

The “Networked” Economy

Results of Spring SIOR Commercial Real Estate Index Survey



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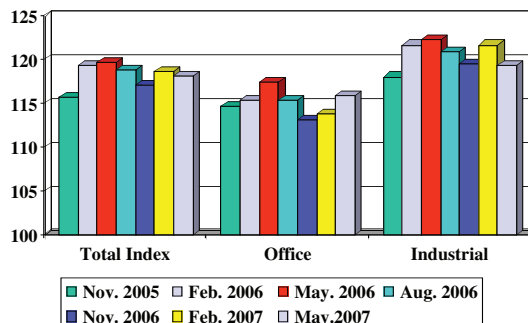
by Hugh F. Kelly, CRE

The relationship between the economy and the commercial real estate markets is complex and dynamic. One size does not fit all in our business, and generalizations can often be dangerously vague. The Spring SIOR Commercial Real Estate Index survey results bring into focus the differences among property types and geography.

With the Index we can trace the influence of real estate on the

economy and the effect of economic change on real estate. In the Spring 2007 results, we can see the impact that a slower residential real estate market can have on broader economic trends. These trends, in turn, affect demand for industrial and office real estate. Analysis of the variables in the Index scores helps us appreciate and anticipate the forces that will shape commercial real estate performance looking forward.

Mixed Results in Spring 2007 SIOR Survey: Offices Gain, While Industrials Retreat



Source: Hugh F. Kelly Real Estate Economics for SIOR

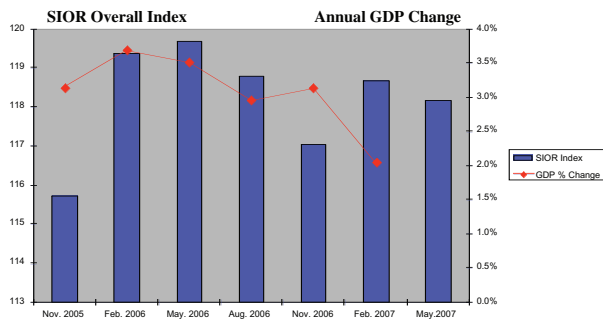
In our survey conducted in late Spring 2007, we can see that the overall Index dipped slightly over the past six months, but has remained consistently in the 117-120 range—indicative of strong real estate industry

conditions. The Index is set to a standard where a score of 100 represents national market equilibrium.) While commercial real estate conditions are not quite as robust as they were in early 2006, they remained favorable to property owners and investors in late Spring 2007.

Correlation of GDP and Commercial Real Estate

It's hardly surprising that we are finding a correlation between national economic performance and the overall SIOR Index. While it is still early in the game to discern the exact relationship between the Index and broad economic measures like the GDP, up to now the Index has either coincided with or moved slightly ahead of the Gross Domestic Product measure. The graph below shows real GDP change in percentage terms, with each quarter compared with the same quarter a year earlier (e.g., 4th quarter 2006 compared to 4th quarter 2005 in inflation-adjusted terms). The Index caught the rise in domestic output in early 2006 and the economic deceleration since then.

Is SIOR Index Suggesting Stronger Economy Later in 2007?

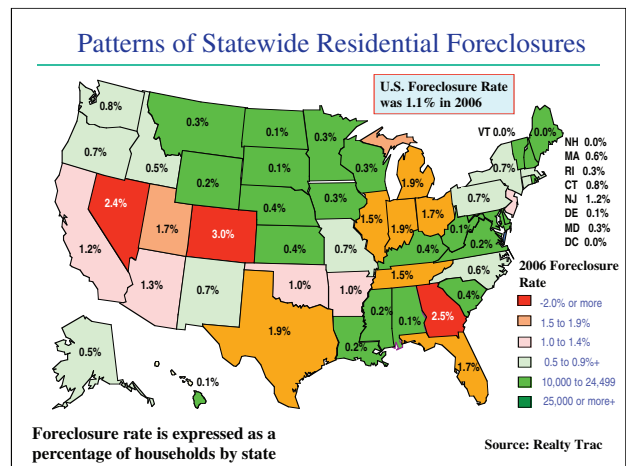


Sources: Data from SIOR Survey and U.S. Bureau of Economic Analysis Computations by Hugh F. Kelly Real Estate Economics for SIOR

Remember that we survey SIOR members before even preliminary GDP figures for the quarter are compiled and released by the government. The dip in our Index in November 2006 presaged the weak results in first quarter 2007 GDP. The return to Index values above 118 in both the February and May 2007 surveys may suggest that the U.S. economy will firm at a higher growth rate later this year. It is prudent to be cautious about such an interpretation of the Index as a predictor, but we will monitor its performance from this perspective as we continue our research.

Looking at the Residential Housing Affect on Commercial Real Estate

Of course, one of the factors slowing down the American economy during late 2006 and early 2007 was the pullback in the U.S. housing market. Related to this was the distress in the subprime residential mortgage area. Residential fixed investment was down 16.7 percent between the first quarters of 2006 and 2007. However, existing home prices did not drop nearly as much as many had feared—with median price down just 1.4 percent according to the NATIONAL ASSOCIATION OF REALTORS®. But housing starts dropped to 1.47 million units as the inventory of unsold homes rose. This drop affected the economy of the previously booming housing markets in the South and West, while the distress in the auto industry affected residential conditions in the Midwest. Housing's multiplier effect in industries from lumber to appliances magnified the impact. The map below shows the residential mortgage foreclosure rate, state-by-state, for all of 2006.



The impact the housing market has is clear in the sharp drop in the scores evaluating the effect of the national economy on the real estate markets. Commercial leasing conditions are less robust—vacancy improvement slowed over the past quarter, and sublease opportunities have edged upward since February. Nevertheless, markets are continuing to see upward movement in rental rates and sales prices. In addition, other indicators of market strength—the extent of tenant leasing concessions, building activity, and prices for development sites—all improved over the quarter. Interestingly, the SIOR survey respondents scored their local economic conditions more favorably than national conditions.

Office Sector Index Rises by 2.14 Points in Three Months

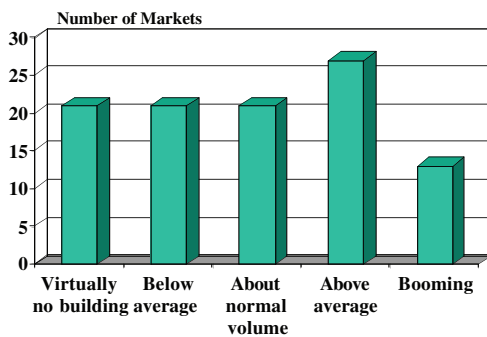
The strongest gain in Spring 2007 was in prices for development sites as 68 percent of the survey respondents characterized conditions in their area as “a seller’s market.”

The variable that measures development conditions also rose substantially—the May 2007 score is the highest we have seen for this variable since the SIOR Index was first calculated in November 2005, so it reflects an office construction cycle that is beginning to get back to normal even though overall national office development is still below average.

Vacancy trends still registered a fairly strong score as 56.3 percent of markets posted vacancy improvement. However, the momentum of increasing occupancy is losing energy, a fact that may be reflected in slower leasing activity.

Occupancy is still sufficiently healthy to support strong rent gains in the office markets. Trends in

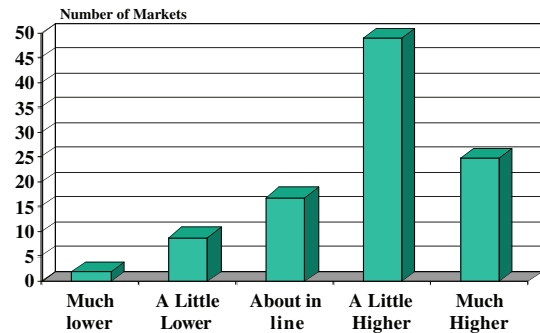
What Amount of Office Development Is Underway?



asking rent posted the highest score of all 10 factors examined in the SIOR office survey. In fact, 48 percent of office reports indicated that rental rates were “a little higher,” and an additional 24.5 percent of survey respondents rated asking rents as “much higher.”

It is apparent that even though the U.S. economy has hit a lull, commercial office markets are still moving forward. Most conventional measures of real estate conditions will confirm this progress for the balance of 2007. However, we are able to detect signs in the leasing and vacancy data, as well as in the development area, that suggest that landlords and tenants will be looking at more

How Do Office Asking Rents Compare to a Year Ago?



Source: Spring 2007 SIOR Index Survey

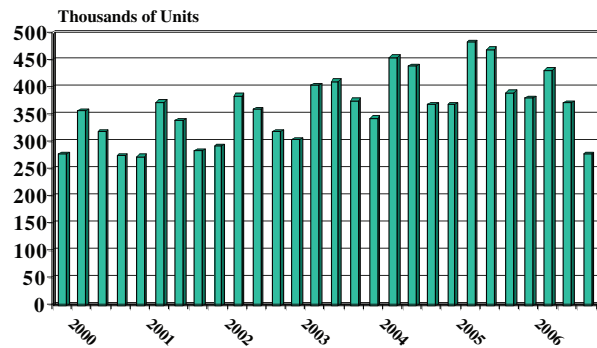
balanced negotiating strength during the latter years of this decade. Real estate’s cyclical patterns continue to obey the iron laws of supply and demand. Rising rents and historically high pricing spur builders to add inventory as markets tighten, giving tenants more choices and indefinitely limit the ability of owners to charge higher rents.

Industrial Index Dips with Homebuilding Drop

Only occasional comments from SIORs indicated a direct relationship between slowing new home construction, the subprime mortgage stress, and the state of the industrial commercial property sector. Florida and Southern California reported specific impacts, but this is not surprising given the soaring single-family and condo market growth there in the middle years of the decade. With starts down to just about a million single-family homes (annualized) at the end of 2006—compared to about 1.9 million at peak in mid-2005—the decreased flow of building materials, furniture, appliances, and other furnishings through the warehousing system reduces industrial demand.

Eight of the 10 variables included in our survey saw lower scores this quarter than three months ago—only site prices and investment value (relative to development costs) posted gains. An easing in price inflation of construction materials (itself a partial effect of the softer homebuilding market) helped the investment factor rise. Just over half of the SIOR respondents placed current industrial investment prices at a premium over development costs and considered the market for development sites still to be heavily tilted in favor of sellers.

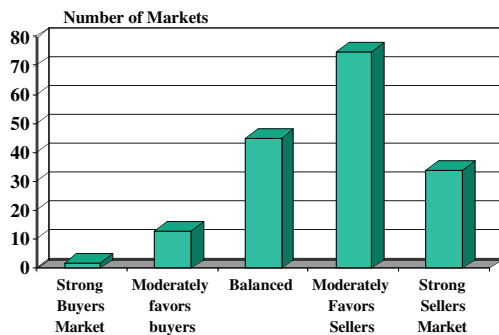
Single Family Housing Starts Dropped Sharply in Late 2006



Source: U.S. Census Bureau

The effect of slower inflation in building materials cost is not likely to last. Dr. Ken Simonson, chief economist of the Association of General Contractors, has called this “the lull between two storms,” and he expects materials costs to begin rising again. The step-up in energy costs has already made its mark, increasing the cost of bringing materials to development sites. If we are simply seeing a mid-cycle economic correction (or “soft landing”), the underlying pressure on development costs could re-emerge in late 2007 or early 2008.

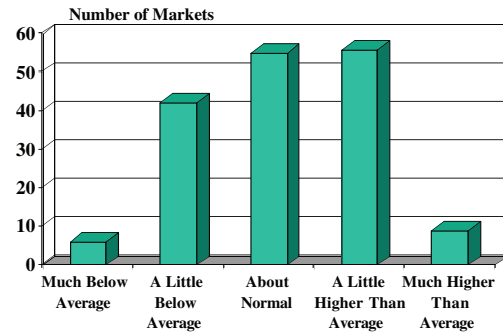
How Do SIORs Rate the Market for Industrial Land?



Source: Spring 2007 SIOR Index Survey

SIOR respondents were far more negative about the condition of the national economy than they had been a year or even three months ago. The score on the question, “How do you view the performance of the U.S. economy from the perspective of your market?” was down 1.15 points from February 2007 and 1.49 points from May 2006. At present, the national economic drag appears to be more critical to industrial than to office properties.

Current Leasing Activity in Industrial Properties

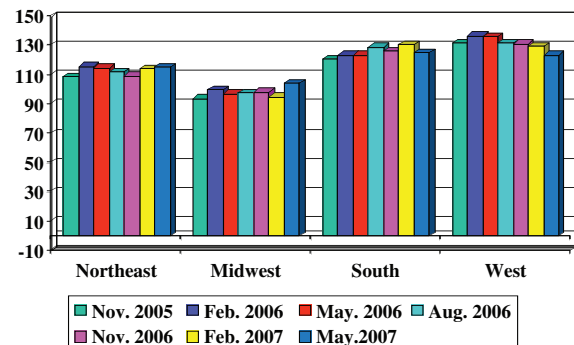


Source: Spring 2007 SIOR Index Survey

While industrials have seen a broad-based weakening in their Index score, we should nonetheless highlight the most basic message in the numbers: they are still well above the equilibrium benchmark of 100 points. Further, even given the recent gains by Offices, the Industrial property sector remains the leader with an Index of 119.33, versus Office’s 115.93 total.

Regional Stories Show Convergence in Spring Survey Figures

Regional Markets Converge: Gains in Northeast and Midwest Balancing Dips in South and West



Source: Hugh F. Kelly Real Estate Economics for SIOR

Midwest

If it is not yet time to break out the champagne, it is at least a moment to sound a trumpet for the Midwest. For the first time since we began SIOR’s Commercial Real Estate Index project, the Midwest has tallied a score greater than 100 – “par value” for healthy markets. This region jumped from 95.13 in February to 104.58 in May. This is a stunning and encouraging result.

Midwest respondents rated six of the 10 factors surveyed as “above par”—asking rental rates, vacancy trends, subleasing conditions, site prices, investment prices, and the impact of the national economy. The highest scores were for vacancy trends and the sublease situation, with development and building volume cited as “below average.”

Anecdotal comments submitted by SIORs, especially in large markets like Chicago, Minneapolis, and Cincinnati, confirm a more upbeat outlook

for this region. The decline in the auto industry and other manufacturing is a regional risk, but we are finding that the darkest clouds may be lifting from over the Heartland.

Northeast

The Northeast also posted a quarter-to-quarter gain and has reversed a pattern of moderate decline that had persisted through 2006. The structure of the Northeast’s economic base accounts for some of its positive performance and stability: Office use is comparatively concentrated and overall reliance on manufacturing production has dropped. The regional Index has moved within a relatively narrow band of 109 to 116 in all six of our surveys to date.

Eight of the 10 Index variables tallied above-par scores in the Northeast, with the only exceptions this quarter being leasing activity and development volume. The greatest contributors to the Northeast’s regional Index were the site prices in this densely-packed part of the

Housing Conditions in Selected MSAs

<i>Metro Market</i>	<i>2006 Single Family Price Change</i>	<i>Foreclosure Rate</i>
Atlanta	-2.0%	4.4%
Austin	+4.9%	2.3%
Chicago	+0.9%	2.0%
Dallas-Ft. Worth	-3.9%	3.8%
Detroit	-1.0%	4.9%
Houston	+1.6%	2.3%
Indianapolis	-4.0%	4.3%
Las Vegas	-0.8%	3.3%
Miami-Ft. Lauderdale	-6.2%	2.8%
Orlando	+3.9%	1.8%
Philadelphia	+3.3%	1.2%
Phoenix	-2.3%	1.5%
San Diego	-4.5%	1.3%

Sources: NATIONAL ASSOCIATION OF REALTORS (Home Prices); Joint Economic Committee of Congress (Foreclosure Rates)

country, subleasing impacts, and asking rental rate trends.

Perhaps the most encouraging sign of continued vitality is that SIORs in the Northeast consider that their local economies contribute more vigorously to real estate market strength than the U.S. economy does.

West and South

The remaining areas of the country—the West and the South—share two characteristics: They still have the highest regional Index scores in the SIOR array, and both took a stumble in recent months. Both

regions are demographically driven economies and therefore are especially sensitive to housing conditions. The state-by-state map of residential foreclosures presented earlier in this report dramatically shows Georgia, Florida, and Texas well above the U.S. rate of 1.1 foreclosures per 100 households (based on Realty Trac data analyzed by the Joint Economic Committee of the U.S. Congress). Markets like Atlanta, Dallas, Las Vegas, Phoenix, and San Diego have been at the center of the mid-decade housing boom. Unfortunately, their economies are showing similar volatility at the end of that boom, as shown in the table on page 57.

West

The West's Index, although sharply off its February 2006 peak of 136.9, was still in a good place at 123.75 points—ranking second only to the South with its only stumbling block being development volume. However eight of the Index components dropped this quarter, compared to February 2006. The steepest drop reflected the impact of the U.S. economy on local commercial property markets.

Other plummeting variables were sublease influences, leasing activity, and vacancy trends.

There is no “panic situation” here, but rather a story often seen before where trends begin on the West Coast and migrate eastward. The Pacific and Mountain Regions were early in the queue of economic and market rebound in the early years of this decade. As early as Spring 2003, we saw this in my *Professional Report* article, “Will This Recovery Rise in the West?” This regional expansion has also matured earlier. The economic and demographic profile of the West maintains a picture of growth and opportunity. If it is coming back to the pack a bit, this is just a reminder that over time local advantages wax and wane. “Go West” is still advice that has a lot of merit, even in the face of the recent retreat in this region's SIOR Index.

South

The South leapfrogged into first place in the regional rankings in February 2007 and kept its hold on that title in May, despite a 5.07-point drop

to 125.38. Unlike the West, which peaked early, the South has been moving up in saw-toothed fashion since we began our Index project in the Fall of 2005. Although nine of the 10 Index components produced lower scores in the current survey than three months ago—only investment price edged ahead—all 10 factors exceeded the 10-point benchmark. In addition, the South’s local economy score of 13.25 is excellent and quite nicely surpassed the national economy as a positive feature for real estate performance.

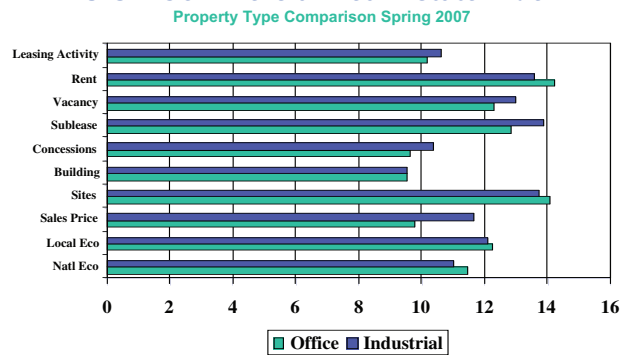
By conventional standards, the South actually looks as if it has terrific momentum. Respondents from the region saw rents rising and vacancies trending down. The emergence of the South at the top of the Index list will not surprise many of the region’s professionals.

Summary

Our measure of the real estate industry in the Spring of 2007 looks like a nationwide balancing act, with gains and losses, winners and losers (at least relatively speaking), and overall very little change in our composite Index. Of course, it’s a big country and a big industry too. And we are connected in a multitude of ways. Mostly, that is a good thing. Greater efficiencies and transparencies help market functioning, and real estate has benefited tremendously from these factors in attracting ever-greater volumes of capital in the past 12 to 15 years. But a domino effect can work negatively as well, and it now looks like the cooling off of an overheated housing market and the fallout from poorly underwritten subprime residential mortgages are combining to hobble the U.S. economy to some degree. The industrial property market and several regions of the country now seem to be feeling the effects.

Most analysts regard this more as a bump in the road than a major economic dislocation, though there have been more than a fair share of gloom-and-doom articles in the press. Fed Chairman Ben Bernanke, while acknowledging the seriousness of the issues affecting housing, had this to say about the broader outlook:

Data Scores SIOR Commercial Real Estate Index



Source: Hugh F. Kelly Real Estate Economics for SIOR

“We [the Federal Reserve] believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system. The vast majority of mortgages, including even subprime mortgages, continue to perform well. Past gains in house prices have left most homeowners with significant amounts of home equity, and growth in jobs and incomes should help keep the financial obligations of most households manageable.”

Remember to keep this in perspective. It is easier to affirm the basically positive message of the Spring 2007 SIOR Commercial Real Estate Index: The Office and Industrial sectors should enjoy favorable conditions for the immediate future.