

A Better Positioning of Commercial Real Estate This Time Around

A research report prepared for the Steven L. Newman Real Estate Institute, Baruch College, CUNY by contributing author Kenneth McCarthy, Managing Director, US Research Services, Cushman & Wakefield, New York.

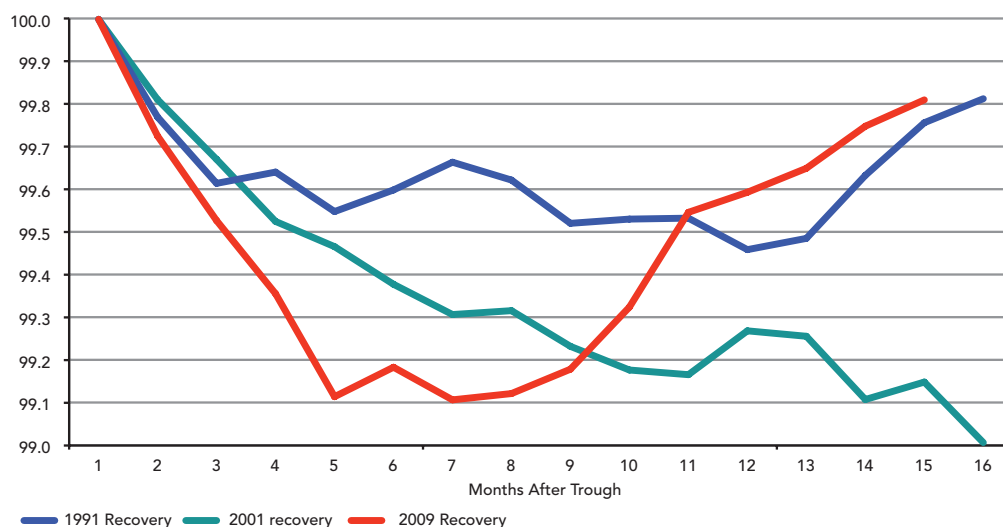
It's official, the recession is over. In mid-September, the Business Cycle Dating Committee of the US National Bureau of Economic Research announced that the recession of 2007-09 officially ended in June 2009. That is when many, but not all, of the key broad-based indicators of economic performance shifted from declining to rising. This gave us a benchmark to assess the recession and the emerging recovery. We can now say that the recession was the longest and deepest in the post-war era. More importantly, we can talk about the state of the recovery and its effect on the commercial real estate industry.

So far, as we all know, recovery has been sluggish. In the first year, GDP has increased 3.0%, about half the 6.0% average first-year recovery rate of the eight recovery periods since 1950. However, the structure of the economy today is far different than that of the 1950s through the 1980s. In those years, manufacturing played a much greater role. In the 1950s, it accounted for 25% of GDP; today it is less than 11%. Since the dynamics of the manufacturing sector tend to exacerbate the changes during a recession and subsequent recovery, a smaller base has caused the declines and recoveries in more recent recessions to be much more subdued. For example, in the 1950 through 1985 period, the average first-year recovery in GDP was 7.2%. In the 1991 and 2001 recoveries, it was 2.3%.

We believe the appropriate benchmarks for our current situation are the 1991 and 2001 recoveries, not the

Figure 1:

US Private Sector Employment Growth in the Last Three Recoveries



Source: US Bureau of Labor Statistics

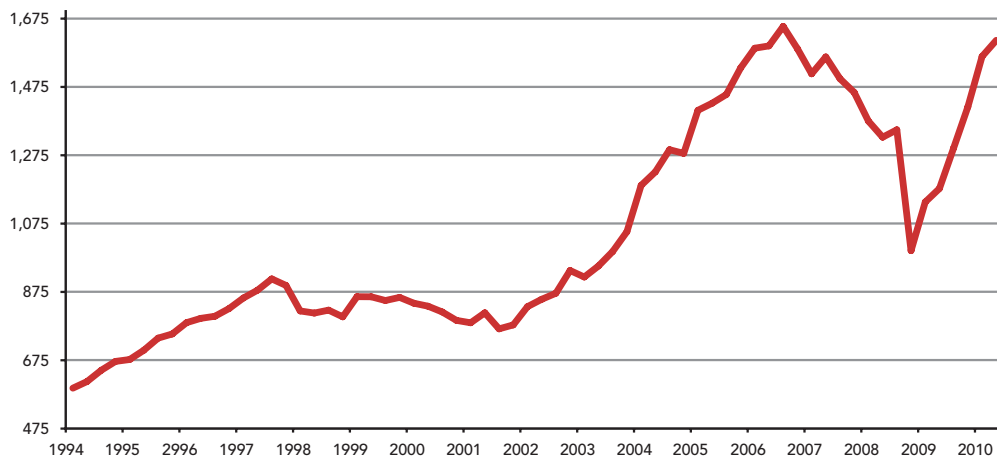
earlier ones. Using that benchmark, the current recovery is slightly above average largely because the recession was much deeper this time around. In the 1991 and 2001 recessions, GDP declined by less than 1.5%; in 2007-09, it fell by a whopping 4.1%, so a stronger recovery is no surprise. Nevertheless, we are still well below the pre-recession peak a full year into the recovery.

For the commercial real estate sector, the key driver of growth is employment. In this recovery, job growth has also been weaker than the long-term averages, but better than the two most recent recoveries. In the current recovery and each of the two previous recoveries, employment continued to decline after the recession ended. In 1991, it took 11 months after the recession officially ended before employment began to increase. In the 2001 recovery, it was

19 months. This time, it only took six months. Since reaching a bottom in December, the US economy has added 863,000 private-sector jobs, a healthy increase, but not fast enough to make a significant dent in the unemployment rate. It has barely budged from the peak of 10.1% in October 2009 to 9.6% in September 2010, nearly a year later.

And that's the real story of the current recovery. If we compare it to recent recoveries, the performance of the economy is not bad, but because of the severity of this recession, it appears particularly weak. Put it this way: If we maintain the current pace of adding roughly 100,000 jobs per month, the US will recover all the jobs lost in the recession by the end of 2016. No wonder confidence is low and consumers and businesses are worried about the future. The key to the current recovery is

Figure 2:

US Corporate Profits Before Taxes (Billions of Dollars)

Source: US Department of Commerce: Bureau of Economic Analysis, *Economy.com*

business confidence. In the past, the consumer has tended to take the lead, boosting spending and creating the demand that prompted businesses to raise employment and increase investment. But consumers are not able to provide the same sort of stimulus they have in the past because:

- **They are worried.** Unemployment remains high causing consumers to remain cautious. In September 2010, the University Of Michigan Index Of Consumer Sentiment was at its lowest level since November 2009. At a time when confidence should be rising, it is falling as consumers are very worried about the future course of the economy. The current index reading is 68.2 (Q1-1966 = 100). The level that is generally consistent with strong consumer spending growth is 90. It will be a long time before we get to that level.
- **They do not have the wherewithal.** One of the biggest supports under consumers has been the increasing value of their assets, particularly their homes. The increase in household wealth and home values enabled consumers to borrow against that wealth by refinancing mortgages or using home-equity loans. As of mid-2010, the value of homes on household balance sheets was 25% lower than at the end of 2006. Total household net worth is currently 18% below the pre-recession peak of three years earlier.

With their balance sheets under pressure, consumers are much less willing to add new debt and boost the economy unless they have no choice (i.e. when goods must be replaced). Spending is increasing, and will continue to do so as employment rises, incomes increase and replacement demand grows, but the pace of growth is likely to remain subdued until households feel more confident and see the value of their assets increase.

Since consumers are unable or unwilling to significantly increase their spending, it has fallen to the business sector to boost spending, and it certainly has the financial ability to boost outlays. Since the collapse at the end of 2008, US corporate profits increased

by 62%, or more than \$600 billion, and are now roughly back to pre-recession levels. This has enabled a substantial increase in investment spending. As of the second quarter of 2010, business investment in equipment and software has risen by 15% since the end of the recession.

Continuing growth in investment coupled with further employment growth will determine the speed of recovery. Employment growth is occurring at a faster pace than in the two most recent recoveries because the large number of layoffs left businesses so lean that they have had no choice but to hire as demand has increased. As businesses add employees, and increase spending, the economy will steadily build momentum. By the second half of 2011, US GDP is projected to be growing at a 5.1% annual rate, compared with 1.7% in the second quarter of 2010. Historically, the real estate industry tends to lag behind the rest of the economy. This is largely a result of the nature of the product. Office buildings are expensive to build and can take a long time to construct, particularly in major cities where land is expensive, it is difficult to acquire a large enough lot and restrictions on building are substantial. As a result, developers tend to wait until market conditions are healthy before embarking on a new construction project.

However, market conditions can change dramatically in the time that it takes to complete a building. Thus, in each of the past two recessions, vacancy continued to rise in many central markets after the recession ended, as employment, the key driver of demand for space, was falling just as new supply was entering the picture.

As a result, in both the early 1990s and early 2000s, the vacancy rate for major central business districts (CBDs) increased

for roughly two years after the recession ended. For suburban markets, the lag times were somewhat shorter. It's worth noting, however, that in the early 1990s, the suburban vacancy rate was elevated well before the recession began.

The 2009 recovery has been fundamentally different. CBDs are leading and the suburbs are following. While still lagging the general economy, the CBD vacancy rate reached a peak less than a year after the recession ended, while in suburban vacancy rate continues to increase. This appears to be a function of the major fundamental difference in the current real estate cycle, and that is the lack of severe overbuilding.

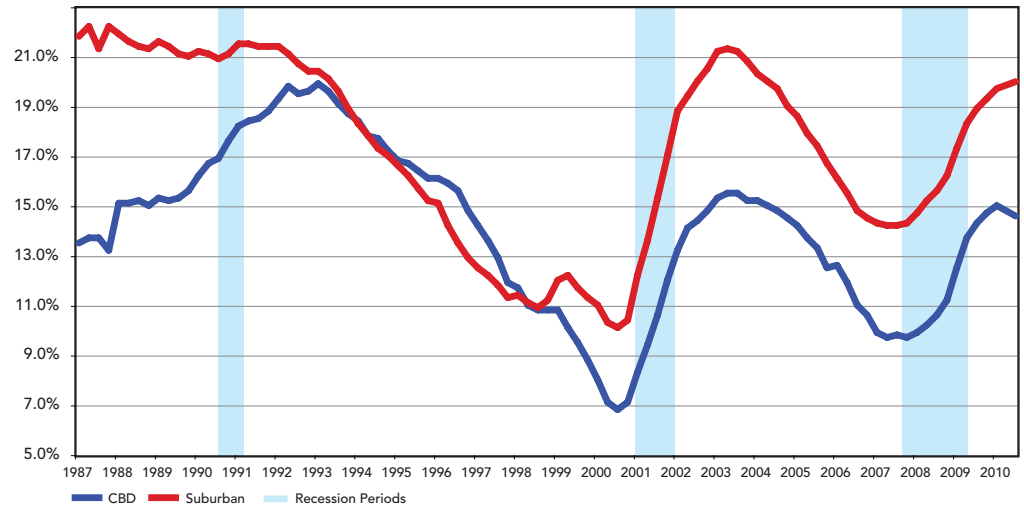
Cushman & Wakefield estimates that in the three years prior to the 1990 recession, US construction completions represented slightly more than 10% of the total office inventory. In the three years before the 2001 recession, completions accounted for 8.4% of total inventory. By contrast, the industry entered the 2007-09 recession with completions of 3.9% of total inventory. As a result, the supply overhang that has in the past plagued the industry and kept vacancy rising long after the recession ended did not occur in this downturn.

This also explains the relatively low peak vacancy rate. It now appears that the national CBD vacancy rate in the US peaked at about 15.0% in the first quarter of 2010. That's below the 2003 peak of 15.5% to say nothing of the 1993 peak of 19.9%. Despite the worst job loss since the great depression of the 1930s, the national vacancy rate peaked below the 2001 recession, when the job loss was 68% smaller.

US Real Estate Conclusions. The performance of the real estate industry before the recession set the stage for a fundamentally different outcome in the

Figure 3:

US National Vacancy Rate



US during and after the recession from a leasing perspective. While office occupancy declined, vacancy increased and rents declined, the weakening of the market was nowhere near what it should have been given the severity of the downturn.

However, although the commercial office sector enters the recovery in far better shape than in past expansions, significant market improvement will largely depend on the strength of the overall economy and employment growth. The current slow pace of job growth suggests that the national office markets will continue to feel the pinch for some time.

Still, the positive message is that real estate is poised to turnaround much earlier in the cycle than in past recoveries, but the pace of the upswing will follow that of overall economic growth.

Americas Summary

Canada. The Canadian economy weathered the global recession much better than most other industrial countries, driven in part by a recovering commodities sector in western Canada and strong financial services growth in central Canada. Canada's highly regulated financial system survived the recession in remarkably healthy shape. Over the year ending June 30 2010, almost 400,000 new jobs were created across Canada. The IMF again predicted that Canada's economic growth would be at the head of the pack among the G-7 this year and next.

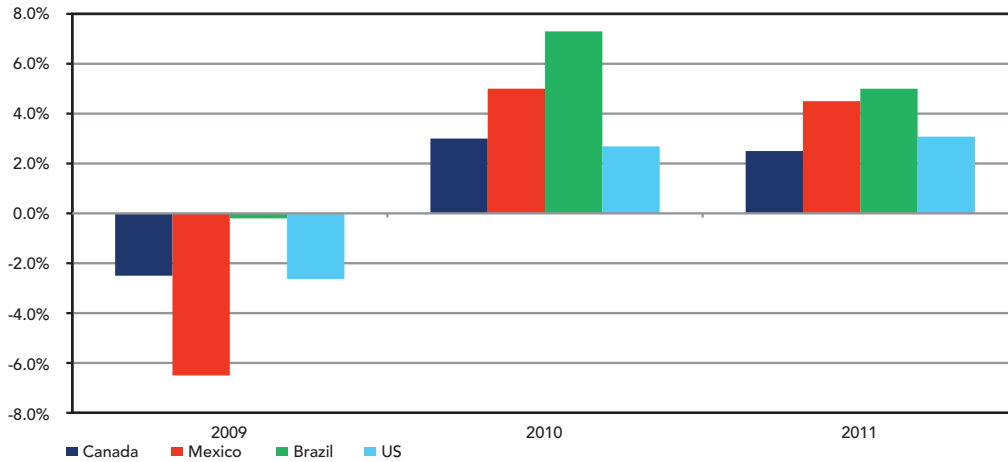
Nevertheless, the global recovery is fragile. While July and August job gains remained positive, job growth fell to about half of what it had averaged over the first six months of the year. Furthermore, GDP growth, which reached 5.8% in the first quarter, declined by 0.1% in July 2010, the first monthly drop since August 2009.

So, while the Canadian economy has certainly shown resilience, the pace of growth has slowed in conjunction with weaker global demand. Expectations include moderate positive growth over the fourth quarter.

Central Canadian office markets have fared very well, with moderate demand strength in recent quarters and tight vacancy. Suburban markets were much harder hit, particularly due to close ties to US markets, but vacancy appears to have peaked in most of these

Figure 4:

Projected GDP Growth - Americas



Source: IHS Global Insight

markets. Toronto, Canada's largest office market, has seen substantial if not remarkable demand in its downtown area, driven by a financial services sector that is expanding rapidly.

Mexico. The Mexican economy came roaring out of the recession with gross domestic product increasing at an annual rate of 10.2% in the second half of 2009. The economy declined modestly in the first quarter of 2010, as domestic demand softened, but rebounded strongly in the second quarter with GDP increasing at an annual rate of 13.3%. As is the case in Canada, future growth will be heavily dependent on the US economic recovery. Demand from the US is a primary driver of economic growth in Mexico, and as the US continues to improve Mexico's economy will also grow although more slowly than during the past year. Overall, Mexico's GDP is projected to increase 5.0% in 2010 and an additional 4.5% in 2011, after contracting -6.5% in 2009.

Mexico's real estate sector has shown solid progress in 2010 and appears poised to continue improving in 2011. Vacancy has stabilized after climbing in 2009 and is likely to begin moving lower in late 2010 and 2011, as the continuing improvement in the national economy leads to higher employment and greater demand for space. Overall, we anticipate vacancy rates to remain high by historical standards, with the CBD vacancy rate at about 5% and the suburban rate remaining above 10% over the coming year. Gradual, steady improvement in line with the national economy is projected in the coming year.

Brazil. The Brazilian economy has been one of the strongest in the world coming out of the recession. Overall GDP barely declined during the downturn (-0.2% in 2009) and has accelerated strongly. In the first quarter of 2010 real GDP expanded at an 11.3% annual rate before slowing to a still strong 5.1% in the second quarter. Unlike other Latin American and North American nations, much of Brazil's growth has been generated by rising domestic demand, as exports have only increased slowly. With a national election in its final stages, activity in the country should slow for the remainder of the year and a bit further in 2011. Nevertheless, overall GDP growth is projected to be a strong 7.3% in 2010 and 5.0% in 2011.

The strength of the economy has also been reflected in the Brazilian real estate market where rents are rising rapidly. Rio de Janeiro, already one of the most expensive cities in

the world, saw rents increase by 60% in the third quarter compared with a year ago. At current exchange rates, asking rents in Rio are roughly \$93 per square foot with class A rents even higher. With economic growth remaining strong, healthier increases are likely in the near term. Increases have also been recorded in the Sao Paulo market (+13.5%) and Salvador, which saw rents rise by 35% over the last 12 months. Overall, it is unlikely that these kinds of economic and rental growth rates will be sustained, but in the near term, Brazil's major markets are expected to continue to benefit from a healthy economy causing vacancy to decline and rents to remain on an upward trajectory. ■

This research report is published by the Steven L. Newman Real Estate Institute, Baruch College, CUNY.

The Newman Real Estate Institute gratefully acknowledges the support of the sponsors who make possible our efforts to promote critical thinking on topical issues for the real estate industry.

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