NATIONAL REAL ESTATE Investor

Forecast 2006: Five trends driving the industry

Written by Matt Hudgins

Dec 1, 2005 12:00 PM

While mounting pressures may produce cracks in the economic recovery in 2006, the nation is on track to close out 2005 on a resilient note. Real GDP growth in the third quarter was higher than expected at an annualized rate of 3.8%. “The economy has so far withstood the energy price shock and some major natural disasters, yet continues to perform very well,” says Hessam Nadji, managing director of research services at Marcus & Millichap.

Despite economic expansion, interest rates have remained low by historical standards, fueling what Nadji says will be record investment activity in 2005. More than $71 billion of properties sold in the third quarter — a quarterly record — bringing the year-to-date total to nearly $190 billion, according to Real Capital Analytics.

Some experts take a more critical view of 2005, however, noting disturbing investment patterns that seem to disregard risks in an economy under increasing strain. “2005 is probably best characterized by a lack of discipline in the market,” says Ken Munkacy, COO of New Boston Fund.

“Hurricane Katrina is almost a metaphor for our industry. The sort of irrational exuberance that Alan Greenspan spoke about years ago has pretty much reached tsunami levels,” adds Munkacy. Boston-based New Boston Fund is a private real estate firm that owns and manages more than 13 million sq. ft. of commercial real estate valued at more than $1.3 billion.

The cumulative effects of hurricane damage, war, high energy prices, capital market volatility and overbuilding in some sectors are all warning signs. “Those things bring stress to the economy, and that will eventually lead to distress, maybe in the third or fourth quarter of 2006,” says Munkacy, who expects to see increasing loan failures next year, particularly in overbuilt condominium markets.

What will be the greatest sources of economic stress in the coming year, and how will those forces affect the economy and shape demand for commercial real estate? NREI takes a look at five hot-button issues for 2006.

Rising energy, construction costs

1

Although fuel prices fell throughout November, they remain high by historical standards. In mid-November, the price of gasoline was 32.7 cents per gallon higher than a year ago, and diesel fuel was up 47 cents for the same period, according to the Energy Information Administration.

Even before Hurricane Katrina, construction costs were climbing due in large part to demand for materials from China and India. The price of steel pipe shot up 57.7% from July 2003 to July 2004, and edged up another 6.9% in 2005, according to The Associated General Contractors of America. Additional increases stemming from rebuilding along the Gulf Coast won't be felt until 2006.

“The biggest thing affecting the industry in 2005 has been construction costs. It's been outrageous,” says Joe Faulkner, executive managing director of brokerage services in the Los Angeles office of Charles Dunn Co., a full-service commercial real estate firm.

In the aftermath of the 2005 hurricane season, experts expect rebuilding efforts and the loss of some production facilities to keep prices high well into 2006 for concrete, gypsum and other construction materials.

The cost of materials is climbing about 1% each month in New England, and in Florida materials today cost 25% to 30% more than they did a year ago, says Jim Kelleher, senior vice president and director of acquisitions at New Boston Fund.

“An office building we built for $210 per sq. ft. in the Washington, D.C. suburbs five years ago would cost us $330 per sq. ft. to build today” as a result of drastic price increases, Kelleher says.

Fuel costs increase the price tag for shipping virtually everything and will squeeze consumers and businesses alike with higher heating bills this winter. In the Northeast, the price of oil will be 30% to 50% higher this winter than it was a year ago and propane prices may be as much as 100% higher for the same period, Munkacy projects.

Economists say high prices for both energy and construction materials are a short-term problem, however, and new sources of commercial construction materials will slow the rise in prices, or even begin to bring prices down before the end of 2006. China, for example, is beginning to produce concrete reinforcing bar and other building materials it previously only purchased, says Jim Costello, senior economist at Boston-based Torto Wheaton Research.

While Costello doesn't believe high construction costs discourage new development, he says that rising costs will encourage some developers to convert well-located office stock to other uses, such as retail, residential or mixed use.

The relatively high cost of interior finishes means tenants may favor completed offices over shell space in 2006, says Michael Silver, president of Chicago-based Equis Corp., a real estate services provider. The exception will be new, highly efficient space that may offset the cost of interior construction, he says.

Of greater concern to investors may be the effect of high energy bills on consumers, says Doug Duncan, chief economist of the Mortgage Bankers Association. That's one reason the MBA expects mortgage delinquencies to increase in 2006. “When home heating costs rise, consumers faced with a choice of making a mortgage payment on time — or heating the house — will heat the house.”

Waning consumer spending

2

In the past four years, mortgage refinancing has given homeowners, on average, a 25% increase in disposable income without a corresponding wage increase, says Dr. Rajeev Dhawan, director of the Economic Forecasting Center at Georgia State University. Entering 2006, however, rising interest rates threaten to halt the spending spree.

“The danger zone is if this 10-year Treasury bond yield is 6% by mid-2006, then the consumer will run out of cash from his housing-equity ATM before job growth replenishes the coffers.”

Economists don't expect a dramatic rise in interest rates, but most say recent increases will continue into 2006. Costello projects the benchmark 10-year Treasury yield will climb to 5.16% by mid-year, up from 4.16% at mid-year 2005. Higher rates will make borrowing less appealing to consumers and tighten discretionary spending. “Consumers are tapped out with household debt at record levels,” Costello says.

Adjusted for high energy costs, consumer spending is already on its way down, according to a recent report by David Resler, an economist at Nomura Securities. Personal spending rose 0.5% in September due to higher oil and gas prices, but spending on non-energy items dropped 0.4% in the same month following a 1% drop in August. That two-month decline is the biggest in 19 years, according to Resler.

The obvious connection between consumers and commercial real estate is retail, and demand for new retail space will taper next year as spending wanes, says Marcus & Millichap's Nadji. Limited construction has held the retail supply in check, however, so he expects the sector to remain strong despite softer demand.

Higher interest rates could boost occupancy in the multifamily sector. The sector saw only limited construction in 2005 due to competition with more lucrative residential condominium projects, says Michael Carliner, an economist with the National Association of Homebuilders in Washington, D.C. Vacancies could increase, however, in markets that have overbuilt with condominiums, as many of those projects may return to the for-rent market.

Other real estate sectors will feel reduced consumer spending in a more general economic sense. “Consumer spending is two-thirds of the economy,” Carliner says, “so everything is affected by that.”

Job restructuring

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Will new and better-paying jobs provide the income boost consumers need to keep the economy bustling in 2006? Preliminary estimates show the nation added 1.9 million jobs in the 12 months ending Oct. 31, and rising interest rates may increase investment, borrowing and hiring by the nation's businesses to keep up the pace of employment in 2006.

Even if the economy adds another 2 million jobs each year until 2010, total employment growth from 2000-2010 will be about 14 million — the lowest figure of any decade since the 1950s, according to Torto Wheaton Research. Economists say today's more efficient companies have simply learned to grow with fewer new hires.

Employment growth won't boost fundamentals equally in all sectors of commercial real estate, either. Employment in manufacturing, for one, steadily declined from 17.36 million jobs in August 2000 to 14.17 million at the beginning of 2004 and hasn't moved much since then, according to the Bureau of Labor Statistics. And judging from General Motors' plans to eliminate at least 30,000 hourly jobs through 12 plant closures in the next three years, the bleeding hasn't stopped.

Economists say those jobs aren't coming back. Some manufacturers have reduced costs by tapping cheap labor in other countries, but many have simply learned to make the same products with fewer workers. And it's not just a domestic phenomenon — the number of manufacturing jobs shrank by 22 million worldwide from 1995 to 2002, says the MBA's Duncan. “The world is eliminating manufacturing jobs.”

Some demand lingers for manufacturing space despite lower manufacturing employment, says Costello of Torto Wheaton Research. “We're able to expand output with fewer workers. As a result, you need space for increasing manufacturing activity.”

And the other industrial space — distribution centers — should enjoy healthy demand as retailers ship food and consumer goods to a growing U.S. population. Industrial vacancy fell 20 basis points to 8.4% nationwide in the third quarter despite an influx of 27 million sq. ft. of new space, according to Grubb & Ellis.

Corporate efficiency also has changed office requirements. Companies that at one time provided an average of 250 sq. ft. of office space per employee are now lowering that ratio to 100 or even 80 sq. ft. per employee, according to Ed Indvik, president in the Los Angeles office of commercial real estate firm Lee & Associates Inc.

With job creation healthy, albeit unspectacular, is the national economy still in jeopardy of a dramatic slowdown if rising interest rates curtail consumer borrowing? It's possible, because average wages aren't keeping up with inflation. Wages grew by less than 3% from October 2004 to October 2005, according to the Labor Bureau, well behind the 4.7% increase in the Consumer Price Index for urban workers in the same period.

Rising interest rates

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In the face of rising prices and other inflationary pressures, the Federal Reserve has steadily increased the short-term federal funds rate to slow the economy and thwart inflation. Long-term interest rates are beginning to follow suit, with the 10-year Treasury yield climbing to 4.61% in early November from 4.55% the previous month.

Economists say interest rates are still attractive and well below historical averages. “This isn't a crunch; it's getting back to normal from an unusual circumstance,” says Carliner of the National Association of Homebuilders.

The Federal Reserve increased the federal funds rate by 25 basis points to 4% at its last meeting, and is expected to enact similar quarter-point increases at its Dec. 13 and Jan. 31 meetings.

But some observers, like the MBA's Duncan, warn that the Fed could go too far, hamstringing the economy by moving home purchase financing out of many consumers' reach. With fewer buyers, home values could suffer and deflate consumer confidence and spending. The MBA is already forecasting a slower rate of appreciation in home values, which should increase 5% to 6% in 2006 compared with 10% to 11% appreciation in 2005.

“The concern is that the Fed not go too far and trigger a steep decline (in home values).” How far is too far? “If they went to 5.5% with the federal funds rate, it could generate a problem for housing.” Dhawan at Georgia State University shares Duncan's concern, and says rising interest rates are a greater threat to consumer spending than energy costs.

Commercial borrowers who financed acquisitions at the top of the market may have problems of their own if interest rates continue to rise, says Bruce Schonbraun, managing partner at Schonbraun McCann Group. “A lot of people in this environment forget that debt is not capital, and that debt has to be paid off.” Schonbraun McCann is a national real estate consulting firm based in New York.

A buyer who obtained a five-year, $80 million loan at 5% interest and a 5% cap rate to purchase a $100 million property four years ago could have difficulty refinancing when the initial loan expires next year, Schonbraun says.

If interest rates and cap rates both rise to just 7% by that time, then underwriters may reduce the amount they are willing to underwrite on the property to perhaps $68 million. “Then you've got a shortfall of $12 million. That's called trouble.”

But cap rates may not rise equally with interest rates. Costello believes investors will see potential for rental rate increases as fundamentals improve, and they will accept a relatively low cap rate in anticipation of improved returns down the road. Torto Wheaton is only projecting a 40 basis point increase in cap rates from the end of 2005 to the end of 2006.

Excess liquidity

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The flow of capital into real estate has slowed from the pace that introduced a record $6.9 billion to the sector in 2004, but the supply of capital seeking real estate investments is still high. Through early November, the year-to-date flow totaled $2.37 billion, according to Arcata, Calif.-based AMG Data Services, which tracks mutual fund money flow and holdings data.

The struggle to win acquisition bids with so much money on the table may be leading to imprudent purchases. "With a scarcity of product for sale, there has been tremendous compression in pricing between the Class A, B and C properties. You see that for brief periods when markets are overheated, and it's a danger sign," says Schonbraun. "In many instances, the dollars chasing the deals aren't discriminating value, they're just chasing deals."

Another explanation for high prices for Class B and C properties is that investors have shied away from the extremely low cap rates and limited upside potential of fully occupied Class A space, says Dan Fasulo, market analysis director at Real Capital Analytics, which tracks real estate investment sales. "One way of generating higher returns is by [buying vacancy and] making a bet that the office market will improve and rents will go higher."

Some experts see today's liquidity as a healthy environment that has benefited buyers and sellers. Investors have had to accept a lower return on real estate acquisitions, but those returns are still good compared with alternative investments outside real estate, says Tom MacManus, president and CEO of North American operations at GMAC Commercial Holdings.

Heavily leveraged investors may be more at risk if interest rates climb, but liquidity in all aspects of the capital spectrum may enable even those investors to refinance if necessary.

In 2006, look for new supply of real estate to answer the intense demand for acquisitions, says Silver of Equis Corp. Governments, universities and other institutions in the public sector are becoming aware of the capital available from their real estate holdings.

"You're going to see more and more public entities seeking to monetize their real estate in some structure that would be easy for the public to invest in, such as a REIT, or they may work with a company specializing in sale-leasebacks."

Many high-credit tenants in the private sector will pale in comparison with the high credit of universities, municipal utilities and other entities in the public sector, Silver says. If rising interest rates cool the investment fever in 2006 and beyond, that high credit will become a deciding factor in investment decisions. "You will see the investor become more selective as to credit risk, and that's where the government will have a real advantage."

The bottom line

Rising prices, less affordable credit and limited prospects for higher wages will squeeze consumer spending next year, and repercussions of a slowdown in consumer spending will reach all sectors of commercial real estate. A lot is riding on the Fed's ability to control inflation without becoming too restrictive on the consumer's access to affordable financing.

"The Fed has a tough job right now," says the MBA's Duncan. "They're still dealing with the after effects of three hurricanes, there are still questions whether risk spreads are wide enough in the long-term markets, we have a very hot housing market that's starting to slow, and there's a dramatic increase in energy costs. This is going to be a tough time for the Fed to make the transition from Greenspan to [incoming Fed Chairman Ben] Bernanke."

Matt Hudgins is an Austin-based writer.

PREDICTIONS FOR MID-YEAR 2006

NREI asked five economists to predict the direction of key indices. Here are their responses:

Jim Costello: Senior Economist, Torto Wheaton Research

Prediction: "The 10-year Treasury bond rate will increase to 5.16% at mid-year, but office cap rates will increase only 40 basis points from the end of 2005 to the end of 2006."

Dr. Rajeev Dhawan: Director, Economic Forecasting, Georgia State University

Prediction: "If the 10-year Treasury bond yield is 6% by mid-2006, then the consumer will run out of cash from his housing-equity ATM before job growth replenishes the coffers."

Doug Duncan: Chief Economist, Mortgage Bankers Association

Prediction: "Productivity gains will remain strong for at least another decade."

Dr. Peter Linneman: Professor of Real Estate, Wharton College School of Business

Prediction: "The fundamentals of the U.S. economy, namely entrepreneurship and incentives to work, will more than offset our politicians' efforts to hamstring that economy."

Hessam Nadji: Managing Director of Research Services, Marcus & Millichap

Prediction: "Economic growth is likely to surprise on the upside during the first half of 2006 due to the rebuilding efforts in the Gulf Coast and Florida. This will motivate the Fed to continue on an aggressive path of fighting inflation through continued rate increases."

>	**GDP (%) Growth**	**Job Creation**	**10-Year Treasury Yield (%)**	**Crude Oil ($ per Barrel)**
>				
Costello	3.8	1.2 million	5.16	N/A
Dhawan	2.9	840,000	5.2	$56
Duncan	3.25	1.14 million	5.2	$53
Linneman	4.2	1.1 million	4.8	$44
Nadji	3.7	1 million	4.8	$59

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