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U.S. Real Estate Caught in the Middle of a Credit Crisis and Faltering Economy

The financial crisis facing the United States and global markets has and will dramatically reshape the commercial real estate landscape in the coming months.

Like it or not, real estate is getting dragged into a period of financial upheaval unrivaled in almost 80 years. Commercial real estate investors did nothing wrong, but what must be kept in mind is real estate is a highly capital intensive industry, and with capital markets going through a dramatic period of adjustment the fallout will be significant.

The subprime mortgage meltdown and ensuing concerns with credit default swaps and other credit instruments have had a crippling effect on financial markets. We are all learning that the banks and, for that matter, all lending institutions are absolutely critical to our industry and indeed the entire economy. It is difficult to truly understand the importance of a sound financial system until times like this when we see such intense pressure building across all spectrums of the economy.

Our outlook is based on ever-changing events. We do foresee a sharp but yet relatively short recession. The severity of the situation leaves little doubt that we can only hope that the massive correction in the equity markets is the beginning of the end.

Economic Outlook

The economic landscape shows continued job losses, with the September employment report down a further 159,000 jobs. This was the ninth consecutive month of such losses. There was a silver lining, though. July and August numbers weren't revised downward as many predicted, and the September number paled in comparison to previous recessionary periods when job losses ranged from 300,000 to 350,000 a month. We believe that's partially because corporate America continues to run fairly lean.

Consumer confidence also remains weak. The latest readings from the Conference Board's consumer confidence index (CCI) shows current sentiment is significantly worse than the lows seen in early 2003. The index tends to move in sync with the price of gas so we need to be a bit careful with this index; however, the CCI is one of the best barometers for gauging the mood of the country and is a good predictor for the nation's office sector.

A case can still be made for remaining bullish on exports even with the latest surge in the dollar although a slowing global economy is sure to be a significant drag on further growth.

Stability in the housing market is absolutely critical to any economic recovery. Housing starts have plummeted to below one million units on an annualized basis, which should help reduce the inventory of homes listed for sale. Existing housing sales look to have stabilized at around five million on an annual basis, which is encouraging.

The significant events in the past several weeks have produced a fragile and weakening economy with any slowdown set to continue for at least the next 12 months. Reasons for pessimism include the still frozen credit markets, the global economic slowdown, job losses and largely ineffective monetary and fiscal actions undertaken by U.S. policymakers. Declining energy prices and a willingness by most central bankers to inject liquidity into the world's credit markets should provide some measure of relief.

These conditions will affect sectors of commercial real estate in different ways.

Office Market

Demand for office space has eased considerably, especially in those markets and submarkets heavily tied to the housing, auto and financial services industries. Weakness in the job market will further depress most office leasing markets. To date rents have held steady but landlords have already increased inducements and will almost certainly face rising pressure to lower rents in the coming months.

Fortunately, developers have not gone overboard, with very few markets overbuilt. New construction represents only 2% of inventory which is well below the 4-5% registered during past economic downturns.

The worst case scenario is for the national office market to show negative absorption of 80 million square feet by the middle of next year. This will increase the vacancy rate to 16.5%, a 3% jump over the next 12 months.

Industrial Market

The industrial warehouse market has been disproportionately whipsawed by the downturn in housing and the general downturn in the economy. Housing in particular has proved to be a surprisingly strong catalyst for the current downturn in the warehouse leasing market.

Leasing has slowed quite substantially. The industrial sector showed negative absorption in the second quarter of 2008, the first time in five years occupancy levels have declined. Based on a depressed housing market, and slowing retail sales and imports, such a pattern is anticipated to continue for the balance of the year and well into 2009. Retail numbers for September came in below expectations, a clear signal that consumers are tightening their purse strings.

New construction is subdued but still represents nearly 1% of inventory. Combined with slower leasing, the nation's overall industrial vacancy rate is expected to climb, increasing 1% to 1 1/2% over the next 12 months. Rental rates have already dipped and will be under more pressure in the coming months.

Investment Sales

The financial morass has severely impacted the ability to buy and sell real estate.

In the office sector, investment sales were down 67% in the first half of 2008. Buyers were apprehensive, and it took longer to complete deals as due diligence periods were extended, and busted and re-traded deals returned in earnest.

Such a steep drop was partially a result of the big portfolio sales completed during the first half of 2007. Take away those blockbuster deals and the numbers aren't nearly as shocking, as buyers and sellers are doing more one-off deals this year.

Lending standards have tightened considerably, a trend that began last year and has accelerated significantly. Today, four out of five domestic lenders have tightened their belts, making it more difficult for buyers to arrange debt financing. The CMBS market has all but disappeared, so funds for investment sales are drying up. Life insurance companies and regional and foreign banks have picked up some of the slack but these sources are running thin.

Deleveraging is bringing values for properties down as debt becomes the proverbial four-letter word. This heightens the risk factor and is placing significant pressure on cap rates. Class A office assets have seen cap rates jump 75 to 100 basis points over the past 12 months while Class B and C properties have climbed even more, by 150 to 175 basis points.

Moving forward, key questions remain on how financial institutions will price capital. Other factors to weigh and watch include:

- Are we just returning to a normal market when due diligence was paramount and a heavy dose of conservatism was considered a sound approach?
- There will be a growing divide between core and value-added deals. Risk will be priced very differently from just a few months ago.
- Paper (mortgage) vs. assets will favor the former as hedge funds and other opportunistic investors will see ample opportunities to buy paper at 20 cents to 30 cents on the dollar.
- Foreign investors have largely disappeared as concern about the U.S. economy has deterred many, dipping from \$50 billion in investment acquisitions last year to only \$5 billion year-to-date July.
- For markets to stabilize, four key components are required: housing sales must remain at or near 5 million units; prices must plateau for a reasonable period; energy prices must remain depressed; and perhaps most importantly spreads must return to more "normal" levels.

Overall Outlook

Events change daily but it is clear that no one can overstate the severity of the situation. Fortunately, the U.S. government and its various agencies are going to throw everything that they have to reverse the course of the current financial crisis. It is still too early in the game to predict the catalyst that will turn around the situation.

In the meantime, several themes will shape the balance of 2008 and well into next year:

- Tepid leasing conditions and tentative tenants are sure to negatively affect occupancy rates in the coming quarters.
- Recession is at our doorstep if not already inside our house.
- Shorter terms will be the norm as companies pause to see where the economic winds are blowing.
- Consumer spending in the short term is set to trend down, putting pressure on retailers and further pressure on the industrial sector; employment will drop but should not go into a free-fall.
- Lower energy prices will give some relief and should boost consumer and business confidence.

- Overall, the strengthening dollar is a positive, allowing the Fed to lower interest rates, encourage foreign investors to finance the twin deficits and act as a catalyst towards lower oil prices.
- Credit will remain very scarce, with little improvement until lenders gain more confidence with various counterparties and the housing market shows some signs of stability.
- Financial regulations will certainly increase in the coming months. It remains to be seen if government will take a rational approach to avoid burdensome costs that will place American companies at a competitive disadvantage.

The story still unfolds and one of the biggest chapters remains. November's elections will reshape the political landscape and consequently the financial direction of the country. As often is the case, stay tuned.

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