Latest SIOR Index Reveals National Economy Hurting Local Commercial Markets

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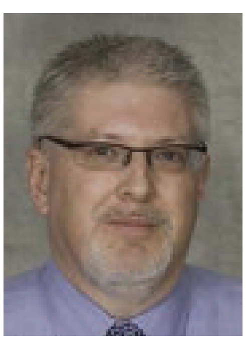

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By Lawrence Yun, NAR Senior Vice President & Chief Economist and Scott MacIntosh, NAR Senior Economist

Economic Background

The economy is not growing, but neither is it contracting. The GDP crawled up by 0.6 percent in the first quarter of 2008, matching the 2007 fourth quarter growth rate. The upcoming second quarter is likely to be similar. These figures are substandard and well below the three percent or higher expansion rate that occurs during better times. Slow economic activity typically results in several months of job losses. Net absorption can, therefore, be expected to be soft over the interim. The only good news is that 0.6 percent is still growth and we can start to put away the "R" word, which has a measurable influence in dampening consumer confidence. A low confidence, in turn, can result in falling consumer spending and further weakening in the economy.

The near-zero growth in the economy is due to disparate forces. Residential construction is taking a heavy toll. Falling new home construction and soft home sales have caused that sector to drop 27 percent. Commercial construction spending, which had been robustly expanding for the past two years at a double-digit pace, also fell for the first time since mid-2005. Fortunately, consumer spending is still expanding, albeit at a much slower pace. Business spending on equipment and software stalled in the latest quarter. Despite the weakness in these domestic segments, the big neutralizer in keeping the economy afloat has been a strong rise in exports which grew 5.5 percent.

With the economy likely to skirt recession (defined generally as two consecutive quarters of GDP contraction), the Fed is probably done cutting interest rates. Any further interest rate cut has the potential to do more harm than good. Higher inflation leads to higher long-term interest rates and much higher commodity prices, including that of oil. Given the lag time for the monetary stimulus to fully make an impact on the economy, it may be better for the Fed to sit tight rather than to cut rates.

On the fiscal side, tax rebate checks will help GDP growth reach two percent in the second half of the year. But that growth will be temporary, unless the housing market stabilizes by then. With a very high inventory of homes for sale, homebuilders will need to further cut back on production. Fortunately, any further cut backs will be mild compared to what has already occurred in the housing sector. Therefore, we can anticipate a GDP growth of two percent in 2009. Not great, but decent.

Commercial Real Estate Specialists Report Fewer Transactions

While many local real estate markets are functioning at or near historically normal levels, very serious concerns about the state of the overall national economy are making office and industrial tenants/users leery. As a result, commercial real estate professionals are reporting lower levels of transaction activity. The Commercial Real Estate Index, representing first quarter 2008 data, compiled by the Society of Industrial and Office Realtors® (SIOR) and analyzed by the National Association of Realtors® (NAR) is at its lowest 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 8.4 points to a first quarter 2008 reading of just 87.2.

The SIOR Commercial Real Estate Index is a diffusion index (see Methodology) where a score of 100 indicates markets in balance. Therefore a score of 87.2 reflects negative conditions in the commercial real estate industry for landlords and sellers. For the first time, the SIOR Index for all regions of the country is below the Index benchmark of 100 points. Although holding its "Number One" position for the country, the South, the only region with an index score of more than 100 points in the fourth quarter of 2007, registered just 94 points for first quarter 2008.

Office Markets Declining Faster than Industrial

A number of findings can be extrapolated from the most current Index results. For a start, it is fairly clear that industrial markets are declining, but not as rapidly as office markets. Office leasing activity fell by 20.6 points in the first quarter 2008 survey. The industrial index fell somewhat less—14.6 points—but still a significant drop. Office specialists were more inclined to indicate that leasing activity was much lower than normal. Industrial specialists were more optimistic and felt that leasing activity was either at a normal level or just a little lower than normal.

Asking Rents Remain Stable Overall

In terms of asking rents, fully 40 percent of respondents thought that they were in line with long-term averages for their specific marketplace. It is interesting to note that more respondents felt that asking rents were higher than normal rather than lower than normal. Rental rate growth for most commercial markets has been positive, which means that fundamentals seem to be holding steady despite a slowing in leasing activity.

Vacancy Rates

While respondents indicated that asking rates in their view, have remained relatively unchanged, the same cannot be said for the vacancy rates. Almost 42 percent of respondents indicated that vacancy rates in their particular markets were above normal, while only 26 percent stated that rates were below historic averages. Once again SIOR industrial specialists had a more positive outlook than SIOR office specialists. These views align to data on overall national vacancy rates compiled by the NATIONAL ASSOCIATION OF REALTORS® that pegged the national industrial vacancy rate at 9.5 percent as of March 2008. The corresponding office vacancy rate was 12.7 percent for the same time period.

Sublease Space Not a Factor in Market Dynamics

Available sublease space is not a major issue for markets represented by the survey participants. Almost 80 percent of respondents indicated that the level of sublease space was normal or that sublease space was playing only a small role in overall market dynamics. The relevance of shadow space is not reflected in this survey. Shadow space is space that is still under a lease obligation, but is not being used by the tenant nor is it being offered for sublease.

Tenants' Market

It is a "tenants' market" when it comes to the views being expressed by SIOR survey participants on the subject of concessions. More than half of respondents felt that tenants are reaping the benefits of the economic slowdown and landlords are providing more concessions than normal. Only 14 percent of respondents thought that current conditions are favoring landlords.

Development Conditions

According to more than half of the survey respondents, development activity is below normal levels. Unlike the residential real estate sector, where homebuilders went overboard in terms of building new inventory, commercial overbuilding has been sporadic and limited to just a few markets. In general, the cost of steel and other building material, as well as the limited credit availability, has kept the level of speculative office and industrial construction to a minimum. Lenders have been requesting that a lead-tenant be secured (ideally a tenant with a strong covenant) before construction financing is provided. In some markets, build-to-suit activity is up, but this often results in older space becoming vacant as tenants leave to move into their newly built accommodations.

One of the most noticeable opinions that can be

extrapolated from the SIOR Index is the feeling that the national economy is having a negative impact on the way business is being conducted in local markets. Clearly there are tenants and investors who are taking a “wait and see” approach when it comes to real estate transactions. The vast majority of respondents (63 percent) felt that the local economy was functioning normally, but that growth and expansion in their local markets were being hurt by fear and uncertainty about what was going to happen to interest rates, the housing market, consumer confidence, and overall national growth.

Regional Breakdowns

The West Takes a Hit

When broken down on a regional basis, the latest SIOR survey reveals that the high flying regions of the past, namely the West and the South, have experienced the greatest decline in office and industrial activity since the survey last quarter.

The SIOR Index for the West fell to 84.6 points, down 13.5 points from just three months ago. The bulk of the slowing activity is being reported in the Mountain and Pacific Regions with an emphasis on Southern California. High rates of mortgage foreclosures in Arizona, California, and Nevada are hurting retail activity, sales, and consumer confidence. Office space in Orange County, California, has been hit particularly hard because the mortgage industry was a major employer in that area.

The falling U.S. dollar has resulted in fewer imports entering the ports of Long Beach and Los Angeles and consequently a slowdown in the demand for warehouse and distribution space. This has had a ripple effect that can be seen in the Mountain Region states of Arizona, Nevada, and New Mexico—where traditional distribution hubs, in markets like Tucson, Las Vegas, and Albuquerque, have also been experiencing a slowdown in activity.

South Declines but Sub-Region, West South Central, Boasts Balanced Market

In the South, the situation is similar, although the SIOR Index numbers are higher than elsewhere. The current Index reading of 94 points is down from 102 points in the previous quarter but is still higher than the other regions. Much of the slowdown in the South has been occurring in the South Atlantic Region, particularly in Florida and Georgia. Texas, in the West South Central Region, has also been experiencing a slowdown in the office and industrial sectors, however, the combined states in the West South Central Region did score 110.5 points—making it the only region to meet and exceed the 100 point benchmark that indicates a balanced market. Both Atlanta and Dallas have experienced significant over-building. In Dallas, for example, more than one quarter of all the office space in the Central Business District (CBD) is vacant.

Concerns about the national economy are keeping tenants and investors from making decisions about real estate options.

Northwest Dips with Wall Street Concerns

The SIOR Index for the Northeast fell 7.7 points from 94 points in fourth quarter 2007 to 86.3 points in the most current survey. Much of the SIOR members' lack of optimism here can be directly related to events on Wall Street. The situation is bound to be gloomy when banks and other financial institutions—major users and occupiers of office space—lay off significant numbers of employees. As with the West, a drop in imports as a result of the falling dollar also means a corresponding decline in the demand for warehouse and distribution space in markets adjacent to ports. While there has been an uptick in exports, survey participants report that this has yet to translate into activity related to the leasing or acquisition of space.

Mid-West Remains Hardest Hit

The region that has continually had the lowest SIOR Index value is the Mid-West. This trend continues in this latest survey with a Mid-West SIOR

METHODOLOGY

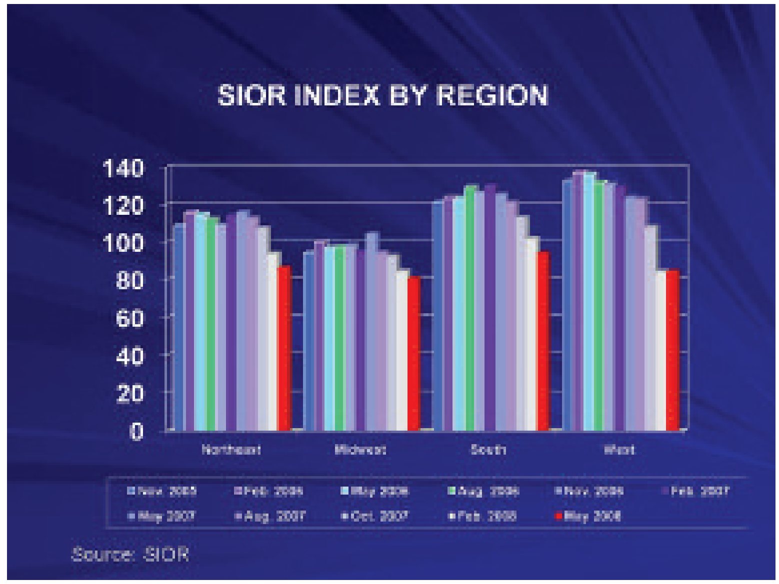
The SIOR Commercial Real Estate Index is constructed as a "diffusion index," a very common and familiar indexing technique for economic measures. Other examples of diffusion indexes include the Index of Leading Economic Indicators, the Consumer Confidence Index, and the Institute of Supply Management's 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 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 since 1989.

Index of 80.7 points down 4.1 points from the last quarter. Michigan and Ohio have been particularly affected by the economic slowdown. Traditional manufacturing centers have not been able to compete with less expensive imported goods, and the demand for manufacturing space continues to wane, despite the availability of some healthy economic inducement packages. The state of the national economy is having the most noticeable impact on the psyche and the activity of office and industrial tenants in this region. Tenants are adopting a "wait and see" attitude before contemplating an expansion or relocation.



Survey Respondents Divided on 3-Month Forecast

An additional question has been added to the survey, the results of which provide an interesting snapshot of the views of SIOR members in markets across the nation regarding short-term local market prospects. Survey respondents were asked where they thought their market would be at the end of the second quarter 2008. Responses were almost evenly divided between those who thought their market would stay about the same (39 percent) and those who thought the market would worsen (38 percent). But, a total of 16 percent of respondents indicated that they though their market would be down by 11 to 15 percent, whereas just three percent felt that their market would be up by the same corresponding percentage rates.

Without an Economic Uptick, Downward Trajectory Expected

The SIOR Index reflecting first quarter 2008 conditions, clearly points to a downturn in office and industrial leasing and sales activity. Concerns about the national economy are keeping tenants and investors alike from making important decisions about real estate options. Lenders too are being more risk averse, which is not always a bad thing. Until a change occurs in the economic slowdown, the SIOR Index will most likely continue its downward trajectory—at least for the short-term.