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Commercial Real Estate Investments Expected to Remain Strong

WASHINGTON, May 17, 2007 - Respectable job growth, improving fundamentals, favorable interest rates and limited speculative construction suggest strong investor appetite will continue in 2007, according to a commercial market update and forecast presented here at the National Association of Realtors® Midyear Legislative Meetings & Trade Expo.

Investment in commercial real estate rose 11 percent to a record $306.8 billion in investment-grade transactions in 2006, with office buildings leading the way. Institutional investors continue to pour funds into commercial real estate, commercial lending volume is up and delinquencies remain relatively low.

Lawrence Yun, NAR senior economist, said fundamentals have firmed in most sectors. "Over the past year, 2 million jobs have been created, and unemployment has been hovering at or below the natural rate of about 5 percent, supporting the office sector in particular," he said. "The office market is the sector of choice, but growing international trade is strengthening the demand for warehouse and distribution facilities.

"With these positive fundamentals and strong spending so far this year, we expect the appetite for commercial investment to remain historically high in 2007,' Yun said.

U.S. exports have been rising solidly, and business spending for building construction is rising at double-digit rates - boosted by record corporate profits. Much of the new commercial construction currently is build-to-suit, or with a lead tenant.

On the downside, construction costs are rising due to global economic expansion, and pressures on core inflation are worrisome. Retail demand is decelerating and the economy is slowing. "Residential construction has become a drag on the economy, resulting in sub-par economic growth," Yun said. "Because commercial sectors follow the economy, commercial markets are in a process of normalizing."

The NAR forecast for major commercial sectors includes analysis of quarterly data for various tracked metro areas. The sectors include the office, industrial, retail and multifamily markets. Metro data were provided by Torto Wheaton Research and Real Capital Analytics.

Office Market

A record $71 billion worth of office properties traded hands in the first quarter, with investors focusing on markets like New York, Boston, Los Angeles and Chicago.

Net absorption of office space in 56 markets tracked, including the lease of new space coming on the market as well as space in existing properties, is lagging new completions and is projected at 70 million square feet between the second quarter of 2006 and the second quarter of this year. The total for 2007 will be in the range of 20 to 25 million square feet.

Vacancy rates in most major markets continue to fall, but the overall rate is up nationally. The second quarter office vacancy rate should average 13.6

percent, up from 13.1 percent a year ago, and is expected to range between 13.5 and 14.0 percent in the fourth quarter of 2007. Annual rent growth in the office sector is forecast at 3.0 to 3.5 percent in 2007.

Industrial Market

New state-of-the-art facilities are being built, increasing the availability of older structures in some markets. The West and Midwest are the most active for industrial property investment, with overall sales volume running 10 percent higher than the same time last year.

"The inventory-to-sales ratio in the retail sector is low, with a similar situation in wholesale inventory, so there is a need to restock - that means there also is a need for more space," Yun said. "In addition, orders for durable goods have been rising."

Net absorption of industrial space in 54 markets tracked is expected to be 197 million square feet between the second quarter of 2006 and the second quarter of this year. The total for 2007 is likely in the range of 75 million to 80 million square feet.

Markets near major ports have the lowest vacancies, including Los Angeles; West Palm Beach, Fla.; and Long Beach, Calif., with vacancy rates of 5.0 percent or less. Industrial vacancy rates nationally are projected to drop to 9.8 percent in the second quarter from 10.3 percent in the same period in 2006, and forecast at 10.0 to 10.5 percent by the end of 2007. Annual rent growth will be 2.0 to 2.5 percent by the end of this year.

Retail Market

Decelerating retail sales are lessening the demand for space, and a negative savings rate is worrisome. That is the only sector experiencing significant vacancy rate increases and declining net rental rates. Even so, investment volume rose 22 percent last year as retail portfolios changed hands.

Net absorption of retail space in 54 tracked markets is seen at 22 million square feet between the second quarter of 2006 and the second quarter of this year, while the total for 2007 will probably be in the range of 15 to 20 million square feet. Vacancy rates in the second quarter are estimated at 8.5 percent, up from 8.1 percent a year ago, and should be 7.5 to 8.0 percent by the fourth quarter of 2007. Rents are expected to rise an average of 1.0 to 1.5 percent by the end of the year.

Multifamily Market

The apartment rental market - multifamily housing - has benefited from the slowdown in home sales. Planned condo conversions are being returned to rentals, and conversions have essentially ended. Investor interest is waning, with multifamily transactions down 29 percent so far in 2007.

Migration trends are favoring warm-weather, low-tax states, including Florida, Arizona, Nevada, Georgia and North Carolina.

Multifamily net absorption is likely to total 229,000 units in 59 tracked metro areas between the second quarter of 2006 and the second quarter of this year, and total 210,000 to 215,000 in 2007. Vacancy rates are projected to rise to 5.7 percent in the second quarter from 4.6 percent a year ago, and will be in the range of 5.5 to 6.0 percent by the end of the year. Rents are forecast to rise 2.5 to 3.0 percent by the end of 2007.

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The next Commercial Leading Indicator index will be May 21; the next commercial real estate market forecast is scheduled for June 13.