Back on Track for Modest, But Continued Growth

NAIOP Confidence Report: Spring 2011
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April 26, 2011

Executive Summary

In a recent survey of NAIOP Forum members, the general consensus is “the future is now” or more accurately, on the horizon. The majority believe the United States economy has turned the corner and is on the road to a sustainable recovery. This perception is fairly widespread, although the outlook is tempered by the realization that the economy faces a number of challenges both domestically and globally that pose some downside risk. Despite recognizing these risks, many real estate professionals believe that the improving economy is setting the stage for a gradual, somewhat lagged recovery in the commercial real estate market. At the same time, they are reporting moderate improvements in capital market conditions and capital flows which are helping the real estate market gain some traction as evidenced by increasing transaction volume, capital flows and underlying market conditions. This generally positive outlook is being evidenced by a growing sense of optimism surrounding the prospects for development, although such enthusiasm is appropriately tempered. It is expected that economic conditions will continue to improve overall. However, before the real estate market benefits from a broad-based recovery, we will have to have job growth, a new round of business investment and ultimately consumer spending. Even when that occurs, the industry will be characterized by more discipline and greater reliance on analytics than in the recent past which will pose some short-term challenges that will have to be overcome but will translate to a more stable market over the long-term.

Respondents to the NAIOP Confidence survey perceive that the economy is back on track and faces prospects for modest, but sustainable growth. Some notable observations from respondents include:

- The housing market is lagging but the commercial market has bottomed out.
- The capital markets are improving, although there are some issues associated with the need for capital to refinance ballooning mortgages and clear the queue of distressed assets.
- Commercial mortgages are available under somewhat more stringent underwriting and at appropriate risk-adjusted rates.
- The commercial market outlook is improving.
- The general environment regarding development remains guarded, although there is some anticipation the situation will improve but in line with underlying fundamentals.

The NAIOP Confidence survey was developed in collaboration with NAIOP Corporate staff as well as an ad hoc advisory committee. The committee helped develop four key areas for the survey to address: economic conditions, capital markets, real estate industry outlook and trends.

Going forward, the survey results suggest the industry will have to work through some challenges, but will ultimately emerge in a more disciplined and sustainable manner. So, the future is getting closer.
Forum Members’ Look Ahead

To make informed decisions, real estate professionals must monitor economic, capital market and real estate indicators to reveal underlying trends that will affect future market conditions. To this point, such analysis has often been defensive, relying on after-the-fact analysis that tries to understand what happened. This has put real estate decision-makers on the defensive, forcing them to react to what has happened rather than what is likely to happen. The objective of this inaugural NAIOP Confidence Report is to compile, analyze and evaluate the perceptions and expectations of its members who represent major players in the commercial real estate market. The results of this survey can help develop more valid and reliable predictions of future market conditions.

The survey was conducted from April 4-8, 2011 with the following results:

- 168 responses which generated a national sample of respondents who were representative of the Forum membership.
- The average respondent was a seasoned professional with some 24 years of experience and an average expected career of another 16 years.
- Over 75 percent of the respondents were developers/owners, with the complement consisting of product or service providers that support the industry.

Part 1: Economic Outlook

Market Cycles. The commercial real estate market is generally regarded as a cyclical industry which can either lead or lag the broader economic cycle. In this case, the commercial real estate market is expected to lag the economic recovery -- which almost 90 percent of respondents believe has already begun. With respect to commercial real estate, almost half of the respondents believe the market has bottomed out while another third believing it will do so by the end of the year. These attitudes incorporate a number of considerations including:

- Economic Conditions. Respondents are generally positive with respect to the economic outlook and believe the recovery is sustainable. They believe GDP growth will be moderate while inflation will not be a concern over the next several years. These expectations are built on a number of factors including strong corporate profits and balance sheets that should allow companies to respond to improved economic conditions. They believe credit markets will return to more normal conditions, interest rates will remain low and inflation will not be a major factor over the near term, although opinions are somewhat divided on those fronts.

- Economy and Market Ratings. To get additional insights into the relationship between the economic recovery and the commercial real estate market, respondents were asked to rate a number of factors that straddle the two markets. The highest rated factors on the economic front were the favorable interest-rate environment, followed by relatively strong business confidence and increasing access to commercial debt. Respondents are concerned over the plight of the housing market but believe once it bottoms out it will translate to improvement in consumer confidence, which should provide an added stimulus to the recent uptick in retail sales.
• **Key Economic Indicators.** Respondents were asked to indicate the key economic indicators they consider when evaluating the future prospects for commercial real estate. The open-end responses covered a range of factors, although most were dominated by employment considerations related to job growth, employment trends and unemployment levels. **Respondents also pay close attention to business and consumer confidence levels, as well as credit conditions, including availability and costs, and the plight of the housing market.** In addition to tracking these factors at the national level, many respondents focused attention on the economic factors that most affected their local markets.

• **Economic Risks.** To provide some insights into the downside risks on the economic front, respondents were asked to identify factors considered the biggest risks to the national economy. Not surprisingly, the employment scene with the lack of job growth and nagging high unemployment was noted as the biggest risk factor. This was followed by concern over business and consumer confidence levels which some believe were tenuous. There was also some concern over increases in interest rates especially if the Fed is forced to increase rates to combat inflation. The stumbling housing market remains a concern, creating a drag on the economy and consumer confidence as well.

**Part 2: Capital Markets**

• **Capital Market Awareness.** In the past, some developers approached the commercial real estate market with a narrow sense, ignoring capital market and economic indicators. This situation has changed as the markets have become more integrated. Recognition of this trend is echoed by the fact that some 75 percent of respondents routinely follow the capital markets as part of their normal business activity. **In terms of capital market indicators, respondents pay significant attention to interest rates ranging from 10-year treasuries to the shape of the yield curve.** They also look at the cost of capital, including cap rate requirements of equity investors and the cost of debt.

• **Ratings on Capital Markets.** In general, Forum members are fairly upbeat on capital market ratings. One of the strong factors they cited is growing investor enthusiasm for real estate investments as well as increasing availability of commercial mortgages, although access to mezzanine financing and construction loans is somewhat more problematic. On the negative side, respondents are concerned about the inability to refinance maturing bullet loans, a situation that will continue over the next several years. They are also concerned about tightened underwriting standards and lower loan-to-value ratios that will make it more difficult to put deals together -- both new ones and those that need to be refinanced.

• **Mortgage Rates and Terms.** With respect to the cost of debt, respondents report lenders are paying more attention to risk -- which has translated to greater spreads for speculative and distressed project financing. In addition, underwriting standards have tightened, with a decline in loan-to-value ratios as lenders move out of the risk spectrum. This outlook varies by type of property and type of loan. In general, interest rates are expected to increase modestly over the next 12 months but should remain low by historical standards.
• Capital Market Issues. Respondents are concerned about a number of issues that may adversely affect the capital markets. **The key issue is the risk of increasing interest rates if the Fed is forced to step in and try to control inflation.** Respondents are also concerned about the overall debt markets. This includes challenges associated with access to capital and stricter underwriting requirements such as reliance on recourse financing. There are also concerns about the plight of bank balance sheets, with respect to mark-to-market requirements versus the “blend and extend” approach some have adopted. Some are concerned that the recent trend to aggressive pricing has driven values to unsustainable levels, which may be corrected as attention shifts to the risk side of the equation. Finally, an issue hanging over the market is the plight of the CMBS industry and the lack of capital necessary to retire the impending surge in maturing bullet loans.

**Part 3: Real Estate Markets and Outlook**

• Cap Rates. Over the past 12 to 15 months investors have focused on large trophy properties, pushing cap rates down to pre-recessionary levels. Interestingly, respondents report cap rates more in line with longer-term historical averages. This is reported at an overall level as well as by property type and subtype. **In general, cap rates are expected to stay fairly stable over the next year, with apartments exhibiting the lowest cap rates.** With respect to office properties, Class A office cap rates are reported at 7.8 percent, with other office properties slightly over 9 percent. A similar spread is exhibited in retail with larger retail trading at 8 percent rates and smaller retail pushing 8.8 percent. Industrial properties are on par with Class A office and larger retail properties, while mixed-use properties are trading at slightly higher cap rates.

• Real Estate Market Conditions. With respect to real estate market conditions, respondents anticipate gradual improvement but no major surge in development activity. This outlook carries over to projects in the queue that will remain on hold until market fundamentals improve to the point that net rents are adequate to generate attractive risk-adjusted returns. **Respondents are divided as to whether investors have a clear understanding of the risk associated with real estate and have appropriately priced it into yield requirements.** Their concern is that the recent surge in values is not sustainable and they worry that the capital markets may be ahead of the spatial markets with respect to supply and demand fundamentals.

• Cost Trends. In preparing the survey, some members of the advisory committee expressed concern over potential changes in costs that may adversely affect the real estate recovery. To explore this concern several questions were posed relative to the trend in costs over the past 12 months as well as the outlook for costs going forward. **In general, respondents reported that land costs were down by some seven percent in the past 12 months, followed by more moderate declines in construction bids and labor costs.** Respondents did not report a significant decline in costs of steel and materials. In the future, land and labor costs are expected to be relatively flat with some upside risk. On the other hand, costs and materials are expected to increase ahead of inflation, leading to a three-percent increase in construction bids.
• **Development Potential.** Respondents were asked to rate the development potential over the next 12 to 18 months. While this inaugural survey does not provide a basis for comparison, the anecdotal evidence suggests that development prospects have been improving. This conclusion is based on several factors, including reports of positive absorption which has led to improvement in supply and demand conditions in a number of markets. Although development activity has been tempered, respondents report generally favorable access to permanent loans for new properties, along with improved tenant demand for such facilities. The outlook for land and construction costs has had a neutral impact on the ratings and should not be a major constraint on the market. However, higher cap rate requirements for speculative projects, coupled with the inability of net effective rents to cover construction costs, constrain the near-term outlook for development. That said, development prospects are moderately positive and likely to stay in sync with the economic recovery and capital market conditions.

• **Property Type Development Potential.** Despite a generally moderate outlook for development potential, respondents did single out some property types that had the best prospects. Leading the pack were multi-family projects followed by industrial properties. Office, including medical office, is also commonly mentioned. Respondents indicated build-to-suit activity would be relatively strong, depending on tenant demand. Interestingly, mixed-use projects and transit-oriented development projects were mentioned less than a handful of times combined.

### Part 4: Future Real Estate Industry Outlook

• **Trends Affecting the Market.** Respondents were asked to identify the most important trends that will affect the commercial market. Responses covered a wide array of factors. Many of these factors related to uncertainty over government policies that could adversely affect the overall economy, as well as local government actions related to land use controls. A number of respondents discussed changes in local building and zoning codes that would affect the density and costs of development in their local markets. They also noted the continued importance of sustainable buildings from both regulatory and marketing perspectives. On the tenant side, respondents saw a continued push toward lower space requirements per employee, along with the demand for more flexible, energy efficient facilities. Some respondents were also concerned about the impending changes in the treatment of corporate leases which would force tenants to revisit their “lease versus own” decisions. However, they also saw this as an opportunity that might open the door for some partnering with tenants who could become equity partners. A number of respondents pointed out the impact of technological innovation which could change the location, nature and quantity of demand for space across property types. Changing population demographics and competitive dynamics were also pointed out as significant trends that could affect the real estate market.

On a cautionary note, some respondents saw potential value declines associated with property suffering from locational and functional obsolescence, as attention shifted toward inner-city and infill locations that benefit from transit systems. In terms of capital, respondents anticipated that investors would rely less on leverage and approach real estate from a more, long-term investment perspective rather than the short-term, commodity approach of the recent past.
• **Biggest Issue Hanging Over Real Estate.** While the respondents were generally upbeat with respect to the commercial real estate recovery, they did point to a number of issues hanging over the industry. Many of these issues related to factors that could adversely affect the general economy and capital markets while others related to market behavior. *Of particular concern was the inability of the federal government to deal with the deficit exposing the country to downside risk as it tries to compete on the global stage.* Respondents were also concerned about the impact of unexpected world events ranging from natural disasters to rising turmoil in the Middle East that could drive up energy costs and forestall the economic recovery. Some respondents also expressed about potential shocks to the capital markets that could shake confidence and put the financial industry on its heels. In terms of the real estate market itself, some respondents expressed concern that some undisciplined maverick developers and rogue lenders would try to get ahead of the demand side of the market.

• **Changes in Real Estate Market.** The final component of the survey explored respondents’ attitudes toward changes that would occur in the commercial real estate market as a result of the recent experiences. Some respondents suggested that the industry would not really change but merely chug along much as it has since the recovery kicked in. Other respondents worried that the industry would revert to the “old normal” which would be characterized by a series of boom and bust periods. *This was a recurring consideration, with some suggesting that the lessons learned would lead to permanent change, while others were less sanguine and postulated the market would ultimately revert to its previous modus operandi.*

A number of respondents believe that the real estate industry would come out of the downturn in a more disciplined manner, with fewer larger and better capitalized developers dominating the industry. In this environment they saw more reliance on analytics and forecasting rather than on wishful thinking and financial engineering. Some thought developers, lenders and investors would be more rational and would pay more attention to real estate fundamentals affecting supply and demand. They saw a return to more disciplined underwriting as well as introduction of the system of checks and balances emanating from the combination of space users, lenders and investors and government regulators. Some respondents anticipated changes in the nature of the built environment ranging from emphasis on smarter more efficient buildings, as well as on connections and linkages among places.