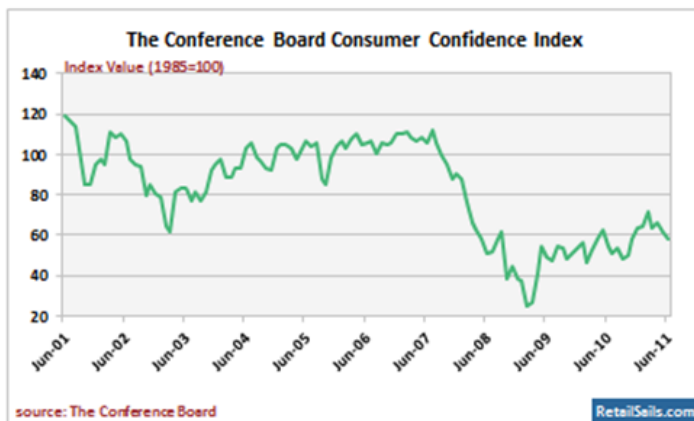


by **KC Conway, MAI, CRE**
 KC.Conway@Colliers.com

What a difference six months makes!

At year-end 2010, the outlook for the economy was hopeful. That hope in Q4 2010 turned into optimism in Q1 as a number of key economic indicators were signaling that the economy and commercial real estate were finding a foothold from which to build a recovery. In Q1 2011, it was reported that Q4 2010 GDP was 3.3%, up from -2.0% in 2009. Retail sales for CY 2010 were +6.5%, compared to -6.5% in 2009. And, consumer confidence had increased to an 8-month high. Contrast that view with the numbers on key economic metrics just reported out as we close the books on Q2 2011:

- **GDP has fallen to less than 2.0%** (1.9%), and consensus forecast is for it to remain below 2% in Q2.
- **The year-over-year rate of change in retail sales has slowed from +8.0%** in Q1 to +6.0% in Q2.
- **Consumer confidence has succumbed to the worries of rising unemployment** (up for the second month in a row to 9.2%) and elevated gasoline prices (up roughly 25% over summer 2010). In June, consumer confidence declined to an index reading of below 60 - its lowest level since November 2010.



So what happened to the foothold for recovery in Q1?

What happened was a series of events ranging from the March earthquake in Japan which disrupted manufacturing supply chains globally, to a steep rise in gasoline prices. Additionally, the downward trend in weekly jobless claims that had fallen below 400,000 claims has reversed course.

Weekly jobless claims have remained above 400,000 since the week ending April 9th.

The *U-3 (official unemployment rate)* has risen in Q2 2011 to 9.2%. States and local governments struggling to balance their budgets lead all employer categories in job cuts. Financial services have seen the next highest level of cuts.

Manufacturing layoffs, supply-chain disruptions, rising energy costs, elevated weekly jobless claims, and worries about employment have converged to send the consumer back into a savings versus spending mode.

Personal Consumption Expenditures data for Q2 2011 corroborates this retrenchment in consumer behavior:



With this reversal in key economic metrics one would expect the deterioration to translate into weak demand and declining prices for commercial real estate. However, just the opposite is occurring for all but retail real estate.

Overall commercial real estate transaction activity is up nearly 70% from this same time in 2010, and the Capital markets are on track to more than double the amount of CMBS issuance completed in CY 2010, or \$40 to \$50 billion.

What is behind this flood of capital back into commercial real estate? It is institutional capital and REITS with built-up cash reserves, as well as foreign investors anxious about holding U.S. dollars in an inflationary environment, rotating into hard assets – such as commercial real estate. The following is a synopsis for each commercial property type at mid-2011 from Colliers Valuation & Advisory Services:

MULTIFAMILY:

Multifamily continues to be the star performer of all property types. It is the only income producing property type experiencing both single-digit vacancy rates and rental rate growth. Rents for apartment properties are rising.

Rent growth is strongest in markets located in growth restricted areas, such as coastal California, Austin, Boston, and Washington DC.

Demand is also being fueled by demographics. College graduates entering the workforce and young professionals are increasingly opting to rent versus own. Constrained new supply is also an additional material factor contributing to the overall health of multifamily real estate. According to Dodge Pipeline, new multifamily completions have fallen from approximately 54,000 units in Q4 2008 to less than 7,000 units estimated for Q2 2011. This combination of rent growth and constrained new supply is attracting investment capital.

The best statistic corroborating the return of capital to multifamily is that 80 of the most active 100-apartment buyers pre-2008 have returned to the market with the purchase of a property in 2011.

Although overbuilding risk in 2H2011 appears low, the flood of capital into multifamily is a risk to be monitored. The key risk to monitor is that cap rates will once again become compressed to levels that encourage the kind of overbuilding that occurred between 2002 and 2004.

OFFICE:

Office real estate was the second best performing commercial property type in the first half of 2011. Office CRE is second in performance to multifamily real estate due to the inflow of capital and improvement in metrics such as Cap rates and additions to supply.

Average cap rates have compressed from an 8%-9% range in 2009 and 2010, to a low to mid 7% range due to competition for Class A properties in core MSAs, and select secondary markets like Denver.

The demand is strongest for leased-up properties located in Central Business Districts (CBDs) with quality rent roll profiles (credit quality tenants with limited tenant-turnover risk during the next 5 years). Institutional capital remains leery of value-enhancement and suburban office properties, where vacancies are near 20% and unemployment rates are highest. REITS and hedge funds in search of profit yields are beginning to venture into the non-core markets, but remain focused on properties located in the CBDs.

Another important indicator of the health of the U.S. office market is the breadth of buyer participation. According to Real Capital Analytics, the market has evolved from a

handful of active participants in 2H2009 to 30 that have acquired multiple properties over the last 12 months.

JP Morgan has been the most active buyer in dollar volume, and CB Richard Ellis Realty Trust, Government Property Income Trust, and Healthcare Trust of America have been the 3 most active buyers in terms of the number of properties acquired.

INDUSTRIAL:

Historically, expansion in manufacturing leads to a recovery in industrial real estate. Such a recovery has not yet developed on a widespread basis for industrial real estate.

Why? One major reason is that:

New supply outpaced demand during all but three of the last ten years (2004, 2005, and 2006).

Beyond this supply and demand imbalance, the demand determinants for warehouse space have changed due to the evolution of global trade, advances in supply-chain management, and changes in the "path-of-goods" movement across the U.S. Demand for warehouse space varies widely because of these changes. Warehouse space can no longer be examined or valued based on simplistic historic metrics such as ceiling height or the number of docks.

The storage that occurred in warehouses is now in containers being shipped. Technology in warehouses with such features as modern racking systems become more important in the demand and rent equation than the number of docks.

The net result is the location and physical features that were important determinants of industrial real estate demand 10 or 20 years ago have changed substantially. This change explains why the recovery in industrial real estate has not been as broad-based.

The investment behavior is concentrated in markets like Southern California, Northern California, Portland, Houston, Chicago, Miami, Atlanta, and Memphis. These are the markets with well-developed intermodal transportation systems.

More than any other property type, industrial/warehouse may be undergoing the most change in terms of demand drivers and physical attributes. There is no longer such thing as a generic bulk-warehouse..

RETAIL:

Unlike multifamily and office real estate, the supply and demand imbalances in retail are more substantial.

Vacancy elevated above 10%, declining rents, 9.2% unemployment and 27.86 million square feet of new retail center space still underway are not metrics that are conducive to attracting capital or encouraging retailers to expand.

At the end of Q2 2011, retail space under construction in the U.S., was approximately \$2.665 billion in hard costs. The debt capital markets have opened up to retail real estate at 70% plus leverage based on today's re-adjusted values.

However, the buy-sell spread between existing owners and the limited population of buyers is wide.

As a result, transaction activity will be limited.

Extracting a Cap rate from the market will be a challenge and likely require other techniques, such as “*Band of Investment*” and “*Mortgage Equity*.” A cost approach can serve as a reasonableness test for a discounted cash flow (DCF) analysis to explain the amount of economic obsolescence resulting from a decade of overbuilding and negative job growth. Because all markets are local, and the housing and labor imbalances vary widely, market analysis is key to defining the cure periods for retail across markets.

Conclusion:

Multifamily continues to be the star performer of all property types based on most metrics, including vacancy, rent growth, transaction activity, cap rate compression and net absorption. Multifamily is also the only income producing property type experiencing both single-digit vacancy rates and rental rate growth. Office real estate was the second best performing commercial property type in the first half of 2011. With respect to industrial real estate, we are not experiencing the kind of recovery in it that is typically associated with an expansion in manufacturing. One major reason is that new supply outpaced demand during all but three of the last ten years (2004, 2005, and 2006). Beyond this supply and demand imbalance, the demand determinants for warehouse space have changed due to the evolution of global trade, advances in supply-chain management, and changes in the “path-of-goods” movement across the U.S. Investment behavior is concentrated in markets with well-developed intermodal transportation systems, such as Southern California, Northern California, Portland, Houston, Chicago, Miami, Atlanta, and Memphis.

And, the outlook on retail real estate is best summarized by REIS's senior economist Ryan Severino:

Even though we've been out of a recession for two years, there aren't a lot of jobs out there, and people are still risk adverse. That's depressing demand for both retail goods and retail space. In addition to weak demand from consumers, landlords are grappling with competition from online sales, which reduces demand for physical stores. Halfway through 2011, it is difficult to feel optimistic about retail properties. Expect continued difficulties for the retail sector in the latter half of 2011.