



## *Economic Perspectives*

### Commercial Real Estate Outlook

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 and no positive change is likely in 2009.

**T**he effects of a deteriorating economy and the worst credit crisis in six decades landed squarely in the commercial real estate sector in 2008. Going into 2008, it was apparent that the sector was softening coincident with the generally slowing economy. Retail spending was declining which quickly flowed into the real estate sector as retailers began closing underperforming stores and new development slowed to a crawl. The same was true in the office sector with declining office jobs and a diminishing need for space to support the ailing housing and allied industries.

We expected that commercial real estate values and prices would decline as a result of reduced transaction activity, rising expenses and rising capitalization and discount rates. And indeed, they did as investors abruptly shifted their analytical focus to “what is” rather than what was merely assumed to be.

Credit availability for commercial real estate was also beginning to soften in early 2008 as both investors and institutional lenders took a more cautious wait and see approach. The credit markets steadily weakened throughout the year and the distress came to a head in September with the unprecedented events that led to a near collapse of the U.S. financial system. CMBS (commercial mortgage backed securities) issuance ground to a virtual halt leaving a huge void in capital for commercial real estate acquisition and finance.

With the secondary market effectively closed for business, that left commercial banks as the primary source of mortgage dollars. The timing could not have been worse as banks too struggle with capital and liquidity adequacy, limited balance sheet capacity, declining markets and regulatory pressure to shore up balance sheets and reduce troublesome loan concentrations.

Indeed, as indicated by the Federal Reserve Senior Loan Officer Survey, banks have been steadily ratcheting up underwriting standards. For most, that does not mean imposition of new and onerous standards (although some borrowers might disagree) but rather a return to fundamental credit principles, something that may have been lost in the exuberant and unsustainable run up which peaked in 2006.

According to the Federal Reserve survey, 30% to 40% of banks reported tightened credit standards in 2007. By the first quarter of 2008, the number surged to 80% and by the end of the year it was 90%.

As the curtain closed on 2008, however, commercial real estate performance was far worse than expected when the year began. Nationally, according to REIS, transaction activity (dollar volume of single property transactions) dropped 85% from its high point in the second quarter of 2007 through 2008 and 74% in just four quarters. Additionally, aggregate net operating income decreased and capitalization rates rose. As would be expected, the combination has forced values down from their cycle highs but the decline has not yet wiped out the gains realized between 2003 and the cycle high in the third quarter of 2005 for retail and the third and fourth quarters of 2007 for office, industrial and apartment.

Mortgage performance held up reasonably well for CMBS loans in 2008. The foreclosure rate was 0.10% which was within two basis points of 2006 and 2007. Whole loans held by financial institutions did not fare as well. Net losses, according to the OCC (Office of Comptroller of the Currency), surged in 2007 and by mid 2008 reached about 0.85% for community and mid size banks and over one-percent for large banks. The average reported by the OCC over 17 years since 1991 was 0.48% although that number is skewed by recent (2006-2008) history which reflects a clear move to riskier loan concentrations earlier in the decade.

As we look forward from the first quarter, the outlook is not good. New commercial development will be virtually non-existent. The Architectural Billing Index is one of numerous indicators leading us to that conclusion. The index is prepared by the American Institute of Architects and its premise is that architectural services precede most commercial real estate development. The index has now dropped to an all time low as virtually nothing is on the drawing boards.

We also expect prices and values to decline further and that will trigger a rise in defaults. Over \$24 Billion in CRE (commercial real estate) loans are scheduled to mature in 2009. That number rises to roughly \$40 Billion by mid 2010. This is on a national basis and we believe it misses many smaller loans less than approximately \$10 Million each held by community and mid-size banks.

When the loans mature, they are going to need to pay off or refinance. That will be a major crunch point as dollars are not available to refinance everything coming due. Indeed, it appears that there is about 2.5 times the loan volume coming due than there are dollars available to refinance them. For example, at the end of 2008 the syndicated loan market was virtually non-existent having experienced a cycle peak of over \$80 Billion in the second quarter of 2007 and then plummeting to roughly \$3.0 Billion at the end of 2008. Moreover, most commercial banks do not have balance sheet capacity to absorb what needs to be refinanced. Finally, as previously described, values are likely to deteriorate further throughout 2009 leaving many projects in high loan to value positions and not refinance-able without significant loan curtailment.

Relief could come in the form of government intervention but as of this writing (March 2009), it has not despite the billions of TARP (Troubled Asset Relief Program) and other dollars that have already been infused into the American financial system in an effort to thaw credit markets and jump start the economy.

Despite all that is being done, in our view, the overriding question remains. What is the incentive for financial institutions of any type to loan into an already impaired market with declining collateral values — values that are almost certain to decline further in 2009?

**Sector by sector. Retail real estate** is clearly the weakest of the four core commercial real estate property sectors (retail, office, industrial and apartments). The sector is feeling the effects of the credit crisis and a remarkable slow down in consumer spending. That combination is forcing structural changes in retailing. Retailers are

aggressively closing under-performing stores, bankruptcies are surging and the effect is flowing through to retail real estate.

According to Real Capital Analytics, retail real estate transaction volume was down 60% in 2008 as compared with 2007. Capitalization rates, (“cap rates”) — the ratio between net operating income and sale price — were up 60 basis points both causing and reacting to falling prices and investors sagging confidence in, and outlook for that sector.

Prices turned negative in 2008 with even the highest grade properties down 9.9% and lower end properties down as much as 25%. Prices and cap rates are now back to 2004 levels and the outlook for the remainder of 2009 is decidedly negative.

**Office real estate.** Office employment grew significantly in the middle of the decade. Much of the growth was in support of the residential real estate sector. What followed was a surge in office real estate development — especially in suburban locations. Despite a distinct and measurable increase in development, it was still more constrained than previous office development booms. That was a result of more constrained hiring practices, tenants being slower to expand into additional space, declining per capita space needs and improved technical capabilities which allowed more employees to work away from an office.

The recession hit the office sector in 2008 as office employment began to decline. Business and professional services, information technology, publishing and financial intermediation (banking and finance) all saw noteworthy declines in 2008 leading to a decline in office space needs. Additionally, corporate downsizings outpaced expansions four to one over the year.

Today, vacancy rates are surging, cap rates are rising and rent growth is flat to negative. The outlook for the remainder of 2009 is negative. Sales volume will be very low and we expect values to decline.

**Industrial real estate**, including warehousing, held up well while the economy was growing. Stress emerged with the housing crunch, then a pull back in consumer spending followed by declining exports as U.S. trading partners fell into recession. To top it off manufacturing declined at home. We expect values to decline in the industrial sector for the same reasons as retail and office. The decline, however, should be more moderate.

Multifamily is perhaps the strongest sector nationwide but decidedly weak locally as a result of the “shadow market” created by an extraordinary number of condominium units and single family residences available for rent

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