Is U.S. Commercial Real Estate On The Mend, Too?

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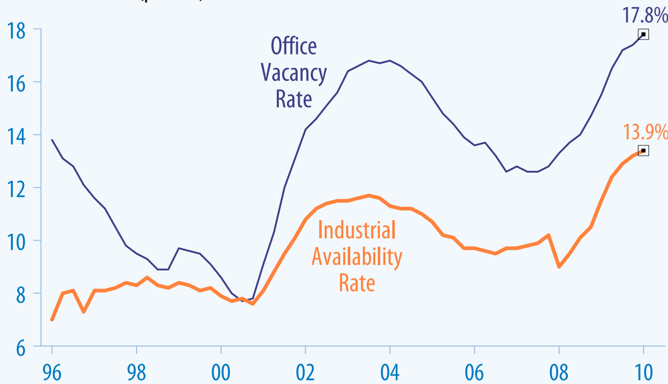
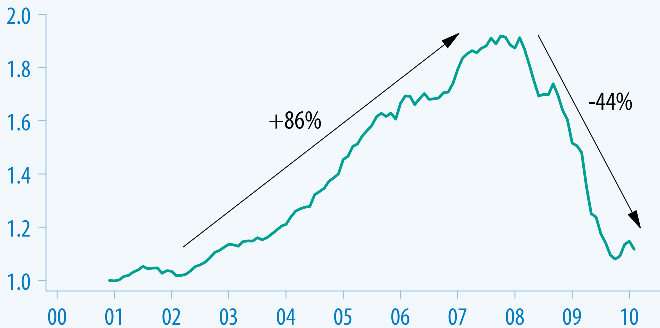
CHART 1
NO SHORTAGE OF SPACE
United States (percent)



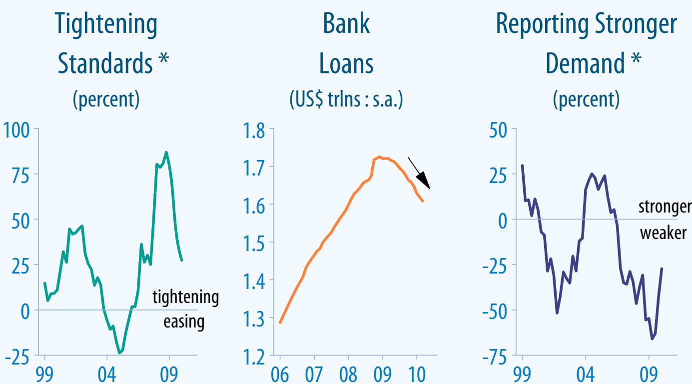
Source: CB Richard Ellis

CHART 2
THE BIGGER THEY ARE, THE...
United States (December 2000 = 1)
Commercial Real Estate Prices



Source: Moody's / MIT Center for Real Estate

CHART 3
NO CREDIT FOR TRYING
U.S. Commercial Real Estate



Source: Federal Reserve Board * % of banks in Senior Loan Officer Survey reporting on CRE loans

Each day brings more evidence of a maturing U.S. economic recovery. Growth started with inventory rebuilding, fiscal stimulus and an upswing in exports; and has recently expanded to business and consumer spending. Even housing, though still shaky, is far removed from its darkest days. But one sector continues to lag: commercial real estate, which involves the development and maintenance of offices, hotels, factories, apartments and retail outlets. **This sector is often the last to emerge from recession, and this time will surely be no different, though there are nascent signs of recovery.**

Commercial real estate markets remain "very weak" according to the Fed's Beige Book, and "troubled" according to Chairman Bernanke. **Office and industrial vacancy rates continue to climb** (*Chart 1*). Shopping mall vacancy rates hit a two-decade high of 10.8% in Q1, depressing rents. The sharp downturn in business travel last year pushed hotel occupancy rates to a record low 55%, with no sign of improvement in early 2010. Though easing somewhat, the apartment/rental housing vacancy rate stayed near a record-high 10.6% in Q1, one-third above normal levels. However, apartment rents rose for the first time in six quarters (according to Reis Inc.), reflecting increased demand from foreclosure refugees.

Though showing recent signs of steadying, commercial property prices have dropped even faster than house prices during the bust, plunging 44% and erasing nearly all of the run-up from 2001 to 2007 (*Chart 2*). Hotel properties have lost half their value.

Steadier property values would help stem the wave of commercial property loan defaults. Delinquencies, though slowing, hit a 16-year high 8.8% in 2009Q4, compared with 10.1% for residential loans. A record number of hotels have defaulted. Moreover, delinquencies on commercial mortgage-backed securities (CMBS) rose sharply in February according to market sources.

Facing still-high delinquency rates, banks continued to tighten lending standards on commercial loans in Q1,

TABLE 1
CREaMed BY GREAT RECESSION
United States
Major Contractions in Real Private Commercial Construction

Peak-to-Trough	Change (percent)	Duration (quarters)
1969Q3 – 1971Q4	-4.3	9
1973Q3 – 1975Q2	-15.3	7
1981Q4 – 1983Q2	-20.9	6
1985Q1 – 1987Q1	-17.1	8
1990Q1 – 1994Q1	-20.2	16
2000Q4 – 2003Q1	-25.9	9
Average	**-17.3**	**9**
2008Q2 – 2010Q1	**-29.4**	**7**

causing bank credit to contract further in the face of weak demand (*Chart 3*). More positively, the CMBS market, a source of cheap funding during the credit boom (more than half of transactions in 2006 were interest-only loans), has started to thaw as investors nibble at high-quality issues. About $4 billion in CMBS was sold in the first four months of this year, more than the $3 billion issued in all of 2009, though that's still a pittance compared with the record $230 billion sold in 2007. Uncertainty over new securitization regulations might be holding back the market.

Amid rising vacancy rates, falling rents and still-tight lending standards, non-residential construction plunged further in Q1, though the decline eased somewhat to 14% annualized from 18% in Q4. The 29% contraction to date, though half as severe as that for housing, is the worst on record, even surpassing the technology bust of the early 2000s and the 16-quarter slog during the Savings & Loan crisis in the early 1990s (*Table 1*). Commercial construction often lags the business cycle by a couple of quarters, and it will probably take longer than usual to bounce back this time given the excess supply built up during the boom. Indeed, the Beige Book suggests ongoing weakness in April. **After contracting 20% in 2009, non-residential construction could decline a further 13% in 2010.**

Still, commercial property construction should stabilize by year end, before growing moderately in 2011. Demand for industrial space will likely recover first in response to resurgent manufacturing activity. New office buildings should follow, as a pickup in hiring will reduce vacancy rates. New York City's property market has already sprung back to life because of the upswing in capital markets activity. However, demand for retail space may take longer to return given relatively moderate spending growth, as will apartment construction due to the overhang of unsold homes.

Non-residential construction accounts for a relatively small slice of economic activity (3½% of GDP), thus even a further large decline won't cause a double-dip recession. Last year's 20% contraction subtracted less than one percentage point from GDP growth, and this year's likely smaller decrease will reduce growth by less than one-half percentage point. However, the knock-on effects can't be ignored. U.S. banks hold about $1.6 trillion of commercial real estate loans, roughly 17% of bank credit, and continued weakness in the sector could persuade many to maintain strict lending standards. A Congressional Oversight Panel report in February warned that nearly half of the roughly $1.4 trillion in commercial loans that are due for renewal in the next four years are "underwater", resulting in possible defaults that could cost banks $200 billion to $300 billion. Owners owing more than their property is worth will find it difficult to refinance, especially in the wake of more stringent loan-to-value standards. The expiry in late June of the Fed's Term Asset-Backed Securities Loan Facility (TALF) for newly issued CMBS won't help the situation.

The Bottom Line: Commercial real estate remains mired by high vacancy and default rates, soft rents and uneasy access to credit. However, the sector should regain its footing later this year as the economy strengthens. Until then, lingering weakness could discourage banks from easing credit standards, providing further justification for Fed policymakers to delay tightening.

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