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2008 COMMERCIAL REAL ESTATE UPDATE

The commercial real estate environment deteriorated sharply in the fourth quarter of 2008 in response to the deepening recession and the paralysis in credit markets that accompanied the financial sector meltdown epitomized by Lehman's collapse in September. Investment performance, as measured in the NCREIF-NPI index, showed a slight negative on a quarterly basis in the third quarter of 2008 and slid sharply to a *minus* 8.29% total return in the fourth quarter. The fourth quarter's decline was the deepest quarterly drop in the thirty-year history of the NCREIF index; it brought property values down by 11% for the year as a whole.

The weakening in commercial real estate (CRE) investment performance is in part a catch-up with the re-pricing of risk that took hold in the larger financial markets in mid-2007. The widening in credit spreads that accompanied the re-pricing filtered into commercial real estate *transaction* cap rates earlier in 2008. Its impact on the property valuations used in the NCREIF index took longer to emerge because of the typical lags in the scheduling of appraisals on NCREIF properties and the deliberative pace of incorporating changing market conditions into appraisals. The process was further slowed by the sharp decrease in the number of transactions and especially the paucity of distressed sales.



The weakening in CRE investment performance is also in part a product of the deterioration in commercial real estate fundamentals as a result of the worsening recession. In the fourth quarter, vacancy rates rose across all four major property types—apartment, industrial, office and retail—and across the vast majority of major metro markets. While vacancy rates are still generally below their highs recorded in the 2003 and 1991 troughs of the prior two real estate recessions, they are rising fast as the economy shrinks. Apartment occupancy is under pressure from the abundance of failed condo projects and excess single-family stock available for rent; yet, net operating income (NOI) growth continued positive for the four quarters ending December. Industrial properties are suffering from declining industrial production, diminishing flows of imports, and shrinking consumer spending. Office property occupancy, in turn, is vulnerable to the huge decline in jobs totaling over 3.5 million* since January 2008. Finally, retail property occupancy is under pressure from shrinking consumer discretionary purchases and resulting store closings. Industrial, office and retail properties all suffered contractions in NOI over the four quarters ending December.

At the same time, the credit crunch is actually helping commercial real estate fundamentals by curtailing the availability of financing for new construction. In response, the pipeline of construction has been contracting especially for industrial and retail properties. Office construction is less responsive because of its long development periods and apartment developers still have access to financing through federally controlled Fannie and Freddie.

THE ROAD AHEAD

Commercial real estate is not the driver of its current woes, only a minor player in a larger context. The global economic recession and the global financial sector meltdown are the stars of this show and they will determine the path of commercial real estate ahead. That path will depend on how deep and how long this recession turns out to be, which will depend, in turn, on how quickly and effectively financial markets can be repaired. The onset of the recession has been established as December 2007, making it already unusually long-lasting. For commercial real estate, the pressure was held off for quite a long time because property market fundamentals were in good

* Source: U.S. Bureau of Labor Statistics.

balance when the recession started. That cushion has dissipated but it did serve to protect CRE values from months of decaying sentiment. Now, decaying sentiment has been joined by decaying fundamentals and the prospect of further erosion in both.

One glimmer of improvement has emerged, however, in the larger capital markets environment which influences CRE pricing. During early 2009, data show that corporate credit spreads have come off their highs, suggesting that late 2008 might prove to be the peak. This development is the first sign that the run-up in risk pricing may have turned a corner. In response, issuance of corporate bonds has bounced up since the beginning of the year and that issuance has been absorbed in the marketplace. If this is indeed a turning point, the upward pressure on cap rates from capital markets will ease, leaving the recession's impact on NOI assumptions as the more important driver of valuation.

The most recent reading on economic prospects for 2009 was reported in the February Blue Chip Economic Survey. It shows a -1.9% consensus forecast for 2009 GDP growth; this would be the weakest annual reading since the deep 1982 recession. The unemployment rate is projected at 8.3% for the year as a whole but it has already reached 7.6% for January.* The majority of forecasters expect the economy to continue shrinking through the first half of the year, to stabilize in the summer and to show weak growth in the fourth quarter. This path is predicated on the success and timeliness of government policy.

The actions of policymakers over the weeks and months ahead are seen as central to determining the depth and duration of the recession. An enormous fiscal stimulus package, totaling an estimated \$787 billion, was signed last week by the President. It will begin pumping spending into the economy later this year but there is no certainty regarding the timing or power of its impact. The fix for the financial sector's dysfunction is not as straightforward though it is likely that policy actions to date have prevented an even bigger mess than has occurred. The Fed continues to dapple in "quantitative easing" by buying instruments in frozen markets and the Treasury is working to revamp the TARP program. Policymakers appear to recognize that repair in credit markets is an essential component of economic recovery. CRE investment performance in the quarters ahead will depend on the outcome of their efforts.

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