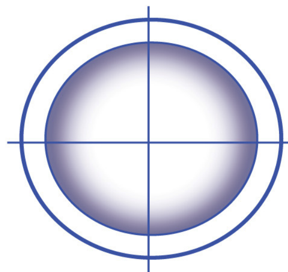

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Commercial Real Estate: Macro Condition & Outlook

Current Conditions & Outlook for the Short and Mid-Term

November 16, 2012 by William L. Pittenger, MAI, SRA

The U.S. economy continues to limp along in an environment shrouded by uncertainty as it performs far below its potential. While still in positive territory, second quarter GDP growth was a paltry 1.3% annualized. The recently announced first estimate of third quarter growth was not much better at 2.0%. Looking back , the economy has grown at around 2.3% over the last 12 months. Looking forward, there are no leading indicators to suggest significant improvement over the next 12 months. The economy needs a minimum of around 2.5% growth to move the needle on employment and start measurably reducing unemployment.

The labor force participation rate, at 63.8%, is just off its 31 year low. In addition, there are 102 U.S. metros with populations greater than 500,000. Eighty five of them lost jobs in the five years since the recession began in December 2007 and still have a deficit. Only 17 metros have gained jobs. The steepest losses were in some of the nation 's historically prime areas for both job creation and real estate development. Los Angeles, for example, currently has a deficit of 333,300 private sector jobs. Chicago is down 204,300, Phoenix is down 150,800 and Miami - Ft. Lauderdale is down some 160,900 jobs.

The housing sector is beginning to emerge from six years of dismal performance. It has been a drag on GDP but is now starting to contribute positively, albeit very modestly. While a bottom likely occurred last July, and recent performance has improved, there are still reasons to be wary of the still fragile recovery.

Some of the uncertainty was lifted recently with the re-election of the President. Nevertheless, remaining uncertainty looms large in the form of the fiscal cliff which could push the nation into another recession in early 2013. Add to that a laundry list of new regulations in process and likely to emerge and businesses continue to have reason to remain fearful and not invest, hire or make other long term commitments.

Enter commercial real estate. Like the broader economy, recovery in commercial real estate is slow, uneven and still plagued by last decade's overbuilding, current foreclosure hangover, the European crisis as well as the usual suspects; tax, regulation and financing uncertainty. Last decade, the commercial real estate sector followed the same pattern as housing. There was unprecedented development and price growth, much of which was created by faux demand until prices peaked in late 2007. The sector quickly collapsed and prices fell roughly 50% from their peak. The fall was faster, steeper and significantly deeper than the housing crash. Moreover, there are perhaps two more conditions currently frustrating recovery. First, there is little measurable demand for new product. Second, most proposed new development today is not economically feasible. In other words, development is constrained in markets where new product is often worth less than it would cost to create.

It is difficult to discern sustained and robust recovery in any commercial real estate product sector other than rental apartments. That sector has been nothing less than hot for nearly three years. Nevertheless, it too is cooling and showing cracks in its most fundamental demand and value drivers. The following is a sector by sector look at current condition and outlook.

With the broader economy struggling to recover and GDP at roughly half of its long term growth rate, the **office market** continues to languish. The office sector became seriously overbuilt last decade as developer rushed to create space to serve the explosive housing growth they believed was coming. In deference to the 1989 Kevin Costner film, *a field of dreams* emerged. They built it but few came as the perceived housing demand turned out to be a mirage. Suburban office markets became seriously overbuilt.

This commentary is written by William "Bill" Pittenger, MAI, SRA Senior Director—Economic & Consulting Services at FOCUS Valuation Advisors. Contact Mr. Pittenger at bill.pittenger@focusvaluation.net.

To receive our commentaries, please e-mail bill.pittenger@focusvaluation.net.

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Historically, suburban office markets have been among the first to recover after a recession. Recessions tend to create new entrepreneurs as displaced professionals create new businesses. They often fund start up businesses with home equity loans and locate in less expensive space in suburban locations. That is not the case so far in the current recovery. Today, entrepreneurs have less financial capacity with which to start businesses or expand. Even home equity is virtually non-existent today and financing a start-up is next to impossible.

As a result, office space in central business districts, which are largely dominated by larger and established companies, appears to be recovering at a faster pace than suburban office space.

The office sector is also facing demographic changes. The so-called *Millenial Generation* represents those persons born between 1977 and 1997. That generation is some 88 million persons strong. They are digitally confident and tend to prefer telecommuting or working in large open spaces. Unlike previous generations, most millenials report they couldn't care less about earning the big corner office. This generation is now entering the work force and is leading the way to smaller workspaces and telecommuting; trends we expect to continue, thus reducing office space requirements.

Nationally, the office vacancy rate, according to research firm Reis, is 17.1%. That is about the 1993 level making the sector the slowest to recover. Average capitalization rates are hovering in the 7.8% range for central business district space and 8.4% for suburban.

Office Outlook. We expect the office sector to underperform its potential for the next two or three years. The sector continues to face significant structural and demographic headwinds. Lease expirations and maturing loans are also a growing risk that could bring more space to already over supplied markets.

The **retail sector** has been plagued by slow or no growth in consumer and retail spending as well as by low consumer confidence and an ever increasing internet retail presence. Many traditional retailers complain that consumers often look at products in their stores then buy on the internet.

The national retail vacancy rate is now 10.9% after peaking at 11%. Regional malls have performed better (9% vacancy) due the dominance of large national tenants who are perceived to have more staying power. That said, they are also quicker to pull the plug on underperforming stores. New construction has declined to near record lows with just 569,000 square feet constructed in the third quarter.

Outlook. The sector has clearly not recovered. Fundamentals such as household income, employment, confidence and spending will need to recover before is assured. New development will remain constrained as most is not economically feasible at this time and there is no leading indicator that suggests a short term change.

The **apartment sector** hast been hot for nearly three years. That begs the obvious question, *"how long can it remain hot."* The short answer is "not long." Indeed, the sector is now beginning to show cracks in its most fundamental demand and value drivers.

According to Reis the national third quarter vacancy rate was 4.6%. That is down from 4.7% a quarter earlier and it seems unlikely that it can decline any further. Occupancy gains are slowing significantly. The third quarter was the slowest gain since early 2010 and around half of what it was for the last few quarters. As the sector is bumping up against the highest level of sustainable occupancy, owners appear to be trying to achieve rent increases. That too could prove difficult in the face of stagnating incomes. Class "A" space has the most room for increase while Classes "B" and "C" have the least.

At this time absorption is still faster than inventory growth but that could change as there are about 130,000 units expected to come on line beginning in early 2013.

Capitalization rates have now dipped into the mid 6% range which is equivalent to 2006 levels. There is anecdotal evidence of a few ridiculously low rates under 6% but those appear to be exceptions. And certainly not the rule.

Outlook. The rental apartment market has clearly been the shining star of the broader CRE marketplace however cracks are beginning to appear in the fundamentals. With broader economic recovery softening while the apartment market is still heating up, it is our view that the recent pace of growth is not sustainable.

The **Industrial Sector** includes two broad sub-categories: Flex/R&D and Warehouse/Distribution. The two sectors are behaving very much like we described for the office sector. After most recessions, the Flex/RD sector is the first to recover as entrepreneurs bring new technology ventures to market. As pointed out previously, however, this recovery is different as entrepreneurs don't have the financial capacity to create new ventures. As a result, the warehouse / distribution sector is out performing so far in the current recovery.

The Flex /RD subsector recorded a national vacancy rate in the third quarter of 14.2% while warehouse/distribution did moderately better at 12.4%. At the same time average capitalization rates according to PWC (formerly Korpacz) were 8.65% for Flex/RD and 7.33% for warehouse/distribution.

Containerized storage is also changing the warehousing dynamic. Port cities are scrambling to deepen channels. Most can accommodate Panamax container ships needing a 35 foot channel depth however newer and larger ships (from Asia) require 42 to 52 feet of channel depth.

Outlook. There is currently improved investor sentiment around the industrial property sector. Nevertheless, recovery is still a 2015 event.

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