IT'S THE ECONOMY

Colliers International's Chief Research Officer **WARD S. CASWELL** looks at where commercial real estate stands today and where it's headed in the years to come.

The year 2008 has come to a close, and with a new year brings new challenges. Finding opportunities among these challenges will require boldness and creativity. Understanding the direction, timing and amplitude of changes will be the key to outperforming the market. So how will recent economic and political events impact our expectations for the years ahead?

The Impact

As commercial real estate (CRE) sales volume slows, less liquidity exists for current owners. Unprecedented run-ups in transaction activity the past few years ended as available credit dissolved. "There is a spread between bids and asks, with a confounding effect of having no debt financing available. This will continue for some time," says Jack Corgel, vice president of Atlanta-based PKF Hospitality Research. The end result: Expect continued low sales activity.

Loan-to-values (LTVs), the ratio of the amount loaned to the property value, traditionally hover between 70 and 80 percent. To minimize their risk, commercial banks are considering deals with 65 percent LTVs or lower. This means fewer deals with significantly less leverage. Lower volume has removed the downward pressure on capitalization (cap) rates, thus lowering prices even as income from investment properties hold. According to David Bowden, president of Canada for Colliers International, "[Canadian] pricing has certainly been affected in early 2008 for anything other than top quality real estate. Now, at the end of 2008, even the best assets are being affected."

Cohen Financial President Jack Cohen puts prices "off 15 to 30 percent from peak to trough" in the U.S.

As sales pressures increase and a credit stasis continues, expect significant price drops. Should sales pressures increase slowly, price changes will be temperate. However, if shocks are sudden, pricing could fall precipitously. Keep your eyes on the amount of loans maturing each period. Commercial mortgage-backed security (CMBS) bonds maturing in 2009 mirror 2008 with steep increases in 2010. It's doubtful debt markets will recover over 2009 sufficiently to handle expected refinancing volume in 2010. Despite the U.S. government's Troubled Asset Relief Program (a.k.a. "The Bailout"), few believe credit markets will rebuild quickly between mistrustful trading partners.

"The entire world is deleveraging. There won't be very many transactions in 2009 as financial institutions need to clear their balance sheets so they can lend. So 2009 and 2010 will be as bad as 2008," predicts Cohen.

More broadly, the amount of outstanding commercial and multifamily debt doubled between 2001 and 2007, according to the Federal Reserve Board of Governors' Flow of Funds Accounts. While delinquency rates are low by historical standards, they are up from the record lows of 2007. It remains to be seen if levels of delinquency approach those in the early 1990s.

Together, this creates buyer opportunities. Expect increases in sale-leaseback activity as tight credit markets drive owner-occupiers to generate cash to fund operations. It also creates demand for efficient property management. "The focus today is on how you operate the asset," says Bowden. Investors may need to hold properties longer than originally anticipated.

Corgel adds, "Opportunity funds with three- to five-year hold periods are going to be hiring more operational people to make their properties work until they can exit with an acceptable IRR (internal rate of return)."

Rick Chichester, president of Colliers International's U.S. operations, puts it this way: "Real estate is going back to its fundamentals of quality, asset management and tenant retention and services."

In addition, leasing markets typically impact sale prices, not vice-versa. The unprecedented run up in sales volume from 2003 to 2007 encouraged owners to increase net operating income (NOI) to support higher prices, especially as cap rates inched upwards. Now, the normal cycle of demand driving rents and vacancies to command pricing should return. "The cost of relocation, combined with difficulties in availability of capital, will drive up renewal rates compared to relocations," says Bowden.

Reactionary Cycles

So how do we approach this market? Perhaps an analogy is helpful. Think of what would happen if your thermostat continued to deliver heat on a cold day, even when the inside temperature had passed the desired mark. Imagine also that it would not kick on again until long after the temperature had then dropped well below the mark. The result would be large fluctuations in temperature inside your home. Engineers recognize this effect and designed logic in your thermostat to reduce the fluctuations.

Commercial real estate markets behave in a similar fashion, with new construction working to cool markets which are heated by growth and demand. The markets react to the same influences as Wall Street, but instead of reaction times measured in minutes, our markets react over the course of years. These reaction lags are what exacerbate the cycles.

How it works: Upward shocks to the cycle usually start with expansion in the job markets, affecting demand for space. This affects property income, which, when compared to replacement cost, affects lending, contributing to the creation of more stock to meet increased demand. The time it takes for the initial increase in demand to circle back with space to accommodate it varies by market and property type, but two years is a good rule of thumb. The idea also works with drops in demand as vacancies rise, rents fall, income drops and eventually falls below replacement cost. Lending stops for new development. Existing construction works through to completion, delivering more space into markets that don't need it, driving vacancies higher and rents and income lower.

Understanding the commercial real estate market requires looking at the entire set of influences and then quantifying the likely effects. While impossible for the stock market, given the long lags in the system, you know how commercial real estate will perform.

Breaking it Down

Credit tightened over a year ago, reducing transaction volume dramatically and, therefore, liquidity. This was the first external shock to the system. Here's how it plays out:

1. Lower liquidity equals higher risk, which raised the premium demanded relative to other investment vehicles. Cap rates rise.
2. Income remained largely unchanged with steady and low vacancies and steady or slightly rising rents. With steady income and rising cap rates, sale values dropped. With lower values but steady income, owners refused to sell at a loss.
3. A year has passed and some owners are forced to sell. Forced sales in a low transaction volume climate result in lower prices. Lower pricing combined with expensive debt stopped new development. Potential space in the pipeline begins to dry up.
4. With the existing stock and deliveries in the pipeline, it can be compared to demand. If demand stays static, then the slowdown in construction would come back around to pricing to reach a new equilibrium.

Job losses—expected to continue or worsen—reduce demand. This is the second external

Canadian Cap Rate Levels and Trends through Third Quarter 2008

	Single-Tenant Industrial		Multi-Tenant Industrial		Office		Community Mall		Tier I Regional Mall		Multifamily	
	Overall Cap Rate	Chg	Overall Cap Rate	Chg	Overall Cap Rate	Chg	Overall Cap Rate	Chg	Overall Cap Rate	Chg	Overall Cap Rate	Chg
Vancouver	6.4	up	6.4	up	5.7	down	6.5	down	5.7	same	5.3	up
Edmonton	6.7	up	6.8	up	6.6	up	6.75	same	6.2	up	6.1	up
Calgary	6.4	up	6.5	same	5.9	same	6.75	up	5.7	up	5.7	up
Toronto	6.7	up	6.9	same	5.9	down	7.25	same	5.6	down	6.4	up
Ottawa	6.9	up	7.1	same	6.3	up	6.875	n/a	6.1	up	6.1	up
Montreal	7.1	same	7.3	up	6.0	down	7.625	same	6.1	down	6.5	up

Sources: Altus, Colliers International

shock to the system. This lowers occupancy rates for six to 18 months following the losses. This lower income further depresses values, which then follow the same cycle as the first shock.

Leading indicators help gauge the timing and amplitude of rent and vacancy changes. The best predictive indicators of leasing markets come from a review of the pressures and trends in landlord concessions. Pressures come from supply and demand concepts. Supply is gauged by looking at existing vacant space and new construction deliveries. Demand is measured with net absorption, which correlates with employment, gross domestic product (GDP) and consumer confidence.

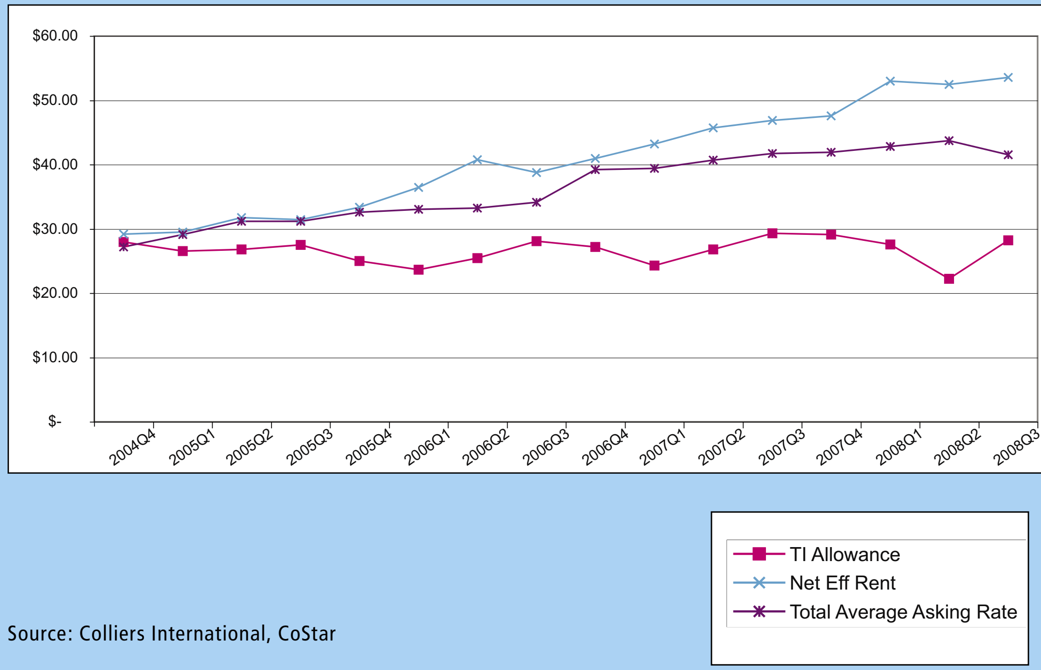
The U.S. picture through second quarter 2007 shows office and industrial absorption outpacing construction, meaning demand was stronger than supply, creating upward pressure on rents. Demand began to fall while construction activity continued. With varying lags across markets and property types, rents held steady for up to a year before declining. Prior to this, however, concessions yielded to pressure. Rents are holding steady in Boston, Dallas, Portland, Ore., Sacramento, Calif., and San Diego. Rents are dropping in the formerly fast-growing markets such as Phoenix and greater Los Angeles.

Markets like San Francisco are interesting. Concessions including free rent, inducements and tenant improvement allowances rose across all classes of office space, even as asking rents rose slightly. In the third quarter of 2008, rents revealed slight drops.

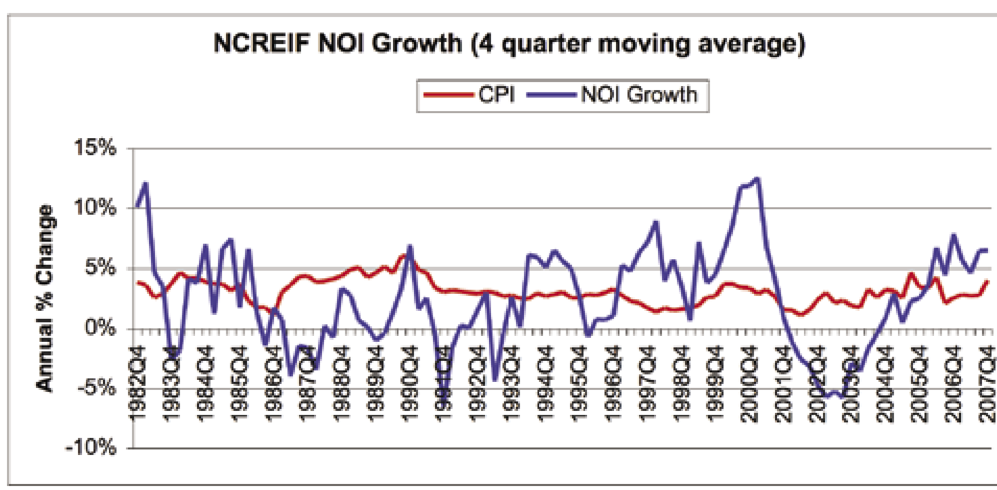
Tenants should look beyond asking rents while landlords should consider the value of inducements in managing long-term cash flow along with reviewing the prospects for their tenants' financial health.

Unfortunately, most CRE participants track asking rents and vacancies as a proxy for NOI to determine property value, but both are trailing indicators. Changes in vacancy eventually put pressure on rents. Tenants are concerned with the total outlay of cash and the timing of that outflow. Building owners have the same concern plus the cost of property maintenance. In general, lease negotiations involve haggling over allowances for tenant improvements, free rent periods, and term—none of which appear within quoted asking rent.

Class A Office Rents for San Francisco's Financial District



Source: Colliers International, CoStar



Source: NCREIF

Additionally, properties marketed for lease are often considered on asking rent range. As a result, owners hesitate to alter asking rent. In contrast, the net effective rent and the amount of concessions are superior leading indicators of market conditions.

The Verdict

In his book, *Moneyball: The Art of Winning an Unfair Game*, Michael Lewis notes that a smart manager could outperform the competition by carefully analyzing better data. Better data means moving beyond the traditional statistics used to rate players.

In the end, by looking at the right variables and knowing how they interact with lags, you have a much better indicator on the state—and direction—of a market, which ultimately improves your investment decisions. KL