



Business Development Board Office & Industrial Realtor Roundtable

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The Road Ahead

Office & Industrial Real Estate

Are we headed for a commercial meltdown?

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Ancient Chinese Curse

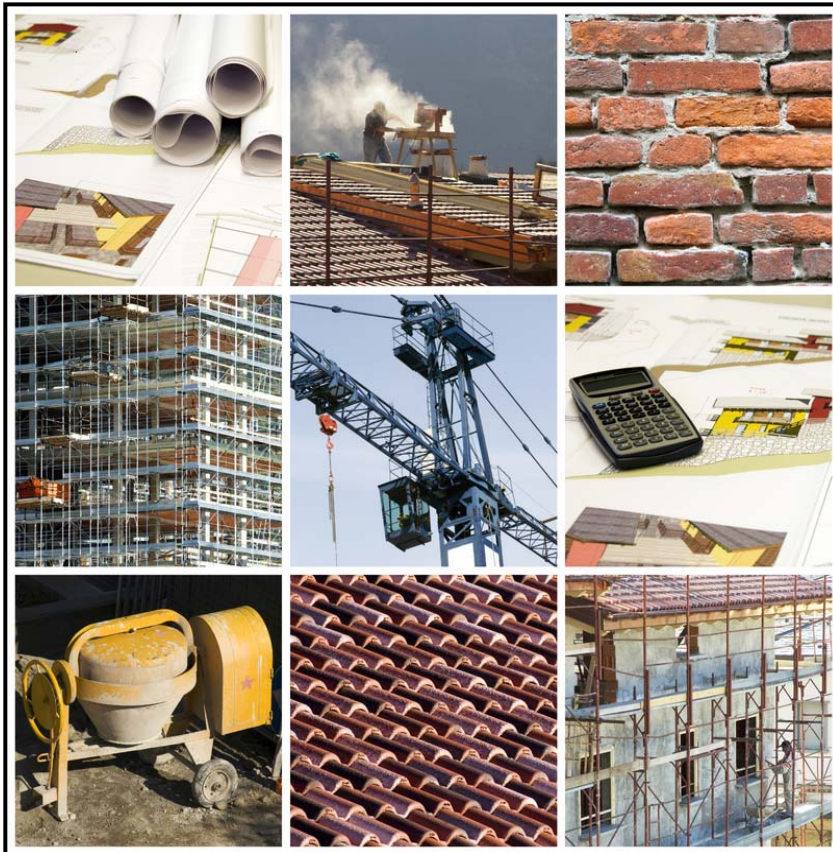
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“May you live
in interesting
times.”

... and the last three years
have fulfilled the curse.

The Commercial Real Estate Sector

A High Level View



The commercial real estate sector stayed afloat long after the residential sector began to sink and even as the broader economy began to weaken. Nevertheless, the commercial sector began to falter in early 2008. Today, most commercial real estate product types are under stress, values have declined significantly and no positive change is likely in 2010 or 2011. Commercial real estate fundamentals have weakened dramatically due largely to declining employment which is now taking a huge toll on spending and office jobs thus adversely impacting office, retail, industrial sectors.

What Happened?

- Commercial development increased dramatically **in response to anticipated growing residential development**. In many cases, commercial development even preceded residential.
- Fuelled by low vacancies and rising rents, values increased disproportionately and capitalization rates began to slip into low single digits.
- *Cap rate compression* began in about 2002 and continued for the next five or six years. Investors were virtually shut out of the market if they did not bet on future growth and buy on the basis of unsustainably low rates.

What Happened?

- When **spending** began to decline coincident with a slowing economy, retail real estate was negatively affected by growing vacancy, reduced rents and prolonged absorption.
- When **office jobs** began to decline due to diminished need for real estate support services, office real estate felt the pressure especially in suburban locations.
- When there was less need for warehousing to serve the construction sector and to store appliances and furniture for new homes, that sector began to deteriorate. **As all these factors, plus unemployment converged to reduce manufacturing, the industrial real estate sector began to soften.**

The Commercial Sector Today?

- Financing (CMBS) dried up. There have been no new domestic CMBS issuances of any consequence in **six consecutive quarters**.
- ***Commercial real estate has now surpassed residential in terms of its rapid and unprecedented value and price declines. That is the answer to the headline question of whether we are in for a commercial meltdown.***
- Prices and values have deteriorated more quickly than they did during the crisis of the early 1990's. According to RERC values declined 20-25% in just *two quarters* in the first half of 2009 as compared to 30-35% in five years in the late 1980's and early 1990's.
- ***Current price levels in most sectors and geographies were last seen in about 1994.***

Where are we today?

- CRE prices slid over 35% in 2009 due to:
- Rising vacancies, lower rents, rising capitalization rates and **inability to refinance maturing debt.**
- An additional 10% to 15% slide is possible in 2010 *without dramatic improvement in the CMBS market, employment and the broader economy – none of which appear likely at this time.*
- Today there are 2.5 times the dollars needing to be refinanced than there are dollars available to refinance them. **Unthawing the CMBS market is critical.** Banks do not have balance sheet capacity to absorb what needs to be refinanced.
- *Current CRE demand is negligible. The need today is to refinance debt created by five year old demand – much of which was bubble inflated and not real demand.*

Where are we today?

- Capitalization rates are up 200 bps (now 8.0% -10.0%) from compression era (2002-2007) rates of 4.5% to 6.5%.
- Lease renewal probability: 64% (RERC).
- Time to re-lease: 7.4 months. (9-12 months in Palm Beach County).
- Lease vs Sub lease difference: -13.85% (20% - 25% in many Palm Beach County sub markets).

Where are we today?

- According to New York Based Real Capital Analytics (RCA), approximately \$2.2 TRILLION in CRE projects acquired or refinanced between 2004 and 2008 have lost value.
- Equity of \$1.3 TRILLION has been wiped out or remains at risk.
- Prices of office, retail and industrial properties have fallen 34.8% since their October 2007 peak.
- The dollar value of distressed properties rose by \$67 Billion to \$115 Billion in the first half of 2009. That's an increase of 122%.
- According to the Federal Reserve, U.S. banks hold about \$1.8 Trillion in CRE loans.
- Florida banks hold \$56 billion in CRE loans – about 34% of total aggregate portfolio total. (FDIC).
- **Troubled CRE loans are 15 times greater than they were in 2006.**

Where are we today?

- CRE delinquencies are now near 7% exceeding the early 1990's when they hit 6%.
- The bubble continues to inflate as only about 10% of troubled assets have been cleared largely in one-off transactions. Many investors appear to be waiting for the bubble to burst to acquire assets at pennies on the dollar.
- Thus far banks are getting an average of \$0.60 on the loan dollar. (FDIC just received \$0.60 – with strings attached). Auction sales are generally about half that.
- PROBLEM: The government's Troubled Asset Relief Program (TARP) morphed into something far different than originally intended and has not been successful in clearing troubled assets.
- PROBLEM: The government's Public Private Investment Partnership (PPIP) has been largely unsuccessful due to its perceived onerous terms and investor's unwillingness to trust the federal government not to change the terms.

The Office Sector



What Drives Office Development?

Jobs

- Real estate and construction related jobs – including office jobs -- have pulled back *dramatically* especially on the construction dependent Treasure Coast.
- Finance related and business services pulled back in 2009 and will continue to do so in 2010.
- Businesses are not expanding but rather are trying to shed space.

Palm Beach County Office

- Palm Beach County had extraordinary office employment growth between 2003 and 2005 – most of it in support of construction, real estate and allied services.
- That employment surge led to an office development surge. The collapse that followed left Palm Beach County with the highest office vacancy rate in the nation at about 22.5%.
- Rents are down 15% to 20%. Concessions are abundant to both entice and retain tenants.
- Capitalization rates are hovering in the 9.5+% range.

Palm Beach Office

- Net leases are turning to gross as tenants struggle with CAM.
- **Businesses that were expanding are now contracting which is bringing significant sub-lease space to market.**
- Tenants are struggling to sub lease and are unable to cover their leases. What was \$20 net space is now \$12 - \$15.
- Mom & Pop have run out of cash.

Palm Beach County Office Outlook

- Office fundamentals are weak and continue to deteriorate.
- Fundamentals will remain weak through at least 2011 but more likely 2012.

A large industrial warehouse filled with high stacks of cardboard boxes on pallets. The boxes are stacked on metal shelving units and pallets, creating a dense, organized storage area. The lighting is bright, and the floor is polished. In the background, a few workers are visible, and the warehouse extends into the distance.

The Warehouse Industrial Sector

What drives industrial & warehouse development?

Retail spending, construction, housing imports and exports

- All components driving industrial and warehouse development remain seriously impaired.
- Diminished demand for warehouse space to store manufactured goods needed by consumers as well as construction materials and so-called big ticket items including furniture and appliances and well as goods to be imported or exported.
- The transportation sector is also suffering.

Palm Beach County Industrial

Industrial & warehousing was the last product sector to weaken.

- Palm Beach County has had significant negative net absorption for the last six quarters. Currently (Q4) 140,000 SF. That is down (improved) from 500,000 in Q3; 720,000 in Q2 and 885,000 SF in Q1 2009.
- Overall sector vacancy is about 12.6% in Palm Beach County. Several sub markets in both markets are recording much higher vacancy at 20% plus.
- **Outlook:** The sector will remain weak through at least 2011. No leading indicator to suggest short term improvement.

Looking Forward



Where are we going
from here?

What must happen for
recovery to occur?

Credit Forecast

- There is currently a synchronized decline in both credit supply and demand.
- Credit availability will improve over the next 24 months however it will not reach its pre-crash rate.
- Banks continue to struggle with capital and liquidity issues as well as unhealthy loan concentrations.
- Bank failures between 2008 and 2012 may rise to 700 which is roughly equivalent on a percentage basis to the five year period between 1989 and 1993 when there were twice as many banks as there are today.
- Bank loan losses have been extraordinary and are unlikely to normalize before late 2011.
- **Loan losses and bank failures going forward will be primarily driven by commercial real estate.**

What must happen for recovery to occur?

- **Housing must return to growth.** The tentacles of housing reach into all CRE sectors and the broader economy. Both the direct and indirect effects are significant. Neither CRE nor the broader economy can truly improve until housing does. Additionally, the broader economy and housing won't return by artificially shifting demand from one period (2010) to another (2009).
- **Employment** must return to more normal levels.
- **Financing** and current real demand must return (refinancing 5 year old bubble inflated demand is not real demand.)
- **Economic feasibility.** Real estate product types must become economically feasible again.

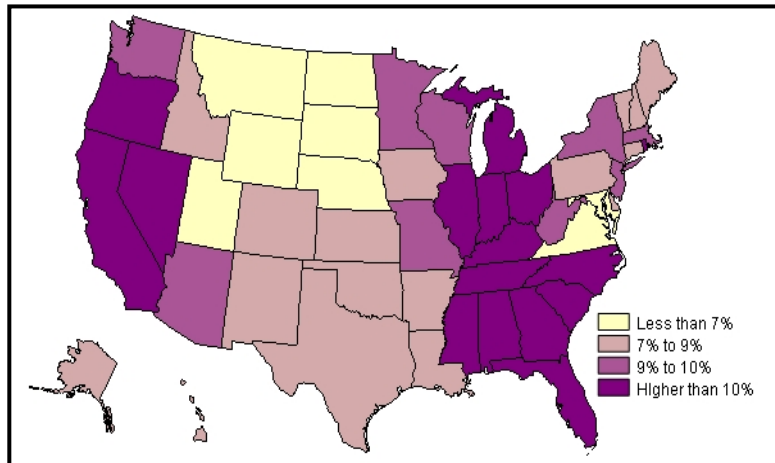
What must happen for recovery?

The housing market must improve. The direct and indirect effects of housing reach deep into the commercial sector.

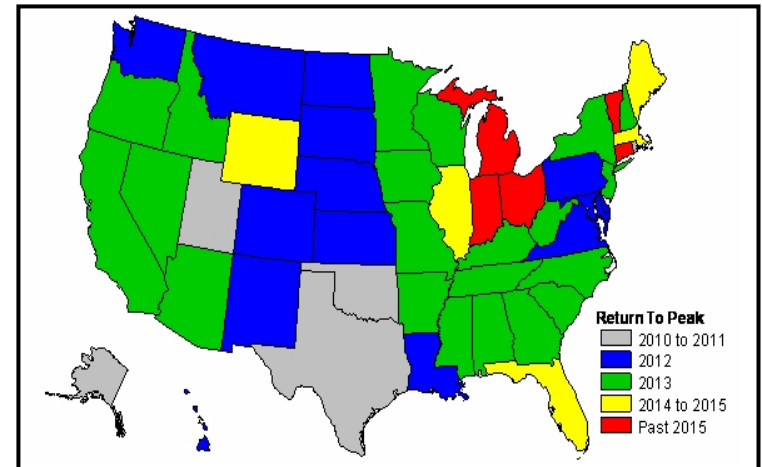
- Under normal (non-bubble) conditions, residential demand is primary and development precedes commercial where demand is secondary.
- When will housing recover locally? It is likely to be 2011 or beyond as continued foreclosures will keep a lid on value and price increases.

What must happen for recovery?

Employment must improve. Consumers can't or won't buy if they are unemployed or worried about continued employment.



Florida
(and 15 other states)
will remain over 10%
unemployment through
2010 and will
not return to
peak employment
until 2014 or 2015



SOURCE: Global Insight

What must happen for recovery?

Financing must become available again

- There is currently a synchronized decline in both credit supply and demand. The only CRE demand is five year old demand fuelled by the run up.
- The CMBS market, which funded over 70% of pre-crash development is virtually non-existent. **There have been NO domestic issuances of much significance in six quarters.**
- Credit availability will improve over the next 24 months however it will not reach its pre-crash rate.
- Banks continue to struggle with capital and liquidity issues as well as unhealthy loan concentrations.
- Bank failures between 2008 and 2012 may rise to 700 which is roughly equivalent on a percentage basis to the five year period between 1989 and 1993 when there were twice as many banks as there are today.
- Bank loan losses have been extraordinary and are unlikely to normalize before late 2011. **Loan losses and bank failures going forward will be primarily driven by commercial real estate.**

All Sectors: New development must become economically feasible

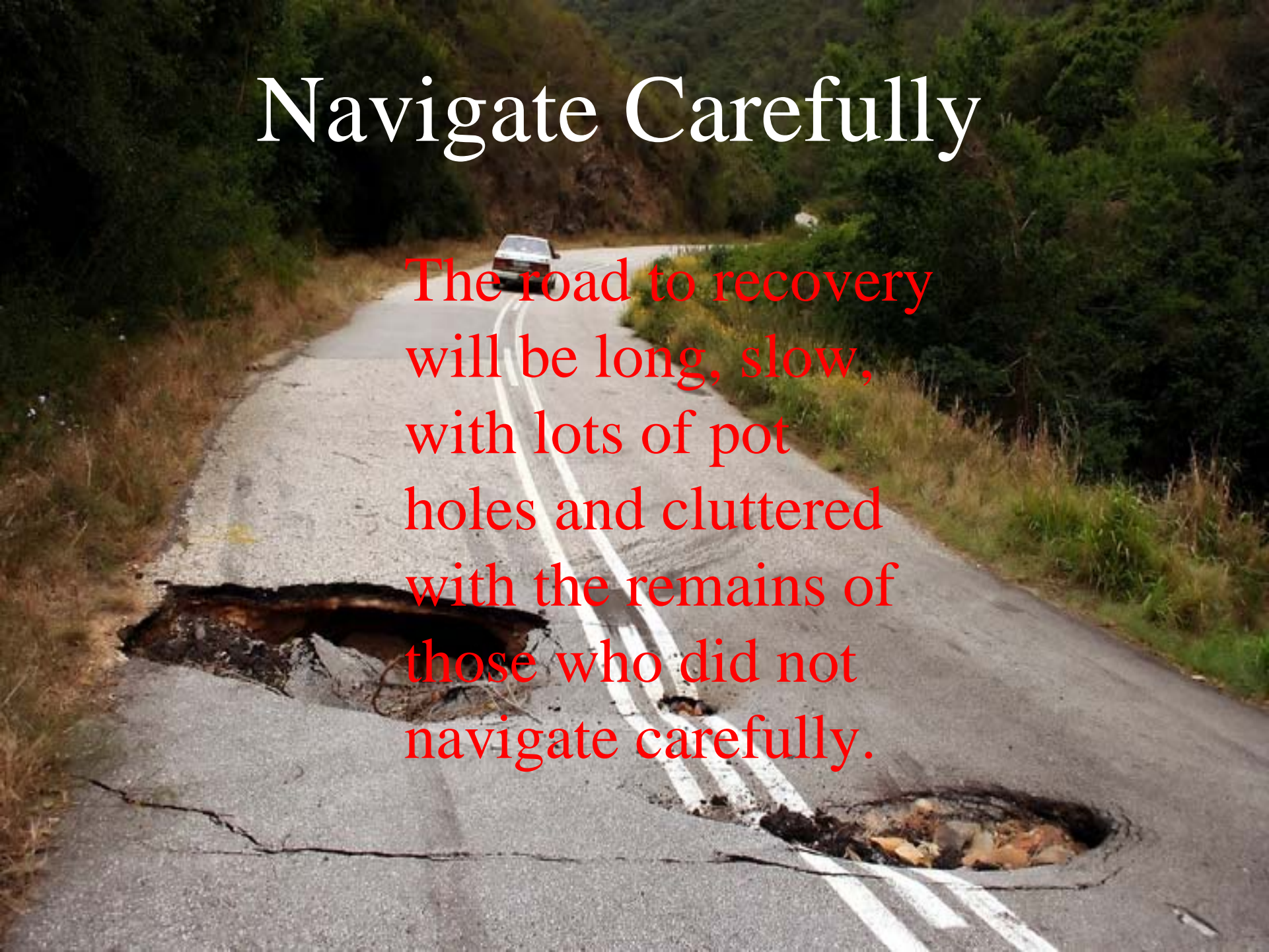
Will not return and are not likely to be finance-able until projects are economically feasible.

The feasibility question?
If this project is constructed,
will it be worth an amount
equal to or greater than
the cost to create it.

The troubling issue is not the hard costs but the soft costs of development especially those incurred in the absorption period.

Navigate Carefully

The road to recovery will be long, slow, with lots of pot holes and cluttered with the remains of those who did not navigate carefully.



Questions or Feedback?

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