

Commercial Real Estate Regains Strength after Mid-Cycle Lull



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by Hugh F. Kelly, CRE

Goethe, a towering figure in German literature, once advised, "Enjoy when you can. Endure when you must." For most of the office and industrial markets across the United States, this is a time to enjoy. Even with the signs of softening experienced during the past year, we found merely a "pause," a period of deceleration in what has been a strong market for commercial real estate. As 2007 began, the commercial real estate industry shook off the effects of 2006's national economic lassitude and resumed the strengthening trend that had characterized this cycle up until the Spring of last year.

SIOR's national commercial real estate survey results showed quarter-to-quarter improvement in its overall SIOR Commercial Real Estate Index. Only the Midwest, challenged by the distress of the U.S. auto industry, slipped significantly in SIOR's most recent tally. The West edged slightly downward

as well, but remained well above the national average strength. Data received from 419 SIOR designees who responded to the organization's sixth quarterly survey of market conditions was tallied to produce end of January results. The results provide a detailed picture of the state of commercial property markets from SIOR transaction professionals across the country.

National Index Rises 1.60 Points to 118.67

The overall SIOR Index had dipped for two consecutive quarters, but reversed direction during the Winter of 2007, stepping up to its current level of 118.67. In the opinions of SIOR's survey panel, both local and national economic conditions were more strongly in favor of improving real estate markets in the Winter months than was the case three months earlier. Asking rents continued to rise, and leasing

concessions were settling in the range of normal negotiating balance. Development, while increasing, was still a bit below the volumes needed to match demand and it was a sellers' market for development sites during the quarter.

Leasing activity remained strong, but not overheated. The continued escalation of construction costs meant that the transaction values in the marketplace were just modestly running ahead of the replacement cost of the facilities. These rising costs are effectively keeping building volumes in check, which in turn is allowing vacancy rates to drop in most industrial and office markets.

Several factors in the marketplace appear to be moving rapidly, and their interactions are limiting movement in the overall Index. Construction costs have moved upward significantly—as much as 35 percent in 2006 in the Northeast—leading to increased lease rates. Across the country, panelists confirmed the influence of cost increases. High costs act as a disincentive for development, and keep investment prices in most markets from posting any significant premium over construction prices.

Thus we have a very complicated balancing act at the present time. Asking rents have stepped up smartly, scoring 13.69 points in the overall SIOR Commercial Real Estate Index (See chart on page 42). Development, however, has not yet hit its stride, scoring only 9.43 points. Investment pricing, perhaps surprisingly, contributed just 10.06 points to the Index. This variable relates how prices compare to replacement costs, and we see that the two are very close, as a rule, across the nation. Looking at prices alone one may see a “bubble” in the pattern of high prices per square

foot and low capitalization rates, but you must factor in the fundamental issue of cost-to-produce. If you add in the very high cost of site acquisition (contributing 13.34 points to the overall Index), then the close relationship between investment prices and replacement cost comes into sharper focus.

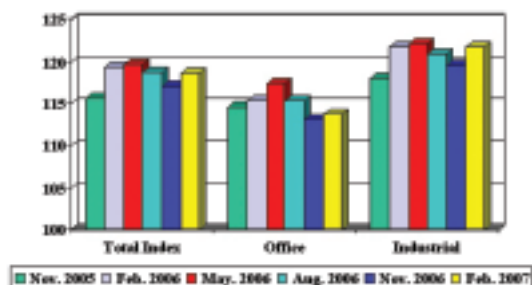
The 1.60 point advance in the Index was accomplished as seven of the 10 variables rose from their Fall 2006 levels. Our graphic showing the Data Scores illustrates both the degree of change for each of the 10 components of the Index, as well as their magnitudes as of Fall 2006 and Winter 2007.



Taking a page from the widely followed Purchasing Managers Index, published by the Institute for Supply Management, we thought it would be helpful to present some of the overall Index data in tabular form. The table on page 42 captures some of the key information in the current Index, and uses the changes from past surveys to offer a more evaluative interpretation of the data. Each variable is identified along with its score for the current survey and the survey before it, calculating the change over the three-month span.

- **Overall Condition** rates each variable on its distance from the 10-point norm
- **Rate of Change** looks at the degree to which the scores have shifted over four quarters
- **Length of Trend** tells the reader how many quarters it has been since the score has shifted direction (whether up or down)
- **Peak and Trough** identify the quarter in which each variable had its highest and lowest scores since we began this project in late 2005.

**Winter 2007 SIOR Survey Shows
Commercial Real Estate
Resuming Upward Path**



Sources: Hugh F. Kelly Real Estate Economics for SIOR

Property Types

Our first survey in the Fall of 2005 produced the lowest score we have seen. This suggests that the market was on the upswing when we launched our indexing effort. The two property types tracked have been consistent in movement—generally rising and falling together from quarter to quarter although their total scores were not especially close.

Offices

The Office Sub-index rose to 113.79 this quarter, up 0.62 points from its previous score. Five variables rose and five fell over the three-month period between surveys, three of which—rents, vacancy, and site prices—did not decrease enough to make any significant difference in market conditions and only suggested a slowing of momentum.

Leasing activity and sublease conditions also posted lower scores this quarter. Leasing activity registered 10.38 points, down 0.21 from the Fall, indicating that leasing is about normal in the

national office market. Leasing has been subsiding from a peak score of 11.16, achieved last Summer. Subleasing conditions remain strongly in the favor of landlords, though this figure has also slid from its Summer 2006 peak. Its score, 10.05, indicates that office owners have little to worry about in terms of competition in the market from their own tenants.

The one significant drop in the office numbers was in “investment pricing.” Of the 154 office responses, 72 indicated that transaction prices for offices were below the level of replacement cost, with an additional 32 respondents estimating that construction costs and sales prices were roughly in line. Only 50 respondents viewed today’s office purchase prices as above the level of replacement cost. This is a stunning result, in view of the widespread opinion that office prices are at hugely inflated levels and destined for a collapse.

Our score for investment prices dipped to 9.16, well below the peak level of 11.32 last Spring. This is one instance where our survey may add

exceptionally important content to the discussion of market conditions, certainly a key perspective that is not captured in more conventional reports of prices per square foot or capitalization rate trends.

Four office variables were primarily responsible for this sub-index's net gain for the quarter. Two of these, the leasing concessions and development components of the Index, are still below the "par value" of 10 points, but did step up significantly in the Winter survey. Building volumes remain below average with negotiating power still slightly in the tenant's favor. The other two elements—the contribution of the local and national economy—appear to be weighing in favor of strengthening office market conditions. Forty-four percent of respondents indicated that their local economies were either strong or booming, versus just 16 percent who believed their local areas were weak or contracting. As far as the contribution of the national economy is concerned, 44 percent viewed macro-economic forces as positive at the present time, and only 11 percent thought the U.S. economy was a moderately negative influence.

Industrials

The nation's huge industrial property sector posted a significant 2.14 point gain in the SIOR's Winter survey, standing at 121.72—well above the entry score of 118.05 measured at the start of our Index survey, which is the low score for industrials thus far. As with offices, the data suggest the survey process caught the market on the rise following the post-2001-recession supply/demand bottom.

Seven of the Industrial sub-index components rose, and three fell, compared with the Fall quarter.

As the chart showing scores for the two property types on page 45 illustrates, the rent change and vacancy change variables for industrials had strong scores. The rent measure improved to 13.63, its strongest showing since we began the survey. The vacancy component rose to 13.17, but is below the peak of 13.88 of Winter 2006. This could indicate some flattening in the vacancy improvements ahead. Nevertheless, of the 249 industrial responses, 159 reported improvements in vacancy over the past year.

SIOR Commercial Real Estate Index

Variable	1Q07 Score	4Q06 Score	Chg. in Score	Overall Condition	Rate of Change	Length of Trend	Peak	Trough
Leasing Activity	11.04	11.01	+0.03	Good	Stable	Two Quarters	Summer 2006	Fall 2005
Asking Rent Change	13.69	13.47	+0.22	Very Good	Improving	One Quarter	Winter 2007	Fall 2005
Vacancy Change	13.07	13.10	-0.03	Very Good	Slowing	Two Quarters	Winter 2006	Winter 2007
Subleasing	13.70	13.92	-0.22	Very Good	Stable	One Quarter	Fall 2006	Fall 2005
Concessions	10.00	9.80	+0.20	Balanced	Improving	Five Quarters	Winter 2007	Fall 2005
Development	9.43	8.81	+0.62	Balanced	Improving	One Quarter	Winter 2007	Fall 2005
Site Acquisition	13.34	12.92	+0.42	Very Good	Slowing	One Quarter	Winter 2006	Fall 2006
Investment Pricing	10.06	10.47	-0.41	Balanced	Slowing	One Quarter	Fall 2005	Winter 2007
Local Economy	12.29	11.99	+0.30	Good	Stable	One Quarter	Winter 2006	Fall 2006
National Economy	12.05	11.57	+0.48	Good	Stable	One Quarter	Winter 2006	Fall 2005
Overall Index	118.67	117.07	+1.60	Good	Stable	One Quarter	Spring 2006	Fall 2005

Only 58 markets indicated a higher vacancy rate than a year ago but some of this is attributable to accelerating construction. Although, on a national basis, development is close to normal (at a score of 9.94 points), 64 markets report “above average” construction and an additional 25 respondents report their markets as being in a “construction boom.” The enthusiasm for industrial development continues to push site prices higher as almost two-thirds of the respondents characterize their areas as a sellers’ market for industrial sites.

As seen in the office segment, both the national and the local economy are considered positive influences for the industrial property sector. In fact, the industrial respondents were even more bullish on the state of economic fundamentals than the office respondents. Large national developers are

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engaged in building industrial facilities and are vying for land as vacancy rates are falling and rents are increasing.

Regions

Two up and two down: at first glance regional inconsistency seems to be the principal geographic story emanating from the data in early 2007.

“Location, location, location” seems to ring basically true, no matter how sophisticated the real estate markets become in terms of financial engineering or

quantitative analysis. The simple table in column two shows the regional sub-index values for Winter 2007, together with the scores on the questions evaluating the impact of local and national economic conditions on commercial conditions. The table clearly depict the critical differences in regional location.

The strength of local economic conditions is directly reflected in the rank order of the regional indexes. And the influence of the national economy on commercial real estate in the South and in the West is rated higher than the impact seen in the Northeast and the Midwest.

The *Northeast* stepped up its index by 5.16 points from the Fall survey, the largest gain of any of the four major regions. The three components with the strongest performance in the Winter survey were site prices (13.96 points), subleasing conditions (13.70 points), and change in asking rent (12.99 points). Optimism is a common trait in the remarks submitted by survey panelists from this region as asking rents continued to rise and vacancy rates declined.

As has been the case since we initiated our Index survey, the *Midwest* tallied the lowest rating in our Winter responses. In a setback, the Regional Index here dropped 3.36 points, to 95.13. In the six quarters we have spent conducting this research, the Midwest has yet to achieve the “par” value of 100 points in its Regional Index. The softness is widely distributed, with five of the 10 questions producing scores under 10. Tenant concessions and development activity generated the weakest scores—6.12 and 6.79 points, respectively. Sluggish development is entirely rational, based on a score of just 8.06

	Northeast	Midwest	South	West
Regional Index	114.52	95.13	130.45	129.51
Local Economy	11.36	8.98	14.23	13.74
National Economy	11.71	10.41	12.72	12.95

points on the variable comparing investment price to replacement costs. Leasing activity was also disappointingly low, contributing only 8.39 points to the final Index value. And, as noted in the table above, survey respondents rated the contribution of the local economy to commercial property a sub-par 8.98.

The bright side is in vacancy trend and sublease conditions. These two variables both came in at a moderately strong 12.35 points, the highest individual contribution to the Index. Although no markets reported substantially higher rents than a year ago, 46 percent of the responses from the Midwest indicated rents had trended upward at least modestly in the past twelve months. SIOR professionals in the Midwest haven’t given up hope. Most view the overall marketplace as improved and coming out of its cyclical trough.

The *South* edged into the top regional spot this quarter, with an Index score of 130.45, up 3.86 points from the Fall. Not a single variable scored below 10 points in this region, and four components of the Index contributed more than 14 points apiece. These were the change in asking rents (14.85 points), site acquisition conditions (14.53), subleasing conditions (14.34), and the influence of the local economy (14.23).

A tiny slip of 1.55 points was enough to bump the *West* down into second place this quarter, with a total Index score of 129.51 points. Like the South, the West did not

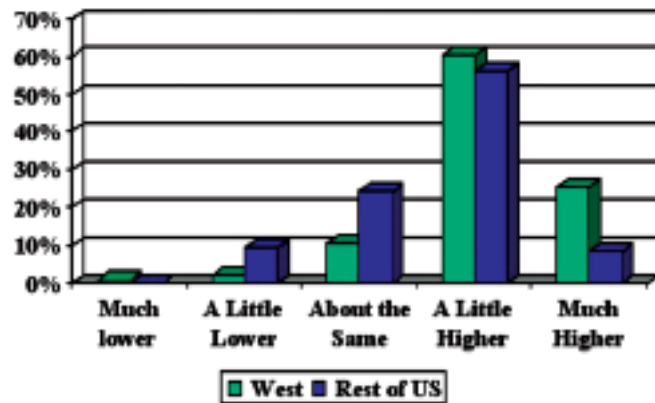
...office owners have little to worry about in terms of competition... from their own tenants.

INDEX SCORING FOR FEB. 2007							
Property Types				Regions			
	National Index	Industrial	Office	Northeast	Midwest	South	West
Leasing Activity	11.04	11.48	10.38	10.18	8.39	12.76	12.05
Asking Rents	13.69	13.63	13.77	12.99	11.02	14.85	15.37
Vacancy	13.07	13.17	12.96	12.38	12.35	13.65	13.58
Subleasing	13.70	14.11	13.05	13.70	12.35	14.34	14.16
Concession	10.00	10.48	9.25	9.63	6.12	11.46	12.21
Development	9.43	9.94	8.55	8.35	6.79	11.35	10.32
Site Acquisition	13.34	13.56	12.97	13.96	10.67	14.53	13.82
Investment Pricing	10.06	10.57	9.16	10.25	8.06	10.56	11.32
Local Economy	12.29	12.61	11.75	11.36	8.98	14.23	13.74
National Economy	12.05	12.16	11.94	11.71	10.41	12.72	12.95
Index Totals	118.67	121.72	113.79	114.52	95.13	130.45	129.51

post a single “sub-par” number (less than 10) for any of the variables comprising the Index. The score for asking rents in this region was extraordinary, 15.37 points, a stratospheric accomplishment given the scoring system. The histogram above shows just how heavily skewed toward positive rental conditions the West was as of the beginning of 2007.

This was not just a case of a single variable driving the totals, however. Strong corroborative support of the health of the commercial property market in the Mountain and Pacific States could be found in the scores for sub-leasing conditions (14.16 points), site acquisition conditions (13.82 points), influence of the local economy (13.74 points), and change in vacancy (13.58 points). Even investment pricing edged into moderate strong territory (11.32 points) despite high site and construction cost influences on replacement values. The office market is seeing rising rental rates and high tenant improvement costs. Some metro areas are even experiencing a shortage of commercial land.

Change in Asking Rents from a Year Ago Western Region versus Rest of the Nation



Source: Hugh F. Kelly Real Estate Economics for SIOR

Skeptics could look at the comments and the numbers from this quarter's SIOR Commercial Real Estate Index, and dismiss them as optimism. There are enough commentators out there who are just waiting for the commercial real estate industry to stumble, proving their expectations of a bursting bubble at long last correct. There is no question that real estate will see its cycle turn downward at some future point. However, there is little evidence that such a time is coming soon. While we will surely see a period in which we are challenged to endure, 2007 looks to be a continuation of a time that we are privileged to enjoy.

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