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Grubb & Ellis predicts commercial real estate will decline more slowly in 2010, recovery in 2011

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Grubb & Ellis Company released its 2010 Real Estate Forecast, which indicates that 2010 commercial real estate fundamentals will decline more slowly than in 2009, with most property types reaching bottom near the end of the year and beginning a slow recovery starting in 2011.

"The national economy has begun a slow and cautious recovery, but the labor market, which often lags the broader economy, will turn around only gradually with sustained improvement unlikely before the second half of 2010. Because commercial real estate lags the labor market, it still has a ways to go before reaching its own low point," said Bob Bach, senior vice president, chief economist of Grubb & Ellis. "The good news is that the freefall we saw in 2009 is over and the future is more certain, giving owners and users of real estate the confidence to begin making decisions again."

Locally, demand for all property types is expected to remain low in 2010, but researchers predict corporate downsizings to subside somewhat and increases in the region's vacancy rate to begin to stabilize by the end of the year. The fact that the Boston area has seen little speculative construction in recent years positions the area well for recovery when the national economy rebounds.

The Boston commercial real estate market is in a different position now than we were after the 'tech bubble' burst in the early 2000s. Unlike the last recession, which largely hit the technology sector, today's recession is impacting industries across the board. As a result, this recession may be more prolonged than the previous one; however, Boston's strength in growing industries like the technology sector places it in a better position to rebound once the national economy recovers.

Commercial Real Estate

Investment Transaction

Volume to Grow in 2010

The investment market, which saw transaction volume maintain artificially low levels in 2009 as banks, CMBS servicers and other lenders delayed working through distressed assets, will start to see some of these assets finally come to market in 2010, prompting an increase in sales volume of 20% to 30% over 2009 levels. Prices, already down 40% from their peak in October 2007, may decline another 10% to 20% in order to meet buyers' expectations.

"Many have called commercial real estate 'the next shoe to drop,' but that's really an exaggeration," said Bach. "It implies that commercial real estate could wreak damage on the financial system equivalent to the subprime residential mortgage losses, which is highly unlikely because the value of outstanding commercial mortgages is a fraction of the value of outstanding residential mortgages. Nevertheless, losses will mount over the next several years. If banks aren't lending because they're coping with losses in their real estate portfolios, this could impede the economic recovery."

Overall, the fact that banks likely will begin writing off their losses on distressed assets in 2010 means that the capital accumulating on the sidelines will start being deployed, and highly leveraged

buildings, many without the capital necessary to attract tenants, will transfer to new ownership, removing what was a major impediment to recovery in the investment market.

Transaction volume in the Boston investment market, which fell by 85% to \$1.2 billion in 2009, from a market-high of \$13.8 billion in 2007, will remain low. Though the delinquency rate on commercial real estate mortgages continues to rise and some lenders have commenced with foreclosure sales, most lenders will prolong taking serious action against landlords still generating cash flow in the hopes that the market will recover soon.

Office Vacancy Rates Will Reach Modern-Day Record

Nationally, the office market begins 2010 approaching record-high vacancy rates and the most sublease space available since the "dot-bomb" era. According to Grubb & Ellis, a rebound in the office sector is heavily dependent upon employment, and the slow job growth inherent in a sluggish recovery will delay improvement in the office market.

"Early 2010 may see a few isolated months of hiring, but sustained growth in employment is unlikely before the second half of the year," said Bach. "The fact that the recession has come and gone, however, should provide the certainty necessary for tenants to start making decisions. We may see leasing volume increase in 2010 as a result."

The national office market's vacancy rate is expected to reach 18.5% to 19% by the end of 2010, the highest on record since Grubb & Ellis began tracking the national market in 1986. Other leasing fundamentals are also expected to continue to deteriorate, albeit at a slower pace before reaching a growth point in 2011. The company expects the market to register an additional 25 million s/f of negative net absorption and rental rates to decline 2% in 2010, compared to 62 million s/f of negative net absorption and a 5% reduction in rental rates in 2009.

Grubb & Ellis researchers expect the Boston office market to start to stabilize in 2010, though lack of demand will continue to put downward pressure on rental rates as landlords and their lenders scramble to attract what few tenants there are in the market. The good news for landlords is the lack of new supply - the pipeline for new office product has been virtually dry in 2009 and will continue to be dry in 2010.

The vacancy rate in the Boston office market is expected to increase to 14.2% in 2010 and experience 2.2 million s/f of negative net absorption - a slowed rate of deterioration following the 3.5 million s/f of negative net absorption that posted in 2009. Overall, the market's down slide will slow in 2010, but a rebound will have to wait for an improvement in Massachusetts' unemployment rate.

Recovery in Sight for Industrial Market

Despite increases in vacancy and negative net absorption, economic indicators that generate demand for industrial space saw upticks in late 2009. These include global trade, freight shipments, manufacturing activity and even retail sales. This, along with the weakness of the dollar, hints that a recovery in the industrial market could be on the horizon.

Leading market indicators for the industrial sector turned earlier than those for the retail and office markets, which is promising, Grubb & Ellis reports. The company also notes that the industrial sector is less dependent on job growth than the office, retail and multi housing sectors, which means it could recover earlier, with vacancy rates beginning a gradual recovery in late 2010 and rental rates following in the second half of 2011.

Vacancy in the industrial sector is expected to reach 11.4% by the end of 2010, 70 basis points higher than year-end 2009. Landlords will have to weather 75 million s/f of negative net absorption, though that figure represents less than half of the 158 million square feet of negative net absorption

in 2009. Warehouse rents will decline 5%, an improvement over the 6% decline in 2009.

In the Boston area, the region suffered substantially during the recession, particularly after a few mid-sized life science companies declared bankruptcy and put several hundred thousand square feet of R&D/flex space onto the market and venture capital dried up for startups. The industrial market faces an uphill battle in 2010 as large corporate users continue to consolidate and downsize their existing operations after committing to too much space in 2007 and 2008 when prospects for the technology and life sciences industries seemed limitless. Among the transactions expected to take place in 2010 will be a "flight to quality" as companies move into better facilities for similar pricing.

Vacancy in the Boston-area's industrial sector is expected to reach 16.2% in 2010 as approximately 2.8 million s/f of negative net absorption enters the market. The industrial market expects no new construction deliveries in 2010, somewhat lessening the impact of increased vacancy in the region.

Retail Sector Faces "New Normal"

With a significant recovery in job growth unlikely to get underway until later in 2010, Grubb & Ellis expects the national retail vacancy rate to continue to climb, contributing to additional negative net absorption. Recovery in retail will be weak in 2010, but it will begin to generate demand for retail real estate starting in 2011.

"It's unlikely the shock of the Great Recession will produce a generation of frugal consumers like the Great Depression did, but on the other hand, retail sales will not bounce back to their debt-fueled levels of 2006 and 2007 anytime soon. Retailers and owners of retail real estate will need to adapt to a 'new normal' in consumer attitudes that may last for some time, including more conservatism and attention to value as households rebuild their savings," Bach noted.

In Boston, 2010 will likely look a lot like 2009. In general, retailers will experience flat sales, under performing stores will close and vacancy will increase. There are a few exceptions to the continued decline. Prime locations in both the suburbs and downtown held up well and will continue to do so in 2010. Also, some retailers are taking advantage of empty shopping centers, low rates and landlord incentives to secure great locations and capture market share that might not have been possible at the market's peak.

Multi Housing to Benefit from Boomers' Babies

Similar to the other sectors of commercial real estate, job growth is key for a robust recovery in the multi housing arena. The apartment market suffered in 2009 as the growing wave of residential foreclosures increased the supply of shadow units - unsold condominiums and houses being offered for rent. Longer term, apartments will benefit from the return of homeownership rates to pre-bubble levels or less, as well as increased volume of 20- to 29-year-old apartment seekers as the boomers' kids move out on their own.

Editor's Note: The complete Grubb & Ellis forecast and regional forecasts are available at www.grubb-ellis.com.

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