SIOR Index – Office and Industrial Markets Advance in the Fourth Quarter 2010

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NAR Economic Overview

Economic activity quickened its pace during the fourth quarter 2010 to close the year on an upbeat note. Based on the Bureau of Economic Analysis's first estimate, gross domestic product (GDP) rose 3.2 percent in the fourth quarter, to close the year at a 2.9 percent higher annual rate than 2009. While that is good news, the rate of growth remains lower than post-recession historic averages of 4.0 to 6.0 percent.

Consumer spending provided the main foundation for the economic advance, increasing at an annual rate of 4.4 percent in the fourth quarter. Notably, during the period, consumers purchased more aggregate goods than were produced, leading to a negative change in inventories. Consumers boosted spending on goods at a double-digit pace. Spending on durable goods increased 21.6 percent, driven by a surge in purchases of cars and automotive parts, which advanced 45.1 percent. Spending on furniture and household equipment rose 11.4 percent, and on recreational goods and vehicles it increased 15.8 percent. Consumers spent 5.0 percent more on nondurable goods as well. With the exception of gasoline and fuel oil, purchases of food, beverages, clothing and shoes were positive.

Consumers also spent more on services. Housing and utilities consumption increased a modest 0.6 percent. However, consumption of health care rose 2.9 percent, transportation 1.9 percent, financial services and insurance 2.9 percent, and food services and lodging 4.1 percent.

Meanwhile, business spending continued to rebound. Private fixed investment rose 4.2 percent. The other categories of business spending posted moderate growth—spending on structures increased 0.9 percent, while on business equipment and software it rose 5.8 percent. Businesses purchased 12.3 percent more industrial equipment, while cutting back on transportation expenses by 26.6 percent. However, inventory investment fell sharply.

International trade provided another positive contribution to economic growth in the fourth quarter. More importantly, the balance of trade took a positive turn, as exports advanced 8.5 percent and imports declined 13.6 percent.

Faced with growing deficits, government spending at the federal as well as state and local levels declined. Spending at the federal level decreased 0.2 percent, while state and local governments curtailed purchases by 0.9 percent.

The employment situation remains a major concern for economic growth. The data released early this month by the Bureau of Labor Statistics was disappointing. Payroll employment grew by only 234,000 jobs in the fourth quarter of the year, closing 2010 with a net of 693,000 jobs added to the economy. This is a long way off from the eight million jobs lost over the past three years. The January 2011 data was not much better, as employment remained essentially unchanged, with the addition of only 36,000 jobs for the month.

The unemployment rate declined 0.4 percent to 9.0 percent in January. However, the number is derived from a different survey which counts non-payroll jobs as well. The survey is also dependent on fluctuations in the number of people actively seeking employment. For January, the number of unemployed workers declined by 600,000. At the same time, the number of workers who wanted to work, but lacking any job prospects had given up searching over the prior four weeks rose by 300,000.

The first-time unemployment insurance claims have declined only slightly, to around 430,000 per week in January. The figure was at 490,000 claims in January 2009. While this represents and improvement, until claims drop below 400,000 per week, the unemployment situation will continue on an elevated path, inhibiting meaningful, consistent job creation.

As the GDP data suggest, the close of the year found consumers in a more optimistic mood. The two main measures of consumer confidence and sentiment also mirrored this change. The consumer confidence index compiled by the Conference Board—a measure that considers respondents' general feelings about the job market and their finances—rose from 50.9 in the third quarter to 52.5 by the end of 2010. Meanwhile, the University of Michigan survey of consumer sentiment advanced from 68.3 in the third quarter to 71.3 in the fourth. Both indices remain below the 100 value typical of economic growth.

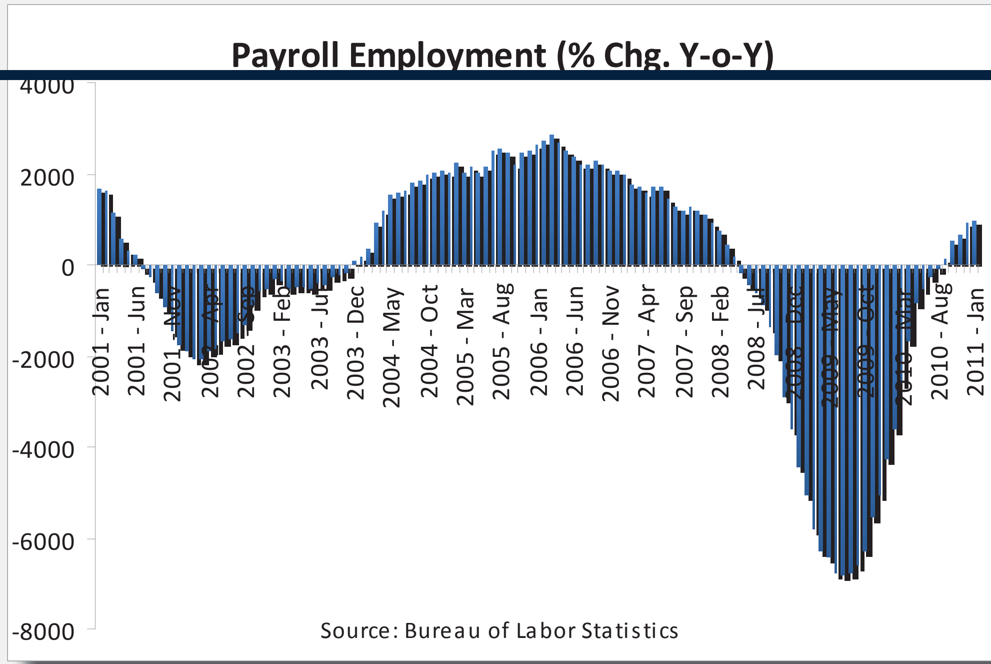
Commercial Real Estate

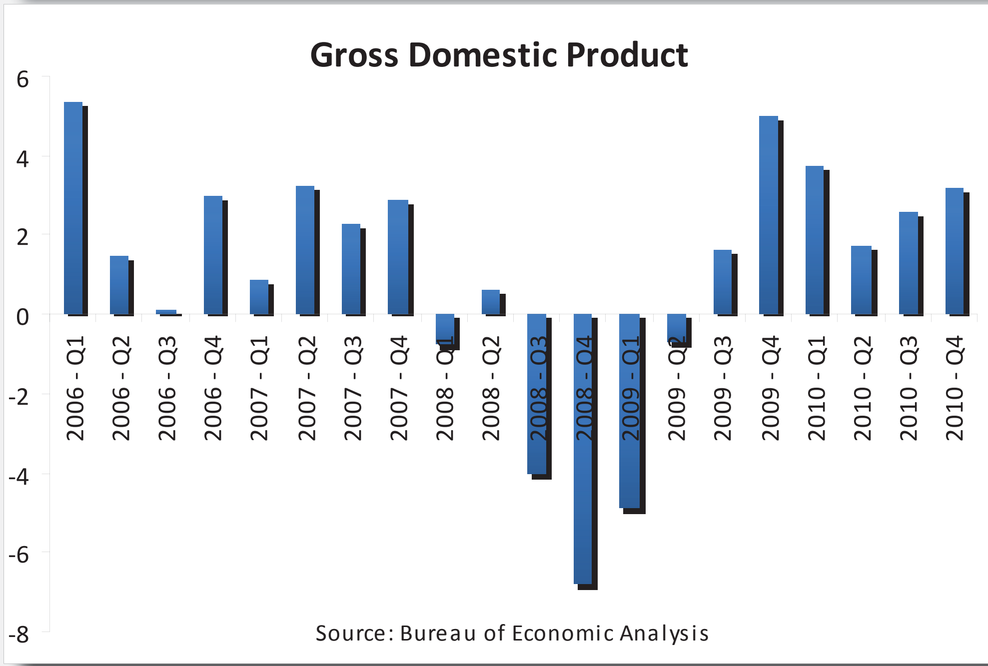
Despite doubts about the economic recovery, fears of a double-dip recession and a second round of quantitative easing by the Federal Reserve, commercial real estate ended 2010 on an upbeat note. During 2010, slightly more than 6,000 major properties traded hands, totaling $120.0 billion. The figure represents a 120 percent growth from the decade-low $54.6 billion in 2009. The significant shift in commercial investments came amid growing capital availability and global investors' changing preferences. With U.S. corporate profits at record highs, investors turned to stable markets and top tier properties. In addition, with steady growth in the U.S. economy, major economic centers like Washington, New York, Boston and San Francisco became attractive alternatives to other major international gateway cities.

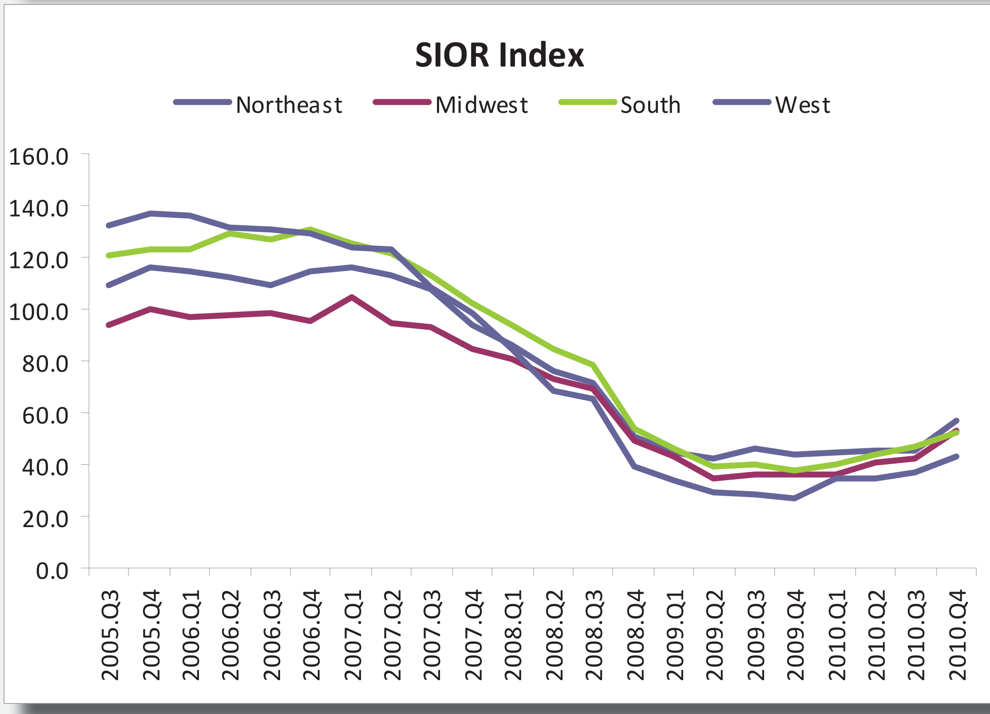
While certain property types continued to struggle with weak fundamentals and high vacancies, apartments were a clear exception. Absorption improved steadily throughout 2010, vacancies declined and rents increased. In markets with stronger economies and low unemployment, like the Washington, DC metro area, rents probed double-digit gains during the year. Not surprisingly, investors found the sector an attractive target. Sales of apartments totaled $30.6 billion for the year, a 107 percent rise over 2009. Prices for apartment properties also increased by 31 percent for both garden and mid/high-rise—the average price per unit was $111,335. Meanwhile, cap rates declined during the year, closing at an average 6.7 percent (compared with 7.0 percent in 2009).

The office market also garnered increased investor interest. Once again, markets where the unemployment rate remained low compared with the national average and where economies remained stable were attractive to both domestic and international investors. Sales of office buildings reached $40.3 billion in 2010, a 152 percent jump from 2009. In keeping with the trend for the year, prices for office properties also rose 15.3 percent from the previous year, to an average $214 per square foot. Cap rates declined from 8.3 percent in 2009 to 7.5 percent in 2010.

Industrial and retail properties also posted double-digit gains in sales. Warehouses lead the way for industrial properties with $10.9 billion in sales. Flex buildings closed $5.2 billion in







property sales, driving total industrial sales up 95 percent over 2009. Due to declining prices for warehouses, the industrial sector was the only one to register no increase in average prices for the year. Meanwhile, retail properties closed $19.8 billion in sales, driven by investor interest in strip centers, which accounted for 58 percent of sales. Average prices for retail buildings increased 9.1 percent in 2010, to $159 per square foot. Cap rates for industrial properties declined from 8.5 percent in 2009 to 8.3 percent in 2010, while those for retail remained unchanged at 7.9 percent.

After the severe decline in the hotel sector during 2009, this past year provided a slight rebound. With the large number of distressed properties entering the market at attractive prices, investors found hotel properties to be a great value proposition. As a result, sales of hotels shot up 427 percent in 2010, with full-service properties making up the bulk of the sales volume. In a telling sign, prices also increased 66 percent, to an average $161,751 per unit, while cap rates declined noticeably from 9.1 percent in 2009 to 6.6 percent in 2010.

On the other hand, commercial REALTORS® had a challenging and difficult 2010. In contrast to the broader markets, investment sales and prices declined throughout the first half of the year for commercial REALTORS®. During the year, about 40 percent of commercial practitioners reported no sales transactions. However, sales flattened out in the latter half. By the fourth quarter, 64 percent of commercial REALTORS® had completed a sales transaction. Sales of commercial properties were up 0.8 percent during the last quarter of 2010 compared with the previous year. During the same period, prices declined 16 percent.

The main culprit for the slow pace of transactions was available credit. In sharp contrast with major properties in large metropolitan areas, a significant number of REALTORS® handle properties in smaller cities where financing is handled by local and regional banks. Following the credit tightening of the past two and a half years, many potential buyers and small businesses have been struggling to secure financing.

SIOR Index Results

With an improving economy and a stabilizing commercial sector, the office and industrial markets are continuing to provide encouraging signs. The January 2011 SIOR Index representing fourth quarter 2010 data, advanced 8.1 points, the largest quarter-to-quarter gain in more

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 indicate 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 ten 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") receives 10 points; "moderately strong" indications ("d") 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 worked with SIOR on research projects from 1989.

than five years, and the highest index total since the fall of 2008. While fundamentals remain soft, respondents in some areas of the country are clearly experiencing a pick-up in the pace of leasing and sales.

The national index, based on 10 variables pertinent to the performance of U.S. industrial and office markets, moved up to 50.7. The figure marked five consecutive quarters of positive growth in both the office and industrial markets—the office index rose 7.3 points while the industrial index gained 8.7 points. The growth was present across all four major regions, with the Northeast leading the way. It is also worth noting that SIORs were more optimistic about the outlook for the next quarter—a significant 78 percent expected markets to improve, up from 59 percent in the previous quarter.

SIOR Commercial Markets

Commercial markets are slowly improving, as the majority of indicators advanced. While overall leasing activity is still soft, traffic is increasing. Motivated by low rents and generous concessions, tenants are moving into higher quality spaces or renegotiating existing leases.

Development and new construction is mostly inactive. Construction activity was lower than normal in 98 percent of SIOR markets, while 84 percent of SIORs experienced no new commercial construction. Not surprisingly, the market is skewed in favor of buyers, with prices below construction costs.

Given the growing national economy, SIOR members find that their local economies are responding more positively as well. Regionally, the Northeast and Midwest recorded strengthening economic conditions.

Outlook

Looking ahead at 2011, commercial real estate is expected to continue on a moderate growth path. As capital from both domestic and global investors enters the markets, it should disperse in a wider geographic pattern. Furthermore, as the economy strengthens and grows, the performance of underlying assets should boost values and, in turn, lead to increased capital liquidity across all property types.