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Market fundamentals remain stable despite slight increase in vacancy rates

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The RI commercial real estate market is healthy with the current market in the tenant's favor. There is a feeling that the capital markets instability will bypass RI, and while there may be a slowdown in institutional investment and sales, this is buffered by a current occupancy level of 88% in Providence Class A space. On the surface that may not sound strong, but of the 330,000 s/f of available Class A space nearly 48% is at the Foundry and currently in shell condition and will be built out upon signed leases. Therefore, excluding the newly added Foundry space, the Providence Class A office market is at a stable 94%.

Economy

The economy is expected to remain at or near recessionary levels throughout 2008. Both consumer and business confidence have declined sharply. Inflation has edged up 4%, due in part to record energy costs and rising food prices. It is anticipated that discretionary consumer spending will remain low given the expectation of continued job losses.

The banking and financial sector has been hard hit by job cutbacks. The economy lost 20,000 jobs in April, bringing the tally to 250,000 jobs for the year. The losses to date are relatively low compared with past economic downturns. The previous two recessions (1990-1991 and 2001) were marked by massive layoffs and corporate downsizing, which led to significant blocks of space being returned to the market.

In contrast, market fundamentals remain stable albeit with vacancy rates edging higher. Most businesses are not over-extended in terms of labor or space. In the past few years, companies have focused on improving space efficiencies, increasing shared workspace, institutionalizing telecommuting, and in general, utilizing technology to improve labor productivity. Thus, job losses are not as pronounced this time around. Average employment growth in the last expansion period was 2.4 million hires per year, which was near to full national employment. This time, average employment has grown at a 21% slower pace compared with that period, with 1.9 million new hires per year during the past six years.

Market Overview

As expected, market fundamentals weakened in the first quarter of 2008, with lower occupancy levels across sectors. This market weakness is still considered moderate based upon historical trends for specific geographic regions and property types. The weakening is not widespread and only affects select portions of the country. Overall, investment activity has seen the most negative impact, with volumes declining by 65% year-over-year. Purchasers have continued to remain on the sidelines, and sellers have not been in a rush to sell. Cap rates have increased overall, but the magnitude of change varies widely across property types and regions, and a paucity of transactions may understate the degree of cap rate movement.

Office

The national downturn vacancy rate decreased slightly to 10.2% in the first quarter of 2008, compared to 10.3% at year's end. In contrast, the national suburban office vacancy rate increased from 14.2% in 2007 to 14.9% in the first quarter of 2008. Office investment activity in the first quarter 2008 continued to be sluggish, dropping by 62% from $34.2 billion a year ago to $13 billion this year, according to Real Capital Analytics.

Although occupancy costs for the most part remain stable, tenants may have an opportunity to secure lower rental rates in markets where office vacancy has increased sharply. The economic slowdown is beginning to have an impact on the office market as tenants defer real estate decisions. Even with a turnaround in the economy, it will take at least 12-18 months for office leasing to fully rebound.

Industrial

The industrial market is showing signs of weakening. The nationwide industrial availability rate increased slightly from 10.2% at year-end 2007 to 10.5% in the first quarter of 2008. In the first quarter of 2007, a robust 22.7 million s/f of absorption occurred; in contrast, the first quarter of 2008 resulted in only 1.5 million s/f of absorption.

Capital Markets

The capital markets continued to falter. First quarter results from Real Capital Analytics indicate that commercial real estate investments are down significantly - from $142 billion in first quarter 2007 to $43.9 billion in first quarter 2008. The slowdown in investment activity is due to the near disappearance of CMBS financing, investors re-pricing assets in light of a weakened economy, and sellers' and buyers' expectations being out of alignment. Investors will increase their focus on market fundamentals, savvy marketing and sound building operating principles to identify opportunities and maintain and potentially increase asset values. Lenders have reacted to the market fluctuations with lower loan-to-value ratios, shorter amortization periods, and increased scrutiny of potential borrowers.

Overall cap rates have moved up between 75 to 175 basis points during the past six months. The effect of this cap rate increase is much more pronounced in the B and C quality assets in secondary and tertiary markets. A quality assets in primary markets have seen little negative impact in capitalization rates to date.

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