties are available at prices below replacement cost. However, the market has become very competitive, and investors should follow the following steps if they expect to be successful:

1. *Develop clear, realistic investment criteria.*
2. *Recognize changed market conditions.*
3. *Be able to make decisions rapidly.*
4. *Be willing to issue a non-binding Letter of Intent at an early stage in the acquisition process.*
5. *Be flexible as to financing contingencies.*

With vacancy rates dropping, rental rates rising and virtually no speculative construction taking place in any area of the United States, the next few years should be an excellent period in the real estate market. Investors must fine-tune their acquisition procedures if they wish to participate in this market.

**January, 1998**

### **Global Investment Problems**

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Investors from all parts of the world will have to deal with extraordinarily difficult decisions in 1998. Those who have benefited from the tremendous growth that was experienced by the emerging countries of Southeast Asia are now confronted with a very different situation, as necessary restructuring and retrenchment spread across the region. Investors in some Latin American countries will be faced with similar problems, while in Europe many investors, particularly in Germany, are faced with the very real uncertainties surrounding the introduction of a new currency.

**April, 1998**

### **REIT's**

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Through the first quarter of 1998, the REIT's have benefited from a recovering real estate market, a stock market that has experienced an historic up-trend and a bond market that has seen yields fall to the lowest levels in years. Clearly, REIT's can be an appropriate investment for some investors who do not have the resources to purchase an individual property. But the positive returns from REIT's are dependent upon continued bull markets in all three markets—stocks, bonds and real estate—to a much greater extent than are the returns from individual properties, and investors should be aware of this vulnerability.

### **October, 1998** **Development**

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Development has been held back, and continues to be held back in many markets, by rental rates that do not justify new construction. However, rents are moving

up at a surprisingly rapid pace, and developers are now finding it easier to make realistic projections that will show a reasonable return on new construction. Most properties that are being developed today are substantially pre-leased, and banks continue to be reluctant to provide funds for purely speculative development. As a result, there are still no signs that the U.S. real estate market will suffer a recurrence of the over-building that characterized the 1980's.

**April, 1999**

### **Where to Invest**

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Excellent buying opportunities can be found in most markets around the country, but Falcon Real Estate believes that the metropolitan areas of the following cities are particularly interesting for new investment at this time:

1. *San Francisco, California;*
2. *Washington, D.C.;*
3. *Chicago, Illinois*
4. *Seattle, Washington;*
5. *Boston, Massachusetts.*

In selecting these areas, we apply the following criteria:

- (1) *strong underlying population growth trends;*
- (2) *favorable economic fundamentals;*
- (3) *a good existing public infrastructure; and*
- (4) *some restrictions on future real estate development.*

**January, 1999**

### **The Real Estate Market vs. The Stock Market**

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As 1999 begins, the U.S. stock market is at or near record highs. The stock market, as measured by the Dow Jones Industrial Average, is now selling at an average price/earnings ratio of 24.8, compared to a p/e ratio of only 11.7 at the market bottom in 1987. At the same time, the average dividend yield has fallen to 1.6%, which is a record low for the Dow. More worrisome are the p/e ratios for many of the high-technology market leaders that now reach 50 to 60 times earnings. And there can be no rational explanation for the extraordinarily high prices for most of the new, untested internet stocks that do not even have p/e ratios since they have no present or prospective earnings. Any market correction that might occur in these over-priced sectors of the market could seriously affect the entire stock market.

In contrast to the generally over-priced and low-yielding stock and bond markets, yields in the real estate market remain in the 7 1/2% to 9% range for well

located, prime real estate with credit quality tenants. The spread between real estate yields and 10-year U.S. Treasury securities is now between 400 and 500 basis points, which is a level that has been reached only rarely over the past twenty years. Not only are current real estate yields attractive, it should be remembered that in most cases real estate yields will rise over the life of an investment as built-in rental increases take effect. It should also be noted that, as opposed to the over-valued stock market, most real estate investments are being made today at prices that are below original construction cost and below current replacement cost.

### **July, 2000** **Diversification**

The market correction that occurred in technology and internet-related stocks in recent months has brought home to many investors the importance of having some degree of overall diversification in their investment portfolios. In considering U.S. real estate as a diversification tool, investors should focus on a number of factors that are inherent in this asset class. Among such factors are (1) the relative stability of real estate—the fact that over time the value of investment quality real estate fluctuates far less than does the value of stocks and bonds; (2) its competitive investment return—the fact that over time real estate provides greater total returns than do fixed income securities, but lower returns than common stocks; (3) the lack of correlation between the investment returns from real estate and the returns from other asset classes; and (4) real estate's relative illiquidity. It is Falcon Real Estate's belief that, on balance, these factors provide support for the view that U.S. real estate is an effective and rewarding diversification tool.

### **Jan. 2001** **Slowing U.S. Economy**

It is still unclear whether or not the United States will suffer an actual recession (defined as two consecutive quarters of negative growth in gross domestic product), but investors need to consider how real estate will perform under the economic conditions now forecast for the year 2001. Specifically, consideration has to be given to the following risk factors in the U.S. real estate market: capitalization rates; interest rates; the supply/demand situation in a given market; leasing and the credit quality of a tenant. In Falcon Real Estate's view, for an investor owning a property with high quality tenants on long-term leases, short-term swings in the economy should be of little consequence.

### **Fall, 2001** **Conclusion:**

In providing advice to our clients over the past ten years, we have tried to give weight to the macro-economic factors that might affect the U.S. real estate market. Therefore, we have continually reviewed economic growth trends in the United States and abroad, along with interest rates and the relative attraction of other asset classes. But in the final analysis, unless there is some extraordinary situation in the economy as there was ten years ago, the principal factors affecting the success of a real estate investment are inherent in the real estate deal itself. It is always imperative to come back to the basics of the deal—location, quality of construction and the creditworthiness of the tenants. And of these three, there can be no doubt that “location, location, location” is the most important.

***For further information,  
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