

How Will Commercial Real Estate Follow the Economy?

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The 2008 job losses and crisis in the financial markets have caused most investors concern about all their investments. Leaving aside publicly traded real estate investment trusts (REITs), commercial real estate as a separate asset class is performing with a very low correlation to stocks and bonds as it has in previous cycles; however, investors still worry about the long-term investment performance of real estate.



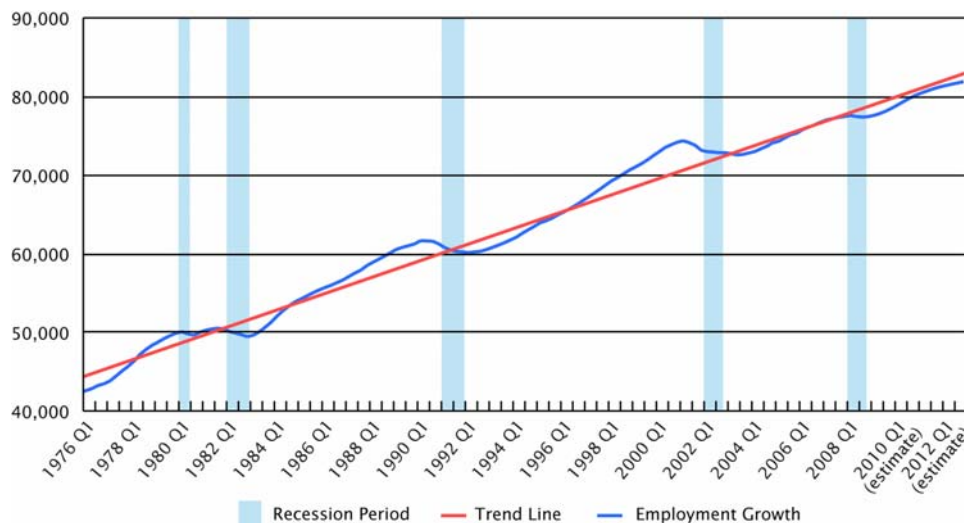
Glenn R. Mueller, Ph.D. is the Real Estate Investment Strategist for Dividend Capital Group. He is also a full professor at the University of Denver's Franklin L. Burns School of Real Estate and Construction Management and a visiting professor at Harvard University.

This study looks at the fundamentals that have driven earnings for real estate in past cycles and then looks at their impact for the future cycle. The analysis starts with the basic economic principles of demand and supply for real estate and then analyzes their effects on occupancies and rents that should drive earnings growth over the next four years.

Demand

The best indicator of demand is employment growth as people use space to work in and new employees also need a place to live. Figure 1 shows long-term composite employment growth for the 54 largest metropolitan statistical areas (MSAs) in the United States. Note that most recessions have lasted for three quarters. At the beginning of the recession, total employment declines for approximately six quarters. The graph shows that since the last recession in 2001, employment growth has followed the long-term trend line instead of rising above it. Thus employment decline is expected to be milder than previous recessions as most companies have stayed leaner than previous expansions. Employment loss is expected to end in the second or third quarter of 2009 with growth commencing in the fourth quarter of 2009. Demand for more real estate space should follow shortly after.

Figure 1
Major MSA Employment Growth



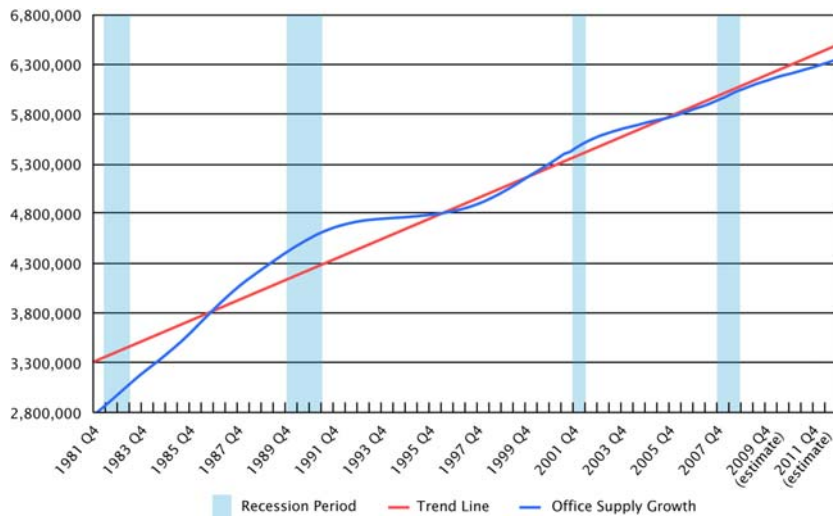
Source: Property and Portfolio Research, Dividend Capital Research.

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Supply

Supply of new commercial space is both property-type and market specific. However, looking at the aggregate supply of each property type helps to define and forecast future trends. Figure 2 shows the long-term supply growth of office space. Supply grew at a much faster pace in the 1980s, which created the office crash in 1990. Note that office supply usually grows through recession periods and then declines afterward. Also note that supply grew at above the long-term trend line in both the 1990 and 2001 recession periods, but has been growing below the trend line since 2005 providing the lowest rate of supply growth in the last 30 years. Thus, office supply should be restricted in the next cycle.

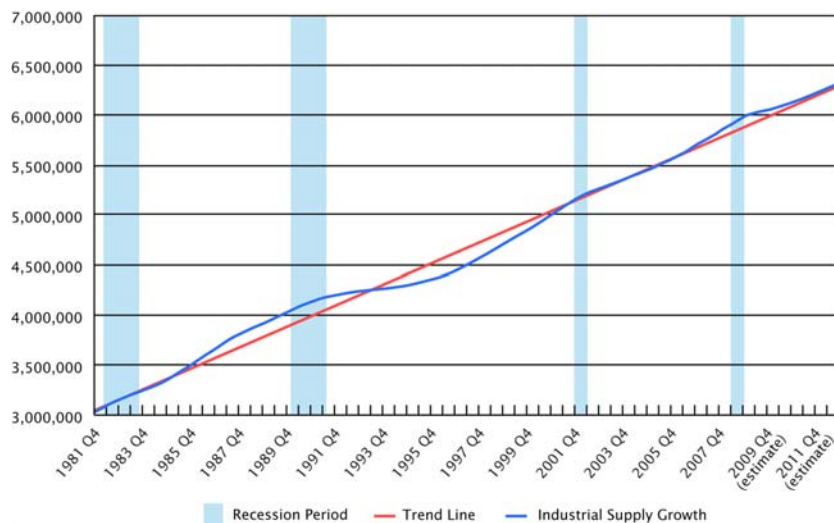
Figure 2
Office Supply Growth



Source: Property and Portfolio Research, Dividend Capital Research.

Figure 3 shows supply growth of industrial (mainly warehouse) space. Industrial supply grew above the long-term trend line in the second half of the 1980s, below trend in the first half of the 1990s, then above trend in the second half of the 1990s to catch up. Industrial supply grew with the long-term trend line in the 2000s and began increasing above the trend line in 2007 as exports grew. Industrial supply growth is forecast to slow after the 2008 recession and space growth is expected to slow in 2009 back toward the long-term trend line.

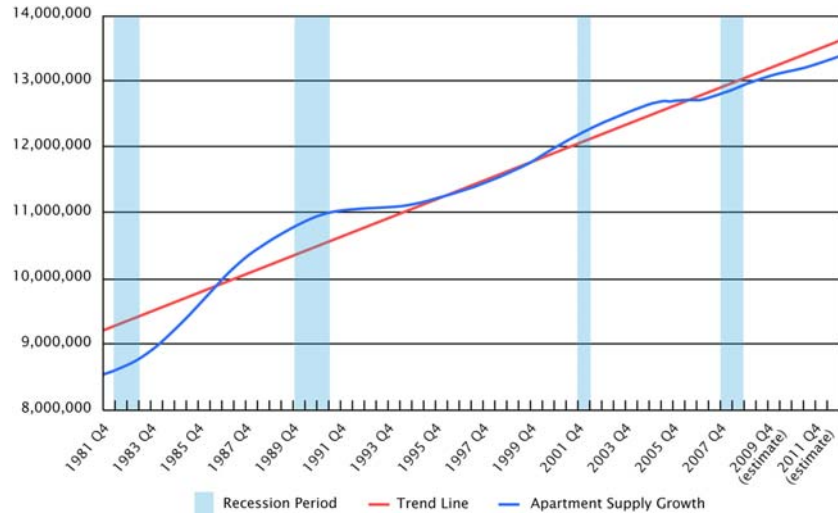
Figure 3
Industrial Supply Growth



Source: Property and Portfolio Research, Dividend Capital Research.

Figure 4 shows apartment supply growth, which grew strongly in the 1980s and then slowed after the 1990 recession. Since 1996, supply grew at close to the trend line until 2004 when sub-prime mortgages were taking tenants out of apartments earlier than usual. The oversupply of homes and lack of credit has slowed apartment supply to below the long-term trend since 2005 and this is expected to continue in the future.

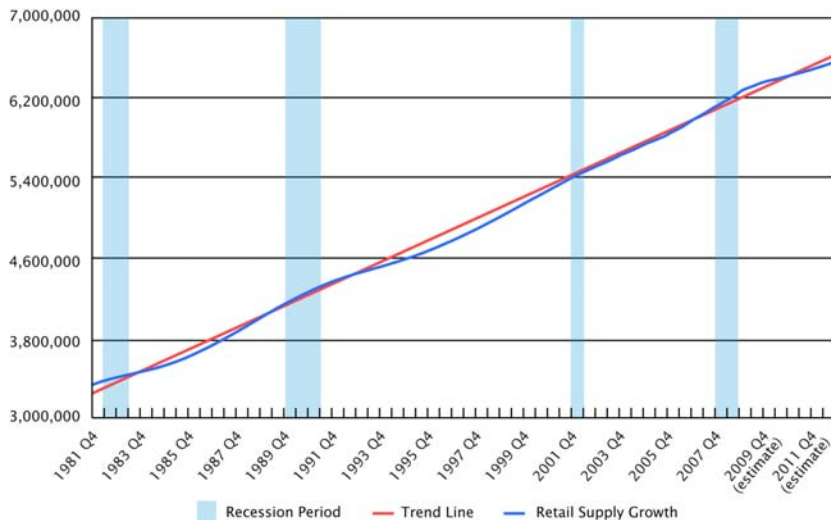
Figure 4
Apartment Supply Growth



Source: Property and Portfolio Research, Dividend Capital Research.

Figure 5 shows that retail supply growth has followed its long-term trend line very closely over the past 30 years. The minor increase in supply above trend is expected to moderate in 2009, dropping supply growth to below the long-term trend line.

Figure 5
Retail Supply Growth

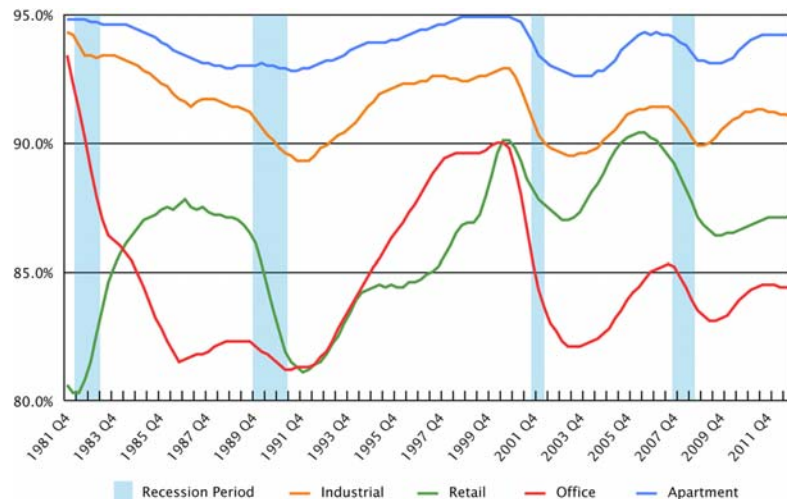


Source: Property and Portfolio Research, Dividend Capital Research.

Earnings Components

Occupancy rates in commercial real estate have historically peaked just before a recession and declined through recession for one to two years after. This comes from a combination of the declining employment growth (demand) that continues for two quarters after a recession combined with the new supply that does not slow until one to two years after the recession. Figure 6 shows this trend rather clearly, but note that the trends become less volatile in each successive cycle. Occupancies are not expected to drop as much in the upcoming 2008 - 2009 down cycle as in previous cycles, except for retail, which may be 1% lower than the previous cycle. The expected lower supply growth analyzed above is helping to stabilize commercial real estate occupancies.

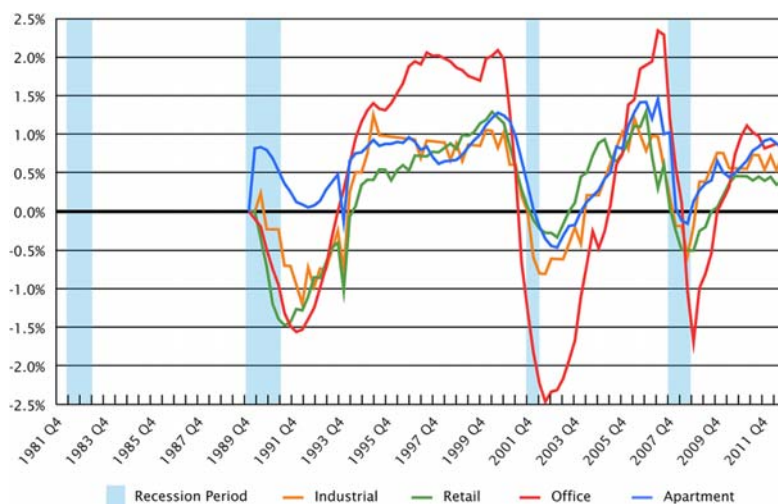
Figure 6
Occupancy Rates



Source: Property and Portfolio Research, Dividend Capital Research.

Rental growth usually peaks just before a recession, stays positive through the recession and turns negative as the new supply comes on line the year after a recession. Landlords drop rents to entice renters to move to their new space. The forecast shows that rental growth should be positive through 2008, negative in 2009 and then turn positive again in 2010. Also note that rental growth lows are not as bad in each successive cycle (except for office in 2003) which provides more stability to the income of commercial properties.

Figure 7
Quarterly Rent Growth

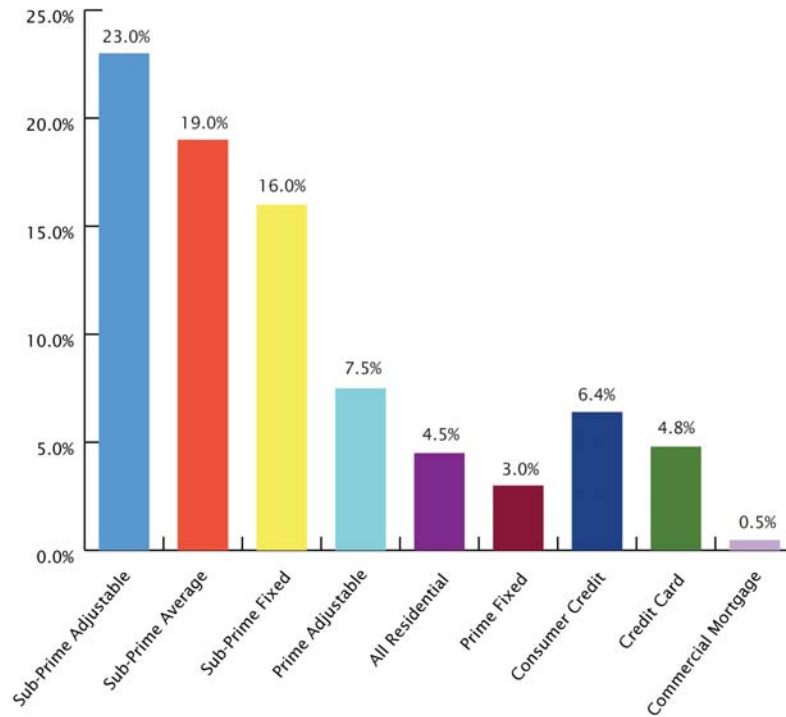


Source: Property and Portfolio Research, Dividend Capital Research.

Evidence of Health of Commercial Real Estate Markets

Figure 8 helps to confirm the health of the commercial real estate markets. The rate of default on commercial loans is a very low 0.5% (that is not a typo — it is one half of one percent). When this is compared to defaults in consumer credit and home loans — both prime and sub-prime loans — it is easy to see why investors have favored commercial real estate debt as an investment over other debt alternatives. Commercial buildings have enough cash flow to pay their mortgages and thus a low default rate. Even publicly traded companies with problems will stop paying their common stock dividend first, their preferred stock dividend second and their corporate bonds third, before they stop paying their employees and their rent so employees have some place to work.

Figure 8
Debt Default Rates September 2008



Source: Bloomberg, Mortgage Bankers Association, Federal Reserve Board.

Conclusion

The economic downturn and job losses of 2008 will probably be deemed a recession when the third quarter 2008 data is finalized in December 2008. Commercial real estate has historically been a delayed mirror of the economy, by moving through its down cycle the year after a recession. Commercial occupancies have been showing minor occupancy declines since the beginning of 2008, but at half the rate of the last down cycle in 2001. Rental growth was stronger in the most recent up cycle that started in 2003 than the previous cycles in the 1980s and 1990s, and the next down-cycle of occupancies and rent growth is not predicted to be as severe. The low commercial loan default rate is evidence of commercial property stability.

While earnings on properties are dependent upon the timing of lease expirations, those leases that do expire in the next few years should not create large occupancy declines or major rent drops. Thus, commercial real estate property earnings should remain fairly stable over the next few years. The low supply of new properties forecast for the next five years also bodes well for long-term occupancy and rental growth. Many analysts also believe that the increasing costs of construction will require higher rents to be able to justify the costs of new construction in the future. All these statistics point to long-term investment prospects for commercial real estate being strong.

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