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New England SIOR and NAIOP hold annual End of the Year Review

January 06, 2010 - Spotlights

The New England Chapters of SIOR and NAIOP held their annual End of the Year Review and 2010 Forecast on Thursday, December 3rd at the Hyatt Regency. This event attracted over 350 commercial real estate practitioners to hear an economist and a panel of commercial real estate experts. Greg Klemmer, SIOR, Chapter president, introduced the moderator and panelists and thanked the sponsors. The moderator was Bret Wilkerson, CEO of PPR Global who offered his overview of the state of the national and regional economy. The expert panelists included Greg Cahill, SIOR, senior vice president of Lincoln Property Co. on the Industrial Market; Jack Kerrigan, executive vice president of Grubb & Ellis on the Suburban Market; Mark Winters, executive director, Cushman & Wakefield on the Cambridge Market, Chris Cuddy, senior vice president of CBRE on the Boston Market; and Frank Petz, executive vice president of RBJ & Associates on the Capital Markets. Here is a summary of their presentations.

Bret Wilkerson, Property & Portfolio Research

Wilkerson started with his overview of the national economy and stated "the beatings will continue until morale improves." He then observed that the U.S. GDP recovery was "I" shaped but now its moving forward. Hong Kong is rolling in stimulus recovery but Europe is still hurting. Asia in general has a more "V" shaped recovery while the U.S. is lagging the rest of the world and has a more "L" shaped recovery. The Feds have expanded their balance sheet to \$2.1 trillion from \$1 trillion from October '08. The Feds are in fact buying a great deal of RMBS. TALF has long-term programs but the Feds need to figure out an exit strategy and therefore will be careful for the remainder of the year. Since the de-leveraging period started, debt has increased \$6.3 trillion and at this rate of de-leveraging it will take the Feds 19.7 years for residential real estate to get back to the good times. The issue right now is inflation which is being driven by capacity of utilization running at 70% but historically it's been 80%. Velocity has not picked up and the Feds are still printing a lot of money. It is imminent that there will be inflation even though today it is deflation with a weak U.S. dollar.

Is Inflation Good for Commercial Real Estate?

Wilkerson concluded that inflation is good for values in real estate and prevents new development so existing building values will increase. Capital flowing back into real estate could also have a huge impact in the next two years.

Job Growth and Income

Job growth will be the last to recover and probably will not happen until 2011 but values will increase earlier. The consumer is experiencing a decrease in income (-3.5%); dividends are down (-20%) and 30% of the unemployed have been unemployed for 26 weeks or more. There will probably be no income growth until late 2011 into 2012. From '92-'01, the fast growth was with electronics. From

'07-'09, the growth was with auto dealers, necessities, health care, groceries and hobby stores. So the consumer has basically hunkered down on spending. However, those old pants are starting to wear out and the consumer is going to have to spend money for replacements. Each past recession has experienced less job growth and it will be so once again because the economy is less flexible and companies don't want more wage expenses on their P&L. The average U.S. worker works 33 hours per week and that is way down from the past decades. For Boston, the job growth has been with education and health care due to federal stimulus money. Education represents 20% of the jobs in Boston and hi-tech represents another 10% of jobs. The office tech market will grow and will experience pent up demand with business expansion, IT purchases and with exports in other countries. In the last 15 years, Boston has never been rated #1 in the U.S. in the office market and in the next 2 years, Boston will be #1 in office growth.

Commercial Rents and Housing

2010 will experience further rent declines. Why?

1. The level of vacancies are still too high
2. Tenants won't have robust absorption
3. The risk with rents as transactions increase will see landlords cutting new lease rates based on their new cost basis being lower from recent purchases.

The great news is that the housing market has never been so affordable! The sales volume is up since April '09 with one-third of the buyers being first timers due to low interest rates and the federal credit. The next 5-6 years suggests strengths.

Loan Maturities

The biggest problems will occur in the next 3 years when \$1.5 trillion of loans has to be refinanced. The CMBS is not an issue until 2025. The issue is with banks that hold construction loans. The market is overbuilt on a national level with retail, housing and condos.

How To Fix the Problem?

1. Conduct a stress test first on banks but Wilkerson really sees this a local market problem with regional and community banks that now hold 50% commercial loans.
2. Modifications that are going-on; the lender is being reasonable as long as you continue the interest payments. Lenders don't want OREO on their books.
3. Dealing with foreclosures and it will experience an increase with volume. There are \$12 billion in construction loans and \$4 billion in permanent financing and the banks want these loans off their books. Development is a real issue as construction work does not generate income for the developer.

So the answer is that the system needs more equity; CASH. There is a need to underwrite rent growth. Values always increase before rent growth and that will probably not happen until 2011. From 2011 and beyond, rents and volume become better especially if there is inflation which will be good in attracting equity to real estate.

Greg Cahill on the Industrial Market

Cahill stated that the outlook is cloudy at best. The recessionary affects will erode the market as pricing has changed. There is instability and it is the largest post WWII recession. Many institutional owners want to exit industrial product investments. The market is still looking for a bottom. There is a negative absorption of 2.5 million s/f. Asking rents have fallen 9% YTD. Manufacturing jobs are down 6% from the 3Q '08. Vacancy increased each quarter in 2009 to 15.7%. Asking rents are \$5.11 per s/f, triple net. The total Boston area market size is 475 million s/f of flex and warehouse.

There is a 16% vacancy on Rte. 3; Rte. 24 is in flux; rents have fallen from the mid \$6s per s/f to the high \$3s. Renewals or lateral moves are a sense of false security. Asking rents have no correlation so landlords just want to make a deal.

Industrial Sales and the Future

Cahill is seeing a continuation of sales falling as there is continued disconnect between price and value. User sales are in the \$25-85 per s/f range in older buildings and with longer term leases. The best deals in the next 6-12 months will be at lower rents. Job growth will be problematic. The 2010 drivers will be weak. Occupancy might stabilize in the 3rd or 4th Q of '10. There will be more free rent and concessions, higher vacancies and finding the bottom will become helpful.

Jack Kerrigan on the Suburban Office Market

Kerrigan stated that the market size is 106.6 million s/f with a vacancy of 16%. YTD absorption has been negative 1.5 million s/f. Rents have fallen 15 to 30%. There is good news however if you are a tenant. The leasing market is not dead. Bay Colony has 66% rent decline from \$68.50 per s/f in '00 to \$23 per s/f in '09. Class A average asking rents are at \$31.46 per s/f. Rents are back to mid-1980s level. In the 3Q of '09, the Northeast 128 office market vacancy jumped to 19% with an average asking rent at \$29.39 per s/f; Rte. 495 jumped to 20.9% vacancy and an average asking rent of \$20.70 per s/f. Rte. 495 south has a vacancy rate of 20.9% and asking rents of \$20.72 per s/f.

So the challenge is how do you value a building?

Unemployment in Massachusetts has declined as there are over 76 major colleges and universities and producing a lot of new workers. There is no strong suburban market but the strongest right now is Rte. 128 and the weakest is Rte. 495. The Rte. 495 market has still not recovered from the tech bust. Sublet space is not necessary either as companies are being conservative in space needs. The market will probably not experience any new speculative development "for a very long time." The future trend will be for build-to-suit development. The opportunities are with land holdings and permitting sites.

Mark Winters on the Cambridge Market

Winters summarized the market as having 18 million s/f of which 10.5 million s/f is office and 7.5 million s/f is lab space with an overall vacancy rate of 14.7%. The Class A lab market has a 1% vacancy while Class B and C has 28.7% and 36%, respectively. Start up companies are minimal as it is driven by venture capital which has evaporated. Because of the lack of start-up companies, the Class B and C market has suffered. Class A space with lab pre-built has a 1% vacancy. If the space has shell space the vacancy is 13% of which 2 buildings in the market represent the majority of the 13% vacancy. The average rent is \$49.26 per s/f, triple net. The overall absorption is negative 57,000 s/f.

For office space, the Cambridge rents are \$25-45 gross. The effective rents are down 20% in the last 12 months. Class A vacancy is 16.1%; Class B space is 7.7% vacant and Class C space is 12.9% vacant. The migration of venture capital firms has been good. Small funds and start-ups want to be closer to Cambridge universities and life sciences.

2010 and Future

New construction will occur but not on a speculative basis. It will happen with credit tenants and long-term build-to-suit leases.

Chris Cuddy on the Downtown Boston Market

Cuddy concluded that 2009 was bad but it could have been worse. The first half of '09 had no

demand but the second half of '09 has seen ample activities with 7 leases over 100,000 s/f and almost all renewals and downsizing for the sake of saving money. The average asking rent is \$43.92 per s/f and the overall vacancy is 9.5%.

Demand Today and Tomorrow

The demand is down 32% from 2 years ago. In the next 3 years, the demand drivers should be from financials, legal firms and investment firms. Some new construction might occur as well. In '09, there was a sublet market of 1.6 million s/f but very little sublet demand because direct space rent is low and tenants do not want to the risk of sublet space and lease expirations. Forecast: 2001 was the worst year of negative absorption and 2009 will be the second worst year with negative two million s/f. There will be more "blend and extend" with existing tenants. In 2010, the market will experience further rent deterioration.

Frank Petz of the Capital Market

Petz was the last of the panelists and posed a question to the audience; "How do we get out of here?" Petz stated that there are signs that the recession is over and that business spending has picked up. Petz summarized the Boston area sales and said that in '09 sales were down 92% with 50% decrease in average deal size. The average selling price dropped from \$244 per s/f to \$138 per s/f. The average deal size over the last few years were as follows:

YTD: '09 \$24 million

'08 \$25 million

'07 \$ 54 million

'06 \$ 52 million

Some assets are selling at 25% of replacement costs with an IRR ranging in the 9-14%.

Foreign Capital

European and Asian real estate markets are up. Asia is up 75% since Jan. '09 and that should be followed by U.S. The U.S. lags behind the rest of the world and Boston is lagging. The Germans are the biggest player in Boston and 5 of 7 deals were foreign purchases. Eighty-seven percent of Boston CBD office sales were with foreign buyers. There is plenty of capital out there and we need this capital to buy. The lenders have a lot of pressure and private equity has pressure as well.

REITs were sellers for liquidity but have moved to "buyers" in the last 90 days. There is not much private equity being raised but a lot of money is situated on the sidelines and has moved to other assets classes.

Funds raised for real estate is now down 76% this year and pension fund advisors will look to sell as financing comes due in '10. In the U.S. the CMBS and national banks represent 70% of total distressed assets. Boston troubled loans are approximately totaling \$3.8 billion (8% of '05-'08 sales volume while the U.S. average 10%). Boston is in fair shape compared to other U.S. cities while Las Vegas is in worst shape.

Theoretically Boston loan losses are 13% less than U.S. average. Pricing and value has huge disconnect and it's too difficult to value properties. Rte. 495 de-valuations are at \$0.53 on each dollar of debt while downtown assets are just under the \$0.75 for every \$1. So there is a lot of opportunities to buy in '10 and '11.

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