

# Commercial Real Estate Outlook

Mid Year 2010



**The U.S. commercial real estate market is strained because of the general U.S. economy.** All aspects of the economic decline have affected the commercial property sector, including the lack of job growth, reduced consumer spending and corporations' continued focus on maintaining low inventories. Low job growth affects office space; weak consumer confidence and constrained spending affect the retail environment; declining inventories lead to less need for space; and pressure on apartment leasing affects the multi-family sector. We believe valuations have settled at the bottom of the cycle, but the outlook indicates they will stay there for an extended period, followed by a slow and perhaps uneven climb.

**Fundamentals remain weak, but the overall negative trend seems to have diminished.** Property fundamentals remain weak. Although metrics seem to have hit bottom, any significant improvement in fundamentals most likely will not begin until mid 2011 into 2012. Its timing depends on property type, location and – more importantly – sustainable job growth.

## National statistics for the first quarter of 2010:

**Office:** Office property recorded a 12.8% vacancy rate, up from 12.7% in the fourth quarter of 2009. We have seen a negative absorption of 3.5 million square feet during the first quarter of 2010. Rental rates continue to show negative trends. The current average is \$21.81 per square foot compared to \$22.58 per square foot in the fourth quarter of 2009, a 3.4% decrease.

**Retail:** This property type has a 7.5% vacancy rate, up from 7.4% in the fourth quarter of 2009. Retail has experienced a negative absorption of 519,824 square feet during the first quarter of this year. Rental rates continue to show negative trends. The current average is \$15.60 per square foot compared to \$15.86 per square foot in the fourth quarter of 2009, a 1.6% decrease.

**Industrial:** CoStar reports a 10.4% vacancy rate, up from 10.2% in the fourth quarter of 2009. Industrial property has seen a negative absorption of 25 million square feet during the first quarter of 2010. Rental rates continue to show negative trends, as well. The current average is \$5.37 per square foot compared to \$5.45 per square foot in the fourth quarter of 2009, a 1.5% decrease.<sup>1</sup>

**Multi-Family:** Multi-family real estate had an 8% vacancy rate for the first quarter. New complexes coming on line have experienced weaker statistics, however, as absorption has been slow. Vacancies above 30% for new inventory have not been uncommon, driving concessions upward in some markets.<sup>2</sup> We have seen positive sentiment coming back to the market recently, however, as investors have driven capitalization rates down, because of expectations that multi-family will be the first to emerge from the recession. The National Council for Real Estate Investment Fiduciaries reported a 4.44% second-quarter return for multi-family property, the best of all sectors.

**Some markets prove resilient, while others continue to struggle.** Maximus Advisors reported in July 2010 that larger metropolitan statistical areas in the United States are forecasted to experience improved economies over the near term, although some will improve only minimally. The pace of recovery in Austin, the District of Columbia/Northern Virginia and Raleigh-Durham is expected to outperform others, followed closely by Dallas/Fort Worth and San Antonio. At the opposite end of the spectrum, Cleveland, Detroit, Northern New Jersey and Oakland are expected to underperform.

## The statistics for property types tell one side of the story, but we see more to the numbers than meets the eye.

**Office:** Compared to the early 1990s, the office sector is experiencing minimal oversupply and little to no construction or development in the pipeline. Demand for space also is significantly reduced. Companies have reduced staff, which has lowered their short-term space needs. As a result, we're experiencing a tenant's market, and some companies have taken advantage of that by increasing space at lower rents based on future expected employment levels. Creditworthy tenants have considerable negotiating power, and the lack of demand from other users will continue to give them the upper hand in most markets, even though we haven't seen as much overbuilding as we did in the late 1980s and early 1990s. We expect continued downward pressure on rents, as tenants have their pick of space and are "shopping" for the best deals.

**Industrial:** We foresee minimal oversupply and limited construction and development for industrial properties. As a result, we don't expect rents to decline significantly, because the basis for low-finish warehouse space is already very low relative to other property types.

<sup>1</sup>Office, retail and industrial data source: CoStar First Quarter 2010

<sup>2</sup>Marcus & Millichap 2010

We expect a slow uptick in demand, much of which is dependent on GDP growth, consumer spending patterns and currency fluctuations, which affect export trade volume.

**Retail:** We are seeing a significant flight to quality, with a focus on core retail properties such as grocery, drug, discounters and lower-priced clothing. Given the current unemployment environment and consumer sentiment, spending is focused more on needs than wants. The overall consumer spending trend is more selective and constrained.

**Apartments:** Apartments began suffering before the recession, primarily due to consumers' access to cheap and plentiful home mortgage financing. Landlords were faced with departing residents who could afford a home at the same net cost as a rental unit. With a weak job market and continued layoffs, however, home foreclosures skyrocketed. Early indicators assumed that many individuals who were foreclosed upon would have to return to the rental market. But slow job growth forced people — mostly the younger demographic profile — to “double up” or return to their parents' homes, reducing apartment occupancy. Counter to this trend, tighter credit for home mortgage financing may now result in more people dwelling in apartments longer, if they can't qualify to purchase a home, which will increase demand. This trend has recently affected the apartment market, resulting in stabilization and improvement in some cases.

**Delinquency rates continue to rise.** The American Council of Life Insurers' delinquency rates for the first quarter of 2010 are at 0.35%, up from 0.19% for the same period in 2009. This number appears to be understated, because life insurance companies are managing their delinquency rates by moving problem assets off their balance sheets for reporting purposes. According to Barclays, commercial mortgage-backed securities (CMBS) delinquency rates are much higher, at 7.18%. We expect delinquencies of 2006 to 2008 vintage loans to increase, based on loan originations at the peak of the commercial real estate cycle. Overall, we foresee commercial delinquencies continuing their upward trend at a much slower pace through 2010 and 2011.

**Capital markets remain constrained, but lenders are showing signs of renewed interest.** Borrowers had a tough year in 2009, as many lending sources dried up. More specifically, the CMBS market, commercial banks and many life insurance companies all but eliminated their allocations to commercial real estate credit. In mid-2010, however, improved liquidity is evident, as lending competition has re-emerged, resulting in spread compression. Those that were lending in the 2009 environment typically were life insurance companies that had healthy balance sheets and limited exposure to the asset class compared to their peer group. With the reemergence of most life companies and a slow return of CMBS conduit lending, the lending environment has changed for high-quality real estate assets and lower loan-to-value opportunities. Commercial banks, however, will continue being pressured by regulators and troubled balance sheets, including failed construction loans and exposure to residential mortgages within their portfolios. Only the healthiest banks will have capacity to continue their commercial lending platforms.

**Weak fundamentals can present an opportunity for those with a disciplined investment approach.** We must be cautious about interpreting the effects of a U.S. economic rebound on the commercial real estate market. We have seen a buildup in both private and public capital that is applying a patient approach to investing and is very selective, focusing on high-quality assets in key markets. The market is now feeling the effects of this capital being deployed on those high-quality assets. Cap rates have bifurcated, with lower caps (6% to 7%) for the highest-quality properties and higher caps (+/-10%) for distressed or less-desirable properties. This gap was not as evident at the peak of the cycle, generally between 2006 and early 2008.

**Technicals drive the gap between the low point and stability in the commercial real estate market.** Technical conditions and lender sentiment will continue to put downward pressure on spreads. In an effort to add yield relative to many other asset classes, life insurance companies have increased their allocation to commercial mortgage loans, but their focus has clearly been on quality. Competition has increased because of the limited supply of lending opportunities that meet the current stringent underwriting standards and because of demand for yields that are greater than those of investment grade bonds. Longer term, an increase in demand for CMBS also may create more demand for commercial real estate, as conduits re-enter the marketplace.

**A high volume of loan maturities looms on the horizon.** More than \$514 billion in debt maturities (CMBS, insurance companies and banks) are scheduled in 2011<sup>3</sup>. Many institutions have provided extensions for loans with near-term maturities that can't be refinanced because of the decline in property values and constrained lender liquidity. Declining cap rates have reestablished equity for those properties that exhibit stable income streams, however. This may mitigate the negative effects and counteract the large supply of refinances expected over the next few years. It will be heavily dependent, however, on interest rates remaining at near-record low levels.

**The U.S. commercial real estate market is in the process of bottoming, and we expect further stabilization over the short term. We must consider these ongoing risks, however:**

- The low interest rate environment is the primary driver mitigating what could be a much tougher commercial real estate environment. Cap rates have declined for higher-quality assets, but only given a lending environment defined by extremely low interest rates. Should interest rates begin to rise materially, while fundamentals remain relatively weak, the liquidity in the equity market may dry up, further extending the recessionary environment for commercial real estate.
- A commercial real estate mortgage refinance crisis may be on the horizon, as loan maturities — especially overleveraged CMBS loans — come due in the short to intermediate term. If job growth does not improve and property fundamentals remain flat, the

<sup>3</sup>Trepp/UBS, June 2010

low interest rate environment is key to mitigating the upcoming refinance risk. Deleveraging — the result of lenders' inability to refinance maturing loans — will most likely require an infusion of equity or force lenders to absorb increased losses.

- A drastic shift in the regulatory environment could cause commercial banks and CMBS special servicers to flood the real estate market with underperforming assets. This could lead to another substantial drop in real estate values and potentially dampen the capital markets' appetite for the asset class.
- Expectations for moderate economic growth and uncertainty resulting in a potential double-dip economic scenario increases the risk of an additional downturn in commercial real estate.

**Despite the overall weakness in the commercial real estate market, we expect to continue identifying lending opportunities on well-margined, high-quality assets that exhibit stable to strong fundamentals and limited downside risk.** Fundamentals remain weak, but we believe the market is in the process of bottoming. We expect continued softness and possibly further weakening in select markets, but we believe the worst has been realized, given a 40% to 50% price decline since the peak. Additionally, oversupply is not the driving issue like it was in the late 1980s and early 1990s. This will lend a helping hand to the real estate market once an economic recovery takes hold. Investing at today's market values and conservative loan-to-value ratios provides solid investment opportunities. We believe pricing for these high-quality commercial mortgage loans will continue to compress but also will add value over other lower-risk investment alternatives.

### **Important information**

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