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Midyear Update

Recovery Ahead?

Commercial Real Estate Waits for the Economic Green Light.
by Nancy Chesley and Bridgett Novak

Editor's note: Unless otherwise stated, prices, rents, and capitalization rates in this article are provided by National Real Estate Index, and absorption and vacancy rates, historical peaks and troughs, and forecasts are provided by Property & Portfolio Research.

Commercial real estate is experiencing continued property value gains in the face of depressed rents and rising vacancies at an unprecedented rate. Despite the decline in tenants, investors are turning to commercial real estate as a safe alternative to other venture capital initiatives.

But what is needed to restore balance?

First, the United States needs job growth. As of April 30, unemployment reached 6 percent, with approximately 8.8 million Americans out of work. Companies expect to cut more jobs and equipment expenditures during the next six months, thus delaying recovery until early 2004, according to a recent survey by Business Roundtable, an association of chief executive officers.

Next, corporate profits need to improve. Profit levels came in at $796.1 billion in fourth-quarter 2002, down from $811.4 billion one year earlier. Of those reporting first-quarter 2003 earnings by early May, companies in the S&P 500 showed a 14 percent year-over-year gain. However, many of the companies meeting or beating earlier estimates are doing so by means of unusually low tax rates, other one-time breaks, or aggressive cost-cutting, rather than increasing revenues. In addition, first-quarter 2002 was weak, providing a very low base. Excluding the energy sector — which was buoyed by a pre-war spike in oil prices — year-over-year gains fell to about 5 percent, according to Thomson First Call.

Consumer spending still needs to increase. Retail sales grew by 1.7 percent in fourth-quarter 2002, a sharp drop from 4.2 percent in the third quarter, and this sluggishness continued in early 2003. In fact, consumer spending held at an annual rate of $7.5 trillion during January and February, the first time spending failed to rise for two straight months since December 1990 to January 1991, when the United States was in a recession and on the verge of the Persian Gulf War.

The economy needs business and leisure travel to resume and improved trade. Increased federal spending and a dropping dollar are boosting demand for American goods, but overseas economies are struggling.

Overall, the nation needs to return to productivity. The first-quarter gross domestic product was 1.6 percent, marking two consecutive anemic quarters. Little improvement is expected in the second quarter, despite the end of the war in Iraq and the corresponding drop in energy prices. However, forecasts for the second half of the year call for growth to register around 3.6 percent.

The country also needs careful fiscal policies. State and local governments are slashing spending, due to decreased revenues and less support from Washington. The outcome of President Bush's tax cuts will send ripples throughout the U.S. economy.

No doubt all of this will happen — the only questions are when and to what degree. Many experts believed the economy would right itself once Saddam Hussein was toppled, but the war has produced more uncertainty. Businesses still are in a wait-and-see mode, and the commercial real estate industry is waiting for a major jump-start.

Office Continues to Struggle

Early indications of an office sector recovery cropped up in late 2002, but a full-scale rebound, tempered by current economic and political uncertainty, isn't expected any time soon. Net absorption turned positive in fourth-quarter 2002, registering 2.7 million square feet, after seven consecutive quarters of negative net absorption. However, unable to sustain the rebound, first-quarter demand was flat. Companies appear to be apprehensive about committing to new

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Retail Construction
Jan. 2001-Dec. 2002

Miscellaneous (car dealer
convenience stores, and m
use projects less than 30,(
Specialty
Wal-Mart
Grocery
Discount retailers (excludi
Mart)
Department stores
Drugstores
Food/entertainment

Source: Property & Portfol
and McGraw-Hill Construc

space due to fears of an even more protracted economic downturn. In addition, layoffs and pre-emptive leasing for growth that never materialized left many companies with large blocks of unused space. However, disciplined construction bodes well for recovery and is the primary reason why vacancies did not reach the highs of the last cycle in the early 1990s.

Developer restraint is evident: Office construction starts in 2002 were 43 percent below 2000 peak levels and still are falling, according to McGraw-Hill Construction Dodge. In turn, vacancy rates are expected to crest close to 17.5 percent this year, below the peak of 18.7 percent reached during the last cycle.

However, unlike the late 1980s and early 1990s, overzealous development is not the main culprit behind the market's current malaise. Rather, the rapid erosion of demand has flooded the market with sublease space while leasing activity has dried up. Office-intensive segments such as high-tech and large Fortune 500 companies have been particularly hard hit; consequently, those markets with the highest concentration of these sectors are suffering the most, even when they happen to be supply-constrained markets, such as San Francisco, San Jose, Calif., Seattle, and Boston. Rents in these markets have dropped more severely and vacancies have risen more steeply than the national levels during the last two years.

While new sublease availabilities have slowed dramatically relative to early 2002, this space continues to cloud the office market forecast. Competition from sublease space has contributed to falling overall rents over the past two years, and year-end 2002 office rents were down more than 15 percent from 2000.

Despite the current uncertain climate, office fundamentals should improve during the next several years. Demand is expected to pick up slowly this year and jump into high gear in mid-2004, aided by restrained development. Office vacancies should return to levels on par with their historical averages by early 2005 as a steady, well-diversified recovery takes hold.

Discounters Boost Retail

In the absence of significant business investment, consumer spending has been the economy's primary support during the recent downturn. Favorable demographic trends and a hot housing market also have bolstered retail sales. However, the solid base is starting to erode as general merchandise sales falter. Economic uncertainty and the impending war depressed consumer confidence to a nine-year low at the end of last year. While confidence kicked up slightly in April as the war in Iraq ended, the index currently remains below 2001 recession levels. Also, with record-low interest rates, the cash-out refinancing boom, which bolstered consumers' cash flow, may begin to lose momentum.

On the upside, construction activity continues to decline modestly. This is not surprising, as retail construction historically has been much steadier than other property types. Still, construction starts have declined by 20 percent during the last two years, according to McGraw-Hill Construction Dodge. Retail construction should continue to drop, as retailers slow their expansion pace and developers cope with a mounting inventory of vacant buildings.

Several retailers, including Kmart, Service Merchandise, and Ames, have declared bankruptcy, resulting in more empty space on the market. For example, Kmart announced earlier this year that it is shuttering an additional 326 stores, including all but 52 of its Super Ks (designed to compete with Wal-Mart Supercenters and SuperTargets). However, discount apparel retailers Ross, T.J. Maxx, Kohl's, and Marshalls, as well as some office supply stores are, in many cases, opening new stores in the vacated spaces.

Despite some well-publicized bankruptcies, the discount department store segment currently is retail's most powerful driving force. Discount retailers' growing dominance, which is led by Wal-Mart, has squeezed not only older discounters and traditional department stores, such as Sears and J.C. Penney, but now is threatening grocers. Wal-Mart in particular is on a construction binge, and its current expansion plans surpass all other grocers and discounters. Over the last two years, Wal-Mart accounted for a whopping 16 percent of total retail construction starts, while all other discounters accounted for another 10 percent. The grocery segment in total comprised 12 percent of recent starts, according to PPR/Dodge Pipeline.

Consumer spending in the grocery segment has declined during the past decade, which is largely the result of two major factors. First, spending on other goods has increased faster. Second, more groceries are being purchased at non-grocery locations, such as warehouse clubs and superstores.

Supported by longer lease terms and stalwart sales growth, retail rents have proved more resilient than other property types. Rents are stabilizing, down just 0.2 percent in 2002, and modest growth is expected to resume this year.

Warehouse Woes

Moderate GDP growth sparked a return of positive demand in the warehouse sector last year. But overall economic activity is expected to remain modest in the near term, and a significant recovery in both GDP growth and warehouse demand is not expected until 2004. Net warehouse absorption continues to recover slowly and should total just 69.8 million sf this year, before ramping up to more robust levels next year.

Developers have scaled back considerably due to weakened demand and tighter capital markets. In 2002, 102 million sf were delivered, but this year, the total is expected to drop to 69.2 million sf. In addition, large big-box build-to-suit projects have dominated recent construction as companies streamline operations in an effort to trim expenses. In fact, 70 percent of total warehouse construction started in 2002 was build-to-suit projects, and of that, 37 percent was for discount retailers. As with the retail market, the warehouse sector faces a threat from the discount retailer giants.

Over the next several years, gateway cities in particular should experience relatively strong growth, as international trade plays an increasing role in the U.S. economy. Mature super-regional warehouse markets, such as Los Angeles, Chicago, and northern New Jersey, stand to benefit the most as developers and investors are more confident in these distribution centers' long-term viability.

Rents should continue to trend downward for the remainder of the year as the market works off excess capacity. Average rents are expected to contract by slightly more than 2 percent, which still is an improvement over the 3.8 percent average annual decline of the past two years.

As a result of a modest demand recovery and slowing construction, vacancy rates should decline from their expected peak of 10.4 percent this year. However, vacancies are likely to remain above 10 percent through year-end.

New Supply Weakens Multifamily Fundamentals

The national multifamily vacancy rate — 7.1 percent in first quarter — should start to trend down in the second half of the year.

In the beginning of the current economic slump, new class A apartments suffered the most, and they're still showing the biggest decline nationwide. But as luxury property owners started offering concessions and lowering rents, tenants moved out of class B units and into class A complexes. For instance, class B apartment rents in Denver fell a dramatic 10 percent between the fourth quarters of 2001 and 2002, compared to a 4.5 percent decline among class A properties. Class A apartment rents fell more than 10 percent during the past year in just three of the 57 metropolitan areas tracked by National Real Estate Index. Not surprisingly, the three are hotbeds of high-tech employment: Austin, Texas, San Francisco, and San Jose.

The softening job market is only one of the factors affecting the multifamily sector. It also is facing stiff competition from residential single-family housing. During the three months ending in January, existing single-family home sales averaged a record high 5.9 million units per month, fueled by low mortgage rates.

Apartment demand should begin to exceed supply in 2004, if supply shuts down as expected. Nearly all of the 54 metropolitan areas tracked by PPR registered positive net absorption in the first quarter. However, the actual numbers are mediocre. Nationwide, first-quarter 2003 net absorption totaled just over 29,000 units. Last year, 50,000 units were absorbed nationwide. Though this was the lowest amount since 1993, the forecast is positive, with absorption expected to total approximately 130,000 units per year in both 2003 and 2004.

Supply remains the wild card. Relative to the other property types, multifamily starts exhibited the least discipline during the last two years. During 2001 and 2002, multifamily starts declined only 13 percent cumulatively; construction starts in the other three sectors fell 20 percent or more during the same period.

The news is a bit better at the metro level. Some of the most troubled multifamily markets, such as Austin, Denver, and Atlanta, have experienced the greatest declines in starts. Conversely, markets that continue to enjoy low vacancies, such as Sacramento, Calif., Los Angeles, and Minneapolis, are building up their inventories. This should bode well for fundamentals in these markets.

The number of apartment-renting households is projected to increase 1.2 percent this year compared to the overall U.S. population gain of just 0.9 percent, and 12 million new U.S. households will form between 2000 and 2010, requiring construction of approximately 190,000 new apartment units per year, according to Clarion Partners. These factors should help the strength of the overall forecast. However, as more investors fill their portfolios with apartment properties (the number of transactions in 2002 increased 21 percent over 2001), there may be a continued push to provide product despite weak market conditions. Increased restraint among developers is key to the near-term health of the multifamily market.

Current economic and geopolitical uncertainties have led to delayed decisions by businesses, consumers, tenants, and real estate investors. However, the outlook for real estate is optimistic.

Market fundamentals are improving, albeit at different rates for each of the major property types, and real estate remains attractive relative to other asset classes.