Decline in SIOR Index—a Sign of the Times

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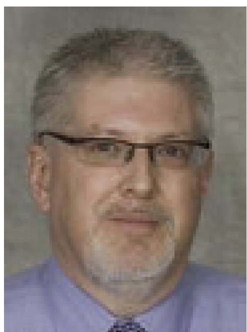

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By Lawrence Yun, NAR Senior Vice President & Chief Economist and Scott MacIntosh, NAR Senior Economist

By all measures, the results of the Fall 2007 SIOR Index survey show members across the country reporting a definite downswing in their markets. The SIOR Commercial Real Estate Index, representing third quarter 2007 data, compiled by the Society of Industrial and Office Realtors® (SIOR) and evaluated by the National Association of Realtors® (NAR), posted the steepest quarterly decline since SIOR began its indexation project in late 2005. The national index, which measures 10 variables pertinent to the performance of U.S. industrial and office markets, dropped 6.5 points to a third quarter reading of just 107.2. While still higher than a value of 100 (indicating a balanced office and industrial marketplace), the index suggests that we are in for some stormy weather before bouncing back to the excellent market conditions that the commercial real estate market has experienced over the past couple of years.

The SIOR Commercial Real Estate Index is a diffusion index (see page 37-Methodology) where a score of 100 indicates markets in balance. Therefore a score of 107.2 reflects positive conditions in the commercial real estate industry for landlords and sellers. But it is clear that the robust market enjoyed until recently has been broken—at least temporarily. Fifty-four percent of SIORs evaluating markets conditions for third quarter 2007 indicated that leasing activity was normal or a little higher, while 40 percent reported lower to much lower activity. The index was based on replies from 371 SIOR member participants who provided their views on market conditions in their respective markets in early to mid-October.

Index results indicate that local economies continued to be strong during summer 2007 with the national economy having little or no effect on local market dynamics. Fifty-five percent of the markets experienced modest growth in rental rates, with 11 percent reporting much higher rental rates. On track with existing rents, only 33 percent of respondents indicated that their market was favorable to tenants with moderate levels of landlord concessions available. The majority of respondents, 63 percent, indicated a balanced market or one where landlord concessions were insignificant. Overall, the investment market was balanced with only a slight up-tick in favorable conditions for sellers.

. . . the commercial market has held on much better overall than the residential market.

Economic Look at Year End 2007

The economy is slowing. In the fourth quarter, 2007 GDP growth shrank for the first time since the 2001 recession. Economic shrinkage was reported in late January and shouts of Recession pushed the Feds Fund to lower interest rates and Congress to pass an economic stimulus package.

The fourth quarter weakness was affirmed by very soft job figures for December. Only 18,000 net new payroll jobs were added during the month compared to 119,000 monthly job gains for the rest of 2007 and 189,000 in 2006. The unemployment rate rose to 5.0 percent, the highest in two years, after hovering at around 4.5 percent in the first half of 2007.

Not surprisingly, housing market fallout contributed heavily to weak overall conditions. Jobs in residential construction and related contractor work fell by 28,500 during December, down by 291,000 from peak employment nearly two years ago. The commercial real estate market appears to be topping out as 16,800 jobs were cut in December. NAR's commercial leading indicator had pointed to a modest slide in the commercial sector back in November. Still, the commercial market has held on much better overall than the residential market. The latest job figures in the commercial real estate sector show 334,000 more jobs now than existed during the cyclical low in February 2004. The multi-year job gains reflect a strong rise in commercial real estate spending. Spending on non-residential private construction totaled $483 billion (annualized) as of the third quarter 2007, which is considerably higher than the $277 billion and $298 billion recorded in 2003 and 2004, respectively.

Overall, no deep worries yet. Technically an economic recession comprises two consecutive quarters of contraction. (It is measured that way because only a sustained economic contraction leads to sustained net job cuts.) The projected fourth quarter decline is due to cutbacks in residential construction activity and from a statistical "quirk" in business inventory investment. The business inventory components generally regain quickly. The inventory-to-sales ratio is touching record lows (i.e., companies are operating with thin inventory) and some build-up in business inventory is inevitable going into 2008. The cutbacks in residential construction are continuing but most of the major declines have already occurred. Subsequent construction declines in 2008 will have less impact. Housing starts have fallen from their 1.5 million-unit pace in the early part of 2007 to 1.2 million in the latter part of 2007. For 2008, housing starts are projected to be 1.09 million units—weak activity but still a rather mild decline from the final quarter of 2007.

The other components of GDP will hold steady. Consumer spending will continue to expand, albeit at a slower pace. It is difficult to foresee a consumer spending contraction given the fundamental improvement in household balance sheets. Compared to two years ago, personal income has increased by $1.4 trillion, four million additional net new jobs have been added, and household net worth has risen by $7 trillion—principally from a rising stock market (the stock market fell in late December and early January, but is still considerably higher than two years ago). On average, wealth in homes has declined by $200 billion

in the past year due to the lower home prices. On a net average however, if you add up the above figures, households are in better financial condition than they were two years ago. Consumer spending will not contract.

Business profit appears to have topped out in the past two quarters. However, business spending will advance at a respectable pace because aggregate corporate profits are considerably higher now compared to just two years ago. Government spending nearly always rises. Net exports also look favorable given the weakness in the U.S. dollar. Foreign purchases of U.S. products will remain strong because U.S. products are competitively priced.

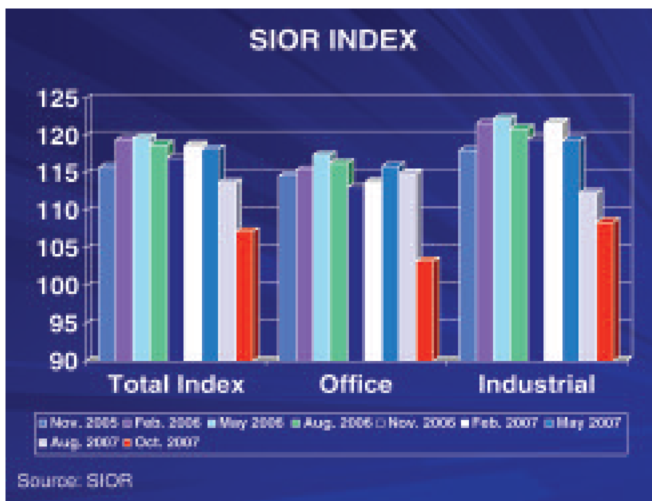
All in all, we should escape recession—despite the screaming headlines we saw in January of an impending recession. The GDP reading for each of the successive quarters in 2008 will be positive: 0.9 percent in the first quarter, 2.5 percent in the second quarter, 2.3 percent in the third quarter, and 2.7 percent in the fourth. Job gains will also continue into 2008.

But even a temporary contraction in GDP has some benefits. Despite a relatively high inflation reading in November (0.8 percent over a single month), weaker GDP growth will hold back inflationary pressures in 2008. We may see yet another rate cut by the Federal Reserve around March. The Fed Funds rate was cut to 3.5 percent in January, and 30-year mortgage rates hovered near 6.0 percent—nearly comparable to the 45-year low rates we encountered in 2004 and 2005 during the housing boom years. Note, however, that this only applies to conforming mortgages and not jumbo rates. A higher loan limit needs to be established for Fannie Mae and Freddie Mac to allow them to participate in the "jumbo" market and thereby bring the interest rates much lower for these loans.

Unfortunately, foreclosure rates will continue to rise in 2008. That is a given due to the weak underwriting standards of past loan originations. Subprime mortgage loss write-downs will also continue. (Write-downs are based on assumed anticipated losses and not actual losses.) Because of inactive trading of subprime debts, the market value of these "toxic" loans is unknowable. It is possible that the actual losses—after tallying the figures for the next several years—could be measurably lower. In our view, a considerable share of the recent spikes in default rates is due to investors walking away from their loan obligations. Fraud is also a factor. However, homeowners will fight hard to keep their homes, so the assumed rise in default rates based on a simple extrapolation of recent figures may not be accurate. Investors/speculators and those who obtained fraudulent loans will have defaulted quickly, thereby leaving fewer in the potential default pool at a later stage.

Recent mortgage originations are much less problematic. We are back to the basics of sound underwriting. Nonetheless, past weak lending standards will mean higher foreclosures well into 2008. Therefore, it is critical for homebuilders to sharply cut back production so as to not add to the already high inventory.

It will look a bit scary at times in 2008. The market will undergo larger than normal volatility. All-in-all, though, the economy should escape recession.



Office Market

In third quarter 2007, the Office Market experienced the most significant Index decrease—dropping 11.7 points from a second quarter 2007 high of 115.9 points—but still higher than 100 points that indicate a balanced market. The decrease represented a decline of office leasing and building transactions.

The impact of the credit crisis can be seen in many markets, especially those where mortgage firms were players in the local office market. In Orange County, California, for example, office vacancy rates jumped more than 2.0 percent in the last quarter. Ventura County, also home to major mortgage lending institutions, has experienced a 2.0 percent increase in available office space. Seattle could see higher office vacancy rates as well, given the fact that Washington Mutual announced a layoff of some 3,000 employees.

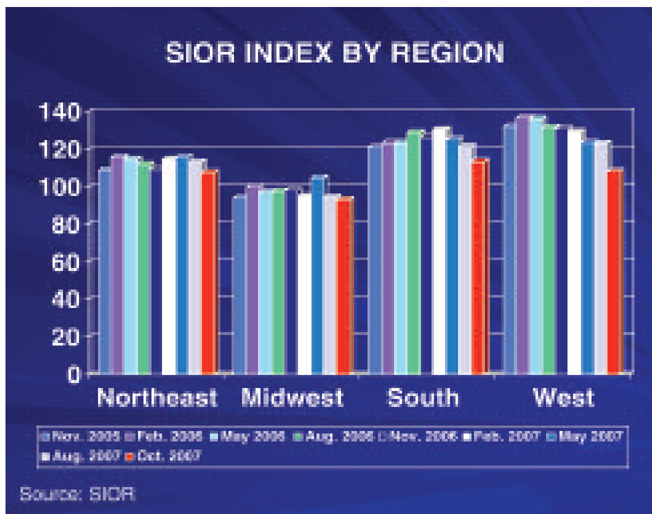
Industrial Market

With the falling dollar, goods manufactured in the United States are more attractive to other counties. As a result, U.S. exports are up this year. However, exports generally don't require the same amount of warehouse/distribution space as imported goods. Vacancy rates jumped by more that 2.0 percent since second quarter 2007 in port markets like Miami and in the major distribution center of Riverside, California. Nonetheless, this being said, port markets like Los Angeles and distribution hubs like Tucson had an availability rate under 5.0 percent in third quarter 2007.

The SIOR Index, which is a measure of practitioner sentiment and based on anecdotal evidence from SIOR members across the country, seems to suggest that the industrial markets are down at the current time. This trend could be seen over the first two quarters of 2007. The SIOR Industrial Index for third quarter 2007 was 108.5, down from the 121.7 seen at the beginning of 2007.

The declining Office and Industrial Indexes are to be watched closely even though respondents indicated that local economies were not affected by the national economy. Although the housing market normally fluctuates according to the time of year, with the spring being the most active, the Industrial and Office markets typically do not fluctuate according to the season.

Index results indicate that local economies continued to be strong, with the national economy having little or no affect on local market dynamics.



Regional Breakdown

The **West,** scoring a total of 108.3 was hardest hit by the mortgage meltdown, as many office buildings in and around Los Angeles and Orange County were vacated. On the Industrial side, fewer imports will lead to less demand for distribution/warehouse space.

Although it slipped 8.2 points from the summer Index, the **South** ranked highest of all regions, with a score of 113.3. Demand for retail property/space, particularly in Florida, helped keep the Index high. A slowdown in imports will affect demand for distribution/warehouse space in port markets.

Concerns about the subprime loan fallout and Wall Street prompted a slowdown in leasing activity in the **Northeast**. The region fell 5.45 points since the second quarter to 107.5. Here again, although the falling dollar makes U.S. products more attractive to Europeans, the need for warehouse/distribution space is not as great when we export as it is when we import products.

The Mid-West continues to experience difficulties and is the only region to track below 100. It scored 92.9 in the third quarter 2007, losing 1.6 points. Markets like Detroit and St. Louis could certainly use a boost in the economy. Until that happens, commercial real estate will remain sluggish. Chicago continues to be the success story of this region.

Did you know . . . ?

By virtue of your membership in SIOR, you also belong to the National Association of Realtors® (NAR) and can avail yourself of many benefits offered by NAR. Check out NAR's Web site at www.realtors.org, click on Realtor® Benefits on the left side of the page, and see if there are services available that meet your requirements. Types of benefits include Errors and Omissions Insurance through Geo. F. Brown & Sons; Health, Life, Dental, Disability, and Long-term Care insurance through Marsh Affinity Group Services; and Automobile Insurance through Liberty Mutual.

METHODOLOGY

The SIOR Commercial Real Estate Index is constructed as a "diffusion index," a very common and familiar indexing technique for economic measures. Other examples of diffusion indexes include the Index of Leading Economic Indicators, the Consumer Confidence Index, and the Institute of Supply Management's Purchasing Managers' Index. In the SIOR Commercial Real Estate Index, a value of 100 represents a well-balanced market for industrial and office property. Values significantly lower than 100 indicate weak market conditions; values significantly higher than 100 measure strong market conditions. The theoretical limits of this Index are a low of zero, and a high of 200, though it is unlikely that such limits would be approached as long as the property markets are operating efficiently.

The Index is based on a survey questionnaire with 10 topics. The topics covered are: (1) recent leasing activity; (2) trends in asking rents; (3) trends in vacancy rates; (4) subleasing conditions; (5) levels of concession packages in leases; (6) development activity; (7) site acquisition activity; (8) investment pricing levels; (9) the impact of the local economy on the property market; and, (10) the effect of the national economy on the property market. Survey respondents are given five choices. For each topic, five choices are provided, corresponding to conditions that are very weak, moderately weak, well-balanced, moderately strong, or very strong.

For each question, answers are tallied and the percentage of responses for each of the five choices is calculated. If survey panelists indicate "very weak" conditions (the "a" choices in the questionnaire), the answer is assigned 0 (zero) points; "moderately weak" ("b" answers) earn 5 points; an indication of "market balance" ("c" answers) receives 10 points; "moderately strong" indications ("d" answers) score 15 points; and "very strong" ("e") responses receive a maximum 20 points. Thus a score of 10 for a given question can be earned if responses are evenly distributed across all five choices, if all responses were "c," or if the answers form a "bell-shaped curve" centered around the "c" choice. The total index value is derived by summing the scores for all ten questions. Index values for each of the two property types are similarly calculated.

The survey was developed by Hugh F. Kelly, CRE, clinical professor at New York University, who has worked with SIOR on research projects since 1989.