



# COMMERCIAL REAL ESTATE OUTLOOK

September 2006

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## Institutions return to commercial real estate in a big way .....

### Overview

Large institutions (life insurance companies, pension funds, etc.) have traditionally been considered to be among the most cautious and risk-adverse investors in commercial real estate. If investing in commercial real estate is risky now, you wouldn't know it by looking at where large institutions are putting their money.

While institutional investors are less concerned with fluctuations in interest rates, they still keep a watchful eye on the overall health of the commercial real estate market. Most institutional asset managers report to very conservative boards who want to see positive returns and income-producing properties, like any private-sector investor.

The health of the commercial real estate market can be measured by the record level of institutional investment in the office and industrial real estate sectors so far this year. Transaction data from Real Capital Analytics show that institutional investors and private equity funds have accounted for half of the office building sales volume over the last eight months. So far this year, institutions account for over one-third of the sales volume of industrial properties.

In the 2001 to 2003 time frame, institutions were net sellers of their office and retail holdings. In the first half of 2004 institutions purchased just under \$10.0 billion in commercial real estate. During the first six months of 2005, this number was \$22.4 billion. This year institutional investors have spent over \$31.0 billion in all sectors, with noticeable up-swings in the acquisition of office and multi-family properties.

**NAR FORECAST:** Institutions are among the most risk-adverse investors in commercial real estate. The fact that they are "ramping-up" their acquisition of office and industrial properties bodes well for these sectors. Based on the number of deals that have yet to close but are in the process, 2006 will be a record year for institutional investment in office and industrial real estate.

### High construction costs are one reason for improving office fundamentals...

One result of the increase in construction costs has been a slowdown in the development of speculative office real estate. (Speculative development refers to beginning construction before a lead tenant has been found.) With fewer options available for tenants, they are often forced to renew "in-situ" or look for new or expansion space within the existing stock. Tenants with a desirable covenant and who are willing to sign a longer-term lease are choosing the build-to-suit route. Basic economics tell us that with limited supply and increasing demand, vacancy rates fall and rent growth gains traction. In most of the primary markets included in this *Outlook*, the scenario described above is occurring.

**NAR FORECAST:** By the end of 2006, the national office vacancy rate will be holding steady at 13% - a low that has not occurred since 2001. While completions are up this year (mainly build-to-suit), the supply of new office building in the pipeline is down and will be reflected in reports for 2007.

## Retail real estate is the only sector expected to see worsening fundamentals....

### COMMERCIAL LEADING INDICATOR FOR BROKERAGE ACTIVITY (CLI)

The NATIONAL ASSOCIATION OF REALTORS® Commercial Leading Indicator for Brokerage Activity, shows that commercial sectors will continue to improve into 2007.

During the second quarter, the Commercial Leading Indicator was at an index of 119.4, up 0.4 percent from a reading of 118.9 in the first quarter. The index is 2.5 percent above the second quarter of 2005, when it stood at 116.5. The second quarter was the fifth straight quarter of growth.

David Lereah, NAR's chief economist, said the improvement is long-term. "Our commercial leading indicator has risen in 11 out of the last 12 quarters, meaning the recovery in commercial real estate will be sustained well into 2007," Lereah said. "However, we are seeing a deceleration in the rate of growth – apparently in response to higher oil prices and interest rates – so the expansion in net absorption and commercial construction should continue, but at a slower pace."

NAR's commercial leading indicator is a tool to assess market behavior in the major commercial real estate sectors.

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### Secondary and tertiary markets benefiting from the demand for new industrial space...

The demand for Industrial warehouse and distribution space has brought the industrial vacancy rate down to a 5-year low – 9.7%. In 2006, a record 204 million square feet of space will be added to the nation's industrial real estate market. Much of this new space is designed to meet the needs of specialized warehousing and distribution industries.

**NAR FORECAST:** Industrial space that is vacated and deemed obsolete by industrial users looking for new space designed for just-in-time production or for new logistical distribution needs will be converted to other commercial or residential uses. This is already happening in many markets. New industrial development will continue to be popular in secondary and tertiary markets where land values are lower and site remediation concerns are minimal.

Of all the commercial sectors, retail appears to have some problems. Rising interest rates and fluctuating oil prices are impacting consumer confidence. These and other issues have softened demand for retail space. While the current vacancy rate of 8.1% is well below the double-digit rates seen in 2002, it is still a cause for concern.

**NAR FORECAST:** The fallout from the merger of Federated Department Stores with May Department Stores is continuing to impact regional malls and main streets in many markets. Vacancy rates are expected to rise.

A slowdown in the housing market is having a positive impact on the multi-family market across the nation. As potential first-time home buyers elect to stay renters, multi-family vacancy rates stabilize and in many markets are declining rapidly. In markets like Los Angeles, where housing affordability remains a problem, the multi-family vacancy rate is just 2.0%, compared with the national vacancy rate of 4.6%.

**NAR FORECAST:** The decline in "condo conversion" activity is having two impacts. First, there has been a noticeable flipping of some multi-family apartment complexes (originally bought for conversion purposes) back to multi-family investors. Second, the return of properties destined for conversion will increase vacancy rates as these multi-family complexes are returned to the active rental inventory. By the end of 2006, the multi-family vacancy rate will be up slightly to 5.2%.

Both revenue per available room (RevPAR) and occupancy rates for the hospitality sector are increasing. RevPAR for the third quarter of 2006 was \$80.96, which when seasonally adjusted for the end of the year will make for an annual average of \$78.25, up from the \$71.46 recorded last year.

**NAR FORECAST:** A record number of new rooms is slated to be built in 2006 and 2007, which will keep occupancy rates and RevPAR at or just slightly above current levels.

SEPTEMBER 2006 ECONOMIC FORECAST

<i>Major Indicators</i>	<i>2006 I</i>	<i>2006 II</i>	<i>2006 III</i>	<i>2006 IV</i>	<i>2007 I</i>	<i>2007 II</i>	<i>2007 III</i>	<i>2007 IV</i>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Real GDP Annual Percentage Growth Rate	5.6	2.9	2.3	2.8	3.3	2.9	3.3	2.9	3.2	3.4	2.9
Non-Farm Employment Annual Percentage Growth Rate	1.7	1.2	0.7	1.2	0.8	0.9	1.5	1.1	1.5	1.3	1.0
Consumer Prices Annual Percentage Growth Rate	2.2	5.0	2.7	2.2	2.0	2.6	2.2	2.0	3.4	3.5	2.4
Real Disposable Income Annual Percentage Growth Rate	4.6	1.5	6.9	3.5	3.8	2.2	2.5	2.1	1.2	3.5	3.4
Consumer Confidence Index	106	107	102	103	103	103	105	106	100	105	104
Unemployment Percent	4.7	4.6	4.8	5.0	5.0	5.0	4.9	4.8	5.1	4.8	4.9
<i>Interest Rates (%)</i>	<i>2006 I</i>	<i>2006 II</i>	<i>2006 III</i>	<i>2006 IV</i>	<i>2007 I</i>	<i>2007 II</i>	<i>2007 III</i>	<i>2007 IV</i>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Fed Funds Rate	4.5	4.9	5.3	5.3	5.3	5.3	5.0	4.8	3.2	5.0	5.1
3-Month T-Bill Rate	4.4	4.7	5.1	5.1	5.0	5.0	4.8	4.5	3.1	4.8	4.8
Prime Rate	7.4	7.9	8.3	8.3	8.3	8.3	8.0	7.8	6.2	8.0	8.1
Corporate Aaa Bond Yield	5.4	5.9	5.6	5.8	6.0	6.0	6.1	6.1	5.2	5.7	6.0
10-Year Gov't Bond	4.6	5.1	4.8	5.0	5.1	5.2	5.2	5.2	4.3	4.8	5.1
30-Year Gov't Bond	4.6	5.1	4.9	5.1	5.3	5.3	5.4	5.4	4.6	5.0	5.4

Source: NAR

COMMERCIAL FORECAST

<i>OFFICE</i>	<i>2005 IV</i>	<i>2006 I</i>	<i>2006 II</i>	<i>2006 III</i>	<i>2006 IV</i>	<i>2007 I</i>	<i>2007 II</i>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Vacancy Rate	13.6%	13.5%	13.1%	13.0%	13.0%	12.8%	12.7%	13.6%	13.0%	12.2%
Net Absorption ('000 sq. ft.)	23,646	12,998	21,437	15,845	24,177	19,664	16,724	90,280	74,457	70,035
Office Employment (thousands)	16,365	16,478	16,552	16,648	16,738	16,823	16,897	16,365	16,738	17,077
Completions ('000 sq. ft.)	9,161	8,914	12,754	16,234	14,634	12,024	9,925	37,336	52,536	38,520
Inventory (millions sq. ft.)	3,257	3,266	3,278	3,295	3,309	3,321	3,331	3,257	3,309	3,348
Rent Growth	1.1%	1.3%	0.9%	1.4%	1.8%	1.8%	2.0%	5.2%	5.5%	8.3%
<i>INDUSTRIAL</i>	<i>2005 IV</i>	<i>2006 I</i>	<i>2006 II</i>	<i>2006 III</i>	<i>2006 IV</i>	<i>2007 I</i>	<i>2007 II</i>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Vacancy Rate	9.9%	9.9%	9.8%	9.7%	9.7%	9.5%	9.3%	9.9%	9.7%	9.0%
Net Absorption ('000 sq. ft.)	100,058	26,768	54,284	62,412	57,710	60,475	56,472	295,817	201,173	233,118
Industrial Employment (thousands)	10,198	10,216	10,226	10,252	10,278	10,306	10,333	10,198	10,278	10,399
Completions ('000 sq. ft.)	58,902	38,978	41,942	60,509	63,332	35,421	34,856	149,292	204,751	155,172
Inventory (millions sq. ft.)	11,998	12,037	12,079	12,139	12,203	12,238	12,273	11,998	12,203	12,358
Rent Growth	0.7%	0.4%	0.2%	0.4%	0.5%	0.7%	0.8%	2.9%	1.5%	3.6%
<i>RETAIL</i>	<i>2005 IV</i>	<i>2006 I</i>	<i>2006 II</i>	<i>2006 III</i>	<i>2006 IV</i>	<i>2007 I</i>	<i>2007 II</i>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Vacancy Rate	7.2%	7.8%	8.0%	8.1%	8.1%	8.2%	8.2%	7.2%	8.2%	8.2%
Net Absorption ('000 sq. ft.)	7,698	(4,337)	242	4,131	3,907	3,234	4,105	30,479	3,942	16,015
Completions ('000 sq. ft.)	5,200	6,961	5,034	6,615	5,728	5,794	4,692	23,049	23,171	21,916
Inventory (millions sq. ft.)	1,495	1,502	1,507	1,514	1,520	1,525	1,530	1,502	1,520	1,547
Rent Growth	0.7%	(0.9%)	(1.0%)	0.1%	0.4%	0.6%	0.6%	2.9%	(1.4%)	2.6%

Source: NAR/TWR

COMMERCIAL FORECAST

<i>MULTI-FAMILY</i>	<i>2005 IV</i>	<i>2006 I</i>	<i>2006 II</i>	<i>2006 III</i>	<i>2006 IV</i>	<i>2007 I</i>	<i>2007 II</i>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Vacancy Rate	6.2%	5.5%	4.6%	4.6%	5.2%	5.1%	4.9%	6.2%	5.2%	5.3%
Net Absorption (Units)	518	125,643	115,124	56,358	(34,363)	64,463	80,932	350,975	262,762	203,050
Completions (Units)	53,364	54,999	56,884	57,474	52,552	55,451	56,051	203,387	221,869	221,869
Inventory (Units in Millions)	13.6	13.6	13.7	13.7	13.8	13.8	13.9	13.6	13.8	14.0
Rent Growth	0.9%	1.0%	1.1%	1.3%	1.3%	1.2%	1.2%	2.9%	4.8%	5.0%
<i>HOSPITALITY</i>	<i>2005 IV</i>	<i>2006 I</i>	<i>2006 II</i>	<i>2006 III</i>	<i>2006 IV</i>	<i>2007 I</i>	<i>2007 II</i>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Occupancy Rate	64.5%	66.1%	71.5%	72.5%	63.6%	65.6%	71.6%	67.6%	68.4%	68.7%
Revenue per Available Room RevPAR (\$/Room)	\$70.43	\$75.40	\$82.85	\$80.96	\$73.84	\$78.08	\$84.15	\$71.46	\$78.25	\$80.50
Completions (rooms)	1,080	3,183	2,472	11,367	9,582	5,774	6,988	4919	26,604	21,108
Inventory (rooms) (millions)	1.93	1.93	1.93	1.94	1.95	1.96	1.97	1.93	1.95	1.97
Change in RevPAR (year over year)	13.0%	12.7%	11.1%	9.6%	4.8%	3.6%	1.6%	12.3%	9.5%	2.9%

Source: NAR/TWR