



# Commercial Real Estate Spotlight

A Quarterly Review of Commercial Markets

March 2005

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**12-MONTH FORECAST**

**Vacancy**

Office	↓
Industrial	↓
Retail	↓
Multifamily	↔

**Net Absorption**

Office	↑
Industrial	↑
Retail	↑
Multifamily	↑

**Completions**

Office	↓
Industrial	↑
Retail	↔
Multifamily	↔

**Rent Growth**

Office	↑
Industrial	↑
Retail	↑
Multifamily	↑

Economic backdrop – green lights ahead...

- ◆ Economic expansion remains strong. Following a 4.4% GDP growth rate in 2004, this rate is expected to reach 4.6% in the first quarter of 2005. Business spending and export growth will lead the way. Consumer spending will moderate slightly while government spending is expected to be far more restrained in light of record budget deficits.
- ◆ The Federal Reserve will continue to raise the short-term fed fund rate. The fed funds rate will rise over the next five Federal Open Market Committee meetings by another 125 basis points (in six short months). Now that the spread between the short and long has narrowed, a further tightening by the Fed will steadily feed into long-term rates. The 10-year Treasury will yield will be close to 5% in the second half quarter of 2005.
- ◆ The job market has kicked in. In the past 12 months, 2.5 million new payroll jobs have been added. The unemployment rate likely will slide to 5.1% in 2005 from 5.5% in 2004.

Industrial fundamentals improve - Southern California continues to outshine...

- ◆ Demand for warehouse and distribution space has been fueling the rebound in key industrial real estate markets nationwide. Absorption began to surpass the level of new supply in the second quarter of 2004 for the first time since 2000. Industrial vacancy will decline to 10.4% by the end of 2005 down from the 10.8% recorded at the end of 2004. Absorption will be down, but still a very healthy 134,844 million square feet in 2005.
- ◆ Large industrial space (more than 250,000 square feet) accounts for a considerable amount of new space in the development pipeline. This fact is significant in a market like Chicago, where of the 67 new industrial buildings (27 million square feet) being planned, 24 of these buildings (16 million square feet) are over the 250,000 square foot threshold. What makes this important is the fact that Chicago has an industrial vacancy rate of just over 21%. Compare this to Riverside California, where the industrial vacancy rate is just 3.7%, and of the 75 (22 million square feet) new industrial projects being planned, 25 (17 million square feet) are over 250,000 square feet.



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### Retail mergers and the potential impact on real estate...

- ◆ The vacancy rate at the end of 2004 was 7.5% and is expected to rest at 6.5% by the end of 2005.
- ◆ The ultimate impact on commercial real estate from recent merger activity in the retail sector has yet to be determined. However store closings in the mid to long term are likely. The acquisition of Sears by K-Mart could result in several stores closing. The same thing could happen should the on-again/off-again merger talks between Cincinnati-based Federated Department Stores and St. Louis-based May Department Stores gets finalized.
- ◆ Retail rent growth will be the best of all commercial property types with an expected 4.8% increase in 2005 and slightly less (4.2%) in 2006.



### Office Market to have decreased availability...

- ◆ Of all property sector types, the office market is poised to make the best comeback over the next two years. In fact, the NAR forecast calls for a full two percentage point drop in the availability rate as the year-end of 2006 approaches. The current vacancy rate of 15.4% is down significantly from the highs of almost 18% seen in 2003. The vacancy rate by the end of 2005 is expected to be 14.2%.
- ◆ Increased absorption is accounting for a good portion of the decline in availability, but, more importantly the progressive decline in the amount of new space coming on-stream is improving the fundamentals in the office market nationwide.
- ◆ The amount of sublet space is declining for two reasons, new demand and internal growth. As the economy improves and corporations "ramp-up", they often need additional space. Sublet space is often available at a discounted rate and therefore is leased-up prior to direct space. Additionally, firms that had unused or underutilized space (shadow space) have been actively putting it to use and removing it from the active market.



### Multi-Family availability will dip below 6% in 2006....

- ◆ Absorption is keeping pace with new supply. There is, however, a disconnect between markets with significant demand and markets where new units are being constructed. The markets that have high demand are not necessarily those markets getting new supply. Hence, our forecast calls for the vacancy rate to remain near 6.0% range at least until 2006, when new construction will fall off by about 10%.
- ◆ Rent growth is expected to be lackluster in 2005 and 2006 at 2.1% and 2.6% respectively, thereby lagging behind rent growth anticipated for office and retail properties. The rate of homeownership is still relatively strong and this is impacting the performance of some multi-family markets.



## Investment sales - another banner year for commercial real estate....

- ◆ All sectors of commercial real estate experienced a 53% increase in transaction volume in 2004 compared with 2003. In 2004, total sales volume was \$181.4 billion compared with \$118.8 billion in 2003.
- ◆ Investment in multi-family and office properties lead the way with a respective 63% and 57% increase in volume last year. Real Capital Analytics reports that over \$48.0 billion worth of multi-family properties sold in 2004, while office building transactions were at a record \$73.5 billion. Industrial property sales volume at \$20.4 billion was up 42%, while retail property sales volume, at \$38.5 billion, was up over 30%.
- ◆ Purchaser profiles and activity levels vary significantly by sector. For example, foreign investors spend over \$12 billion on US commercial real estate last year, of which three-quarters was spent on office properties. Publicly traded Real Estate Investment Trusts (REITs) were primarily involved in the acquisition of retail properties, accounting for almost 14% of the \$38.5 transaction volume.



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**Defeasance:** Making an investment "whole." Or a process of retiring a mortgage before its maturity date by replacing it with in many cases - collateral. A significant factor in the defeasance of commercial mortgages these days is the increase in the value of a property and therefore an owner is able to borrow against the property value, often at a rate significantly below the rate of interest of the original loan. It is estimated that the commercial defeasance industry in 2004 was a \$6.0 billion business in the United States. Also sometimes referred to as "yield maintenance."