Commercial real estate sectors disrupted by credit squeeze and economy

ORLANDO, Fla. – Nov. 11, 2008 – The disruption in the capital markets means many commercial real estate transactions have been cancelled or postponed, while the weak economy has eroded otherwise healthy market fundamentals, according to a commercial market update and forecast presented at the 2008 Realtors Conference & Expo here. Lawrence Yun, National Association of Realtors (NAR) chief economist, said commercial fundamentals have shifted.

"With the exception of the multifamily sector, the loss of jobs is reducing demand in commercial real estate to the point where many markets can expect rents to weaken," Yun said. "Vacancy rates are trending up, but the completion of new commercial space will decline in response to lower demand."

Yun said the credit crisis has hit the commercial real estate market harder than the residential sector. "Even sound transactions in healthy markets to buyers with good credit were curtailed," he said. "Credit has started to loosen somewhat, but we have long way to go to get back to normal. In addition, commercial debt rollover is now facing much higher interest rate costs."

In some cases, economic conditions led to properties becoming undervalued. "Although many people value commercial real estate in diversifying their portfolios, it's important to consult with a Realtor specializing in commercial real estate to learn about options and opportunities in a given area," said Yun.

Doug Duncan, chief economist at Fannie Mae, said the over-leverage of financial firms led to the unraveling of credit on Wall Street. "Central banks around the world are cooperating as never before to stabilize the credit markets," he said. "Since the beginning of this year, 1.3 million U.S. jobs have been lost. Initially it was confined to the real estate and real estate finance sectors, but it's broadened recently – we've lost a half million jobs in just the past two months."

Duncan said an economic recovery depends on a housing recovery. "Everything depends on the structure of the economic stimulus," he said. "Mortgage spreads over Treasuries rose from 1.5 percentage points to 2.25 percentage points. In addition, when the commercial paper market stopped, all short-term financing evaporated. We need to be able to securitize loans."

Duncan said commercial mortgage-backed securities have a chance of coming back faster than residential mortgage securities because there is a feedback loop. "Due to ratings based on performance, there is an incentive to produce well," Duncan said.

As a result of these challenges, transaction volume in commercial real estate fell 70 percent from the second quarter of 2007 to the second quarter of 2008.

Yun's forecast for four major commercial sectors analyzes quarterly data in the office, industrial, retail and multifamily markets. Torto Wheaton Research provided historic data.

Office market
The loss of jobs is reducing the demand for office space. Office vacancy rates are projected to rise to 14.4 percent in the second quarter of 2009 from 12.9 percent in the second quarter of this year. Annual rent growth in the office sector is likely to be 3.2 percent this year, but it should decline 0.4 percent in 2009; rent grew 8.0 percent last year.

Net absorption of office space in 57 markets tracked, which includes the leasing of new space coming on the market as well as space in existing properties, is expected to be 14.7 million square feet this year and 10.9 million in 2009, contrasted with 57.3 million square feet last year.

Industrial market
Healthy exports have been offsetting lower demand for industrial space from the economic slowdown, but uncertainty in the current environment could weaken overseas demand, even with the relative weakness of the dollar, which has been a primary support of export activity. However, American goods remain attractive to overseas buyers.

Vacancy rates in the industrial sector are forecast to rise to 10.8 percent in the second quarter of 2009 from 9.9 percent in the second quarter of this year. Annual rent growth will probably be 1.1 percent this year and 1.0 percent in 2009; it rose 3.6 percent last year.

Net absorption of industrial space in 58 markets tracked is anticipated to be a negative 16.7 million square feet this year, then reversing to grow to 35.3 million in 2009; net absorption totaled 120.3 million last year. A clear pattern of building to suit specific needs remains, leaving many obsolete structures unoccupied.

Retail market
Consumer spending will continue to tighten for the foreseeable future, with further dampening of the retail market.

Vacancy rates in the retail sector should be 10.4 percent in the second quarter of 2009, up from 9.7 percent in the second quarter of this year. Average retail rent is projected to grow 1.2 percent in 2008 before contracting 0.9 percent in 2009; rent grew 3.2 percent last year.

Net absorption of retail space in 53 tracked markets is likely to shrink by 2.6 million square feet this year before increasing by 2.8 million in 2009; last year 11.1 million square feet were absorbed.

Multifamily market
The outlook for the apartment rental market – multifamily housing – continues to stay fairly positive as many potential first-time homebuyers remain on the sidelines.

Multifamily vacancy rates are expected to rise to 5.9 percent in the second quarter of 2009 from 5.4 percent in the second quarter of this year. Average rent is forecast to grow 3.9 percent in 2008 and 4.0 percent next year, compared with a 3.1 percent gain in 2007.

Multifamily net absorption is estimated at 61,400 units in 59 tracked metro areas this year and 188,200 in 2009, in contrast with 234,400 last year.

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