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## **New England SIOR/NAIOP hold mid-year market review June 10th**

July 08, 2009 - Spotlights

The New England SIOR/NAIOP Mid-Year Commercial Real Estate Market Review was held on Thursday, June 10th at 8 a.m. at the Westin Waterfront Hotel. Over 350 commercial real estate practitioners attended to hear Doug Poutasse and an expert panel. The event began with an economic overview by Doug Poutasse, executive director of NCREIF and a panel of market experts that gave a summary of each sector of the Greater Boston's commercial market. The panelists explored the drivers and market fundamentals behind 2009 statistics, including emerging trends in specific markets, new growth areas, and a general outlook for the future.

The market expert panelists included: Retail Market, Ben Starr, partner Atlantic Retail Properties; Suburban Market, Christopher Tosti, executive vice president/partner, CB Richard Ellis; Cambridge Market, Peter Bekarian, vice president, Jones Lang LaSalle; Boston Market, John Barry, partner, Richards Barry Joyce & Partners; and Capital Markets, John Fowler, executive managing director, HFF, L.P.

David Begelfer and Greg Klemmer, SIOR started the program by welcoming the audience and thanking the sponsors. Klemmer introduced the program format and then introduced the first speaker, Doug Poutasse.

Here is a summary of the presentations:

Doug Poutasse, Economic Overview

Poutasse started with a title, America's Lost Decade of Growth: What Happened? He researched the last 56 years of U.S. consumer consumption and asked if this last decade was hyper consumption and if we were now at the end of that economy?

With the high consumption level, we should not be surprised that we now have a problem in the economy. This consumption crowds out other activities such as manufacturing, trade, etc, and now risk is back in 2008. So let's look at 2008 and look specifically at 37 days we will never forget in this economy, September 7 to October 14, 2008. We re-built a global system in 37 days on the sly. We made direct equity investments into banks that are now semi-nationalized. Four banks folded in a week or merged. Goldman Sachs, Merrill Lynch, Lehman Bros. and Stanley Morgan merged or are gone. The U.S. spent 70 years insuring bank deposits and then rebuilt the entire system. On Oct. 14th, the U.S. Treasury made equity investments.

In 2009 there is no capital to borrow and consumers cannot purchase goods. There is no credit so the consumer does not purchase goods. Therefore a Circuit City has no sales and terminates which then hurts the landlord who is not collecting rent and can't make a debt payment and the bank has a foreclosure problem. The question becomes, "How do you break this cycle?" The answer is "Flood the world with money" and that is happening now in an unprecedented manner. How much money supply growth has there been? Two unprecedented events have occurred to solve this problem.

First, from 1919 to 2004, the U.S. money growth year to year averaged 10%. In 2009, the money growth is over 100%! After the Great Depression, there has never been a money growth average over 10% until 2009. The monetary base has doubled in the last year which is unprecedented.

The second unprecedented event is the projected federal deficit. It will be over \$1 trillion. No one knows the future of the deficit but it is a scary point that in 2012 the projected recovery slows down and then stabilizes in 2020 at a \$900 billion deficit. Then baby boomers retire and add burden to the deficit with Social Security and Medicare needs.

Since 1945, in a 12 month period the most jobs lost was three million. Now in 2008-09, it has doubled. Some economists believe that by 2012, we will be back at the job peak and that 2010 will be the bottom of the job loss. The thinking by some is that we will have a direct job decline and quick snapback on job creation. When we go down hard, the thinking is that we will come back sharply. But "when" is the true question and no one knows what kind of jobs.

Since the 1940s to the 1990s, each calendar decade has averaged a 20% job creation increase. Now in 2010 it is 0%.

We are going from being a growth country to a cyclical country. The good news is that New England has lived through cyclical growth and understands its impact and can deal with it better than other parts of the U.S. We had a cyclical economy in the 1960s and 1970s and had 0% job growth when textiles were lost and we started converting to a hi-tech economy.

#### Surplus

There are high vacancies but no jobs for people to buy homes or fill the vacancies. We built product that we do not need rather than the scenario where people needed the product and we overbuilt. We just don't need all the real estate that we have built; retail, office, industrial, etc. and now there is nowhere to hide. The retail consumer spending reports have never been negative until this year.

Commercial real estate lags the rest of the economy and until we hit the bottom of occupancy, we can't project the bottom of the rental market and we aren't at the bottom yet. Maybe by 2011 we will hit bottom and that is a long time for rental rates to drop.

The NCREIF index was down in December 2008 and has decreased 38% since Dec. 31st so people are selling out of real estate. There is still more room to decline. With NOI's down about 15% and an increase of cap rates from 5.5% to 7%, it translates to a 38% decline in commercial value.

#### Ben Starr: Retail Market

Starr started by saying he knew we were not going back to the good old days. The evolution of the superstores rose in the mid-1980s and 1990s. In 2008, it was the first time that growth experienced a decrease. The category killers were killing off stores and truncating the market. Now it is time to pick up the pieces as people have stopped purchasing. No one has experienced this phenomenon. Some stores like Staples had to borrow money to operate. With little competition for space and an increase in vacancies, the negotiating leverage has shifted from the landlord to the tenant. There is confusion on both sides as tenants do not really understand landlord issues with lenders and financing.

Grocery stores are holding up and have been resilient. There will be more competition in this category especially with wholesale clubs. There will be a rise with deep, deep discounters and this has stopped the bleeding with vacancies and helped landlords but the rents are much lower with long term leases. The long term prospect of discounters has dragged down the image of the shopping centers and future attractiveness to quality tenants. There has also been a great deal of activity with smaller sized tenants such as banks, fitness centers and restaurants.

Retail tenants have too many options across the U.S. and no longer have to be in Boston or Biddeford or Kittery. It is now about real demographics, real quality and having less rent. There is now a return of the regional chains not seen since the 1980-90s. Family chains are coming back and getting lower rents with less competition. It is a real opportunity for tenants for 2009-10. Owners will have to get their "hands dirty" and know their tenants and weaknesses. Institutional owning and collecting rents will not be a survival mode.

Chris Tosti, Suburban Office Market

Tosti summed up the market with his opening statement "It stinks". In 2007, there was one newly constructed building, 2008 there were four and 2009 there are only three. Supply is not the problem and hasn't been since the 1990s. Sublet space is also not the problem since there is less sublet space now than in the 2001 dotcom era. Currently YTD '09 there is only four million s/f for sublet.

The problem is clearly the demand side as follows:

- \* 1Q '08: 8.75 million s/f in demand

- \* 1Q '09: 6.1 million s/f

- \* June '09: 5.9 million s/f

Financial and hi-tech companies will lead us out of this issue. Software will start the ball rolling.

Tosti stated that when the following two occurs, it will be a good sign. 1) When consumer confidence rebounds, and 2) When there are signs of organic growth from Boston tech firms.

Peter Bekarian, Cambridge Market

Bekarian concluded that the Cambridge market is in the best shape of any submarket in Boston and that is a reverse from the last downturn. There is no new supply coming on the Cambridge market except one building at 280,000 s/f so the problem is not being compounded. Absorption is down and the most active users are in the 20-40,000 s/f range. There are no large space users but no large vacancies either so the market is stable. Rents are declining due to the lack of deal flow rather than large competing blocks of space.

Today there is a healthier balance as evidenced below:

1999: -1.5 million s/f and 0.30 % vacancy

1Q '09: 250,000 million s/f and 10.75% vacancy

In 2002-03, there were large blocks of space available and landlords refused to compete with sublet rents in the mid-teens. Now there is no dramatic increase of sublet space and a good past tenant stabilization. In 2009, lab rents are averaging \$ 51.17 per s/f and direct office is averaging \$ 38.30 per s/f. Today's rents translate to 2001 rents and not the disparity we had in 2005; this is good news.

Same as last year, education, pharmaceutical, consulting, biotech, software and back office. Big companies are staying in Cambridge for the access to intellectual talent. Nine of the most active companies in Cambridge were not even present in Cambridge 10 years ago such as Google, Novartis, Microsoft, etc. so Bekarian is optimistic about the next 12-18 months. There is only one new building under construction of 277,760 s/f although 7 other projects have been permitted or going to be rehabbed.

Bekarian has good optimism as Harvard and MIT are still in good shape and more immune to recessionary pressure. They have added 10,000 net new jobs YTD April '09 or a 2.1% growth rate. Class A vacancy only stands at 8.4% for office and 11.5% for lab. Tenant sentiment is cautious and rents are softening because tenants are not jumping to move and renewing instead.

John Barry, The Boston Office Market

The market is comprised of 67 million s/f and it is balanced. The vacancy rate is 10% although it was only 8.5% two quarters ago. The 2002 vacancy, as comparison, was over 15%. The last four quarters has had negative absorption but was 1.2 million s/f absorption four years ago.

We are not going down to \$40 per s/f rents and will probably stay in the \$50s per s/f. In 1990 the rents averaged \$31.20 per s/f and in 2009, 200,000 s/f has leased at an average of \$53 per s/f. Today there is 1.7 million s/f available and more space is coming onto the market but mostly in low rise buildings. The financial district holds 85% of this upcoming space. There is 1.37 million s/f of sublet space available with an average rent of \$33.47 per s/f and there is not a big discount rent. It would take about 6 months to lease which is healthy with an average term of 13 months. With rent being slightly above \$30 per s/f, there is impact on direct space as those rents are decreasing.

Space above the 30th floor has little availability and only one vacancy over 200,000 s/f. In 2010 there will be no vacancies over 200,000 s/f while 2011 will have more.

75% of the comps are renewals. September '08, rents were in the \$50-60 per s/f range. But May '09 renewal rents are under \$55 per s/f (\$52-53per s/f). Tenant demand is healthy also.

John Fowler, The Capital Market

Fowler stated that it was "ugly" in NYC right now while 2006-'07 was a lot of fun. But we will survive this downturn. The U.S. sales volume in 2009 was \$13.6 billion. In 2008, Boston had \$3.2 billion in sales and in 2009 \$ 0.9 billion. There is capital for creative and core deals however. One Beacon St. experienced a buy-out. June '09, the Center for Life Sciences is 91% leased, loan amount is \$350 million at high 7% interest and de-leveraging. Russia Wharf has a 40% loan to cost ratio with 50% guaranteed with a tenant in place. The maturing debt market is a problem however. In 2009, there is \$24 billion maturing and 2010, there is \$40 billion. Assets are impaired and loans are either extending or will have to be foreclosed. There is no money being made; just extending.

In the future, assets will have to be sold and there will be new players; probably institutional buyers. In early 2010, more transactions will happen once this foreclosed period passes. First mortgage debt funds are being created to buy distressed problems.

Institutional returns today are in the 7.25-8.25% range; 60% LTV ration and a DCR of 1.5 to as high as 1.8. But the old days of 200 BP over 10 T-Bills are gone. The 48 year average T-Bill is 6.83% and the market will not go below that number. It will hover at 200 BP above the 48 year average.

We are in the second inning of valuation decline for commercial real estate values. It will be until 2011 to 2012 before we see any stability.

We thank our sponsors, Hiscock&Barclay; Atlantic Retail Properties; CBRE; HFF; JLL, RBJ & Associates; and Banker&Tradesman.

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