nerej CELEBRATING 55 YEARS

Escaping air from residential bubble inflate a commercial?

October 18, 2011 - Spotlights

Occasionally, I've written articles about real estate "bubbles" and my conclusion has been that they occur more frequently, and with greater volatility, than in the past. My last time "bubble" article was about a year ago, when the housing market was slightly on the rebound (due to stimulus), and commercial real estate market was flat. In the brief time since then, the situation has reversed aggressively in opposite directions. Depending upon the indicator of housing sales, starts, or contract signings, the residential market has fallen between 5% and 10% from a year ago. On the other hand, commercial real estate activity has increased by some measures at 10% or more.

In thinking about this dichotomy, I asked myself whether we're all living in the same world. Isn't it the same warm bodies that occupy both houses and offices? How can one market be down so long at the bottom, with predications of instability for the next few years, and the other market moving higher in the same weak economy? Can there be irrational depression in housing and irrational exuberance in commercial, all at the same time? When one market collapses, do we simply move investment to another?

Clearly, none of the markets should behave exactly like one another. Housing is more emotional, not typically dependent upon rents, perhaps more tied to a neighborhood and amenities than commercial. Commercial is more tied to business demand, regional locational factors, access, etc. However, they both rely generally on economic growth, available credit, and a stable balance between supply and demand.

Regarding credit, money is cheaper than it has ever been, and the Federal Reserve has committed to keeping it that way. It is true that residential buyers may be facing more scrutiny in obtaining debt due to the housing crisis, but obtaining commercial debt is also subject to rigorous due diligence. I conclude that there is no significant lending difference causing these markets to go in different directions.

I pondered whether supply/demand inbalance was a significant factor. Clearly, houses were over built particularly in some of the areas of the country where there is a glut. However, in supply constrained areas such as the Boston area, there has been little if any new construction in residential, similar to the office market. In our area, there is simply very little new construction, supply is constrained, and thus little difference in this aspect.

If market fundamentals are not causing a significant difference between residential and commercial markets, that is, there are no new people, no new jobs in either, then there must be something irrational at play: The foundation of a commercial bubble?

We will not see a bubble in residential for quite awhile, since the statistical evidence, the news stories, the evidence of foreclosures, have all sunk into our heads that the recovery will be slow. In short, we have seen, and we believe, that this bubble has popped. The opposite is true for commercial real estate. You hear every day that there is an enormous amount of liquid cash seeking yield. There is competition in the market for property, almost a desperation to get modest yields of 3% to 5%, which are still above yields available elsewhere. Yet, while there has certainly been some improvement in the economy, and some modest increase in jobs in certain areas, commercial rents have not improved commensurately with the increase in sales prices of buildings. It cannot be said that recent interest in commercial real estate is based upon market fundamentals. It can only be said that this same interest is based upon investors' expectation of the future, and that there are many buyers competing for properties, creating some momentum in herd mentality.

By most definitions, we are witnessing a small bubble in commercial real estate which will either be sustainable with an economic turnaround, or will be popped. Investors who can hold on will be "right" in whatever time frame it takes. However, others less unfortunate who might follow the herd will suffer if the economy takes too long to improve. The additional wrinkle will be if there is any change upwards in interest rates. Commercial investors had better lock historically low rates as long as they can, just in case rents don't increase as planned.

Daniel Calano, CRE, is the managing partner and principal of Prospectus, LLC, Cambridge, Mass.