

Grubb & Ellis 2008 Commercial Real Estate Outlook

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Commercial real estate investment metrics painted a stellar picture in 2007. The blockbuster \$39-billion sale of Equity Office Properties (EOP) to Blackstone and the subsequent resale of many former EOP properties to other investors vaulted the market to a sixth consecutive year of record-breaking capital flows. Capitalization rates remained low through most of the year before ticking up slightly in the fourth quarter.

The EOP sale will be regarded as a peak in the real estate investment cycle, however. The turmoil in the credit markets that began in August 2007 disrupted investment transactions through the balance of 2007 and thus far through 2008, shutting off the spigot of easy money that fueled the market in recent years. The commercial mortgage backed securities (CMBS) market remains largely inactive with investors shying away from structured financial products in general. This has created an opening for balance sheet lenders such as banks, insurance companies and pension funds, which are still lending but at more conservative terms. A gap has opened between buyers expecting significant discounts and sellers clinging to pre-August 2007 pricing levels. With less debt available, deal volume has fallen, which has created uncertainty over long-term sustainable pricing levels.

The good news is that delinquency rates on commercial mortgages held by insurance companies, banks and thrifts and in CMBS are well below historical averages as a result of solid commercial real estate fundamentals. Vacancy rates are low, absorption was positive through 2007, construction levels are moderate (with the exception of retail and hotels) and rent growth, though decelerating, remains positive. While delinquency rates are expected to rise as floating rate loans reset and fundamentals soften in tandem with the slowing economy, they are likely to top out well below historical peaks.

Outlook

Real estate investment transaction volume this year will fall short of the 2007 record by a minimum of 25 percent, attributable to fewer big portfolio transactions, more conservative lenders and lingering uncertainty over long-term sustainable pricing levels. Expect cap rates to increase up to 100 basis points with Class A properties in supply-constrained coastal markets anchoring the low end of that range, and Class B and C properties in secondary and tertiary markets anchoring the high end. With high-leverage private money on the sidelines, low-leverage investors, such as institutions and foreign funds, will see this as a buying opportunity – perhaps the best one in years. High-leverage investors who bought recently and face loan resets will be forced to decide whether to invest more capital or sell their properties, potentially at a loss. The pain for these investors will be magnified if the economy slips into a recession and net operating incomes begin to deteriorate. After the dust settles, commercial real estate will return to what it has been historically: a solid, income-based asset class with a small appreciation kicker.

Here is a quick outlook for market fundamentals:

- Expect office market conditions to soften moderately in 2008 as the construction pipeline continues to deliver new space started prior to last summer's credit squeeze, while absorption declines, particularly among financial services firms. Medical office will be an exception because demand is driven by demographic trends such as the aging of the population and is less dependent on cyclical economic factors.

- Demand for industrial space is likely to soften as well, but to a lesser extent compared with office demand. The growth of imports will continue despite the weak dollar, which will power demand for distribution centers around ports and inland hubs.
- Demand for retail space is in the crosshairs of the macro-forces weighing down the U.S. economy, namely peak energy prices, high levels of household debt, the sinking housing market, and a deteriorating labor market. Expect leasing activity to decelerate modestly, though much of the space scheduled for delivery this year already has been pre-leased.
- Multifamily is the only one of the four core property types for which there is a silver lining to the housing slump. Apartment occupancies will rise in areas with high rates of foreclosure, although job losses will temper these gains. Areas with large amounts of shadow supply in the form of unsold condominiums could see apartment vacancy rates increase.
- The hospitality market will face stronger headwinds in 2008 as demand weakens just as the construction pipeline delivers a surge in new supply.

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