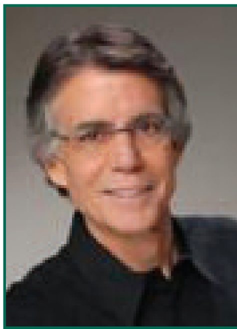
How the Housing Market Will Affect Commercial Markets



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By Elliott Pollack

We all know that real estate is a market of markets. What happens in one city might be completely different from what happens in another. However, certain basic dynamics, such as credit and general economic conditions, have an impact everywhere. The extent to which they affect some cities compared to others depends on each community's specific economic circumstances. Thus, when we ask how the disarray in single-family housing will affect commercial properties, the answer is that it depends.

The Impact Will Vary by Area

While the impact will vary, overall it will be negative. It will also be exacerbated by the fact that the United States is either in or near a recession. Given the current dynamics of the economy, GDP growth and job creation over the next six months to a year will be mediocre at best. However, some cities will be hurt more than others. Commercial markets that will be hurt the most are those that already have relatively high vacancy rates, a significant amount of construction in the pipeline, and a significant oversupply of housing.

The four states that had the most significant housing bubbles in real estate, Arizona, California, Florida, and Nevada, will be hurt because the job creation in those markets will be weak, as will population inflows. Weak or declining employment means lower or negative absorption for office and industrial space. This will be especially true in suburban office markets.

Furthermore, slower population inflows and significant declines in single family building activity mean significant declines in retail absorption. In markets where this is accompanied by vacancy rates that are already above normal, the outlook becomes downright bleak in the near to intermediate term. At the other end of the spectrum, those cities and states that are doing relatively well—mainly because of resource-related economic activity—and have only moderate vacancy rates, should survive with

far less pain. However, they will not escape the overall downward economic trends plaguing the country.

The Impact Will Vary by Product

Retail Markets: The old adage of retail chasing rooftops is correct. Retail chases income in a community; if there is sufficient income, retailers will show up. However, if there are fewer rooftops, you will see a retrenchment on the part of retailers until they are sure the demographics are there to justify the building. We are now moving in that direction.

Commercial markets with high vacancy rates . . . significant construction in pipeline, and . . . oversupply of housing will be hurt most.

Office: In many markets, vacancy rates in the office sector have been increasing. This is partly because there was increased construction when commercial real estate was much stronger. Because of substantial lead-time required to develop new office space, the space currently under construction will be coming onstream during a national recession and early stages of recovery. Thus, we are facing a situation where the absorption rate is going to slow and vacancy rates are going to increase. So in many markets, we are likely to see downward pressure on rents.

Industrial: A lot of industrial space, especially small industrial space, is used by construction-related businesses that will be contracting. In addition, it is just a matter of time until wholesalers and retailers need less warehouse space. On top of that, vacancy rates are trending up in this market as well.

Multiple Industries Will Be Affected

Since commercial markets live and die by factors such as employment and population growth, we are in a period where retail, office, and industrial markets are likely to become overbuilt in many areas. Some markets will return to equilibrium before others. In these markets, a return to normal conditions could take as little as a year or two. In other markets where the imbalances between supply and demand are more out of line, it could take three to four years to return to normal.

Here is an example showing the effect a drop in housing construction has across the economy. According to IMPLAN (*Impact Analyses and Planning*—a software package and database for estimating local economic impacts) multipliers for the Greater Phoenix area, for each 1,000 fewer homes that are built, 4,000 fewer jobs will be needed in the economy. This includes direct, indirect, and induced employment. Thus, in the Phoenix market, where single-family permits fell from 63,000 at the peak to less than 20,000 in 2008, significant job declines will be expected across many industries.

To gain some perspective on the extent of these impacts, consider the following. According to IMPLAN, the bulk of the job losses (56 percent) will be in construction—not only the workers in the field but also persons in the home office. However, another 10 percent of the lost jobs will be in trade; five percent will be in finance, insurance, and real estate; and almost 20 percent will be in services. Also affected are the manufacturing and transportation industries. Thus, these declines will affect absorption in office and industrial real estate as well as retail and, if these declines are not offset by growth in other areas, absorption will be negative.

On top of that, most markets have a fairly sizeable inventory of commercial properties under construction at a time when the absorption outlook is less than sanguine. A high vacancy rate combined with weak absorption is the formula for declining rents—regardless of construction costs. This will add additional problems to the market.

Lack of Capital

Furthermore, one only has to look at the current credit crunch to see that less money is being circulated for purposes of making business loans. Debt coverage ratios will be more difficult when pro formas show that rents are declining (or certainly not increasing) and that higher vacancy rates are more prevalent. Down payment requirements are likely to be higher at a time when less money is available to lend.

Remember, the same overbuilding and credit crunch conditions affect the housing market as well. These financial factors have created an environment where individuals are having a hard time selling their homes so that they can move to other parts of the country. In areas where population inflows have been negligible, the impact is not as pronounced. However, for fast-growing states, population flows are likely to slow in the next year or two. This will be even more pronounced in markets with the greatest oversupply of housing. Thus, for Arizona, California, Florida, Nevada, and the other growing and overbuilt states, population flows will slow compared to historical trends. Thus, we are in a cycle that is fueled by many components and that will not end anytime soon.

Consumer-Centered Factors

Not all of the pending weakness in the commercial markets are due to the oversupply of housing. Other factors exacerbate the problem. Consumers are currently being plagued by low savings rates, high levels of debt, the negative wealth effect of a flat stock market, declining housing prices, and increases in food and oil prices. All this puts substantial pressure on consumers' ability to spend. This, in turn, will fuel even more job losses and further weaken commercial real estate conditions.

Despite this litany of concerns, it is important to bear in mind that real estate is a market of markets. Therefore, it is not necessarily useful to apply the overall generalities of the national real estate market to individual communities. But, while one must look at each market on its own, the overall picture is not good. This situation is not expected to be as bad as 1988 through 1992, but many markets (especially those with significant housing oversupplies) will find themselves in difficult situations.