Viva El Cycle

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The current hard pullback in the commercial/multifamily real estate cycle could be setting up a powerful rebound when the upside finally comes.

In May 2008, *The Wall Street Journal* quoted Rob Feckner, president of the Sacramento, California–based California Public Employees' Retirement System (CalPERS) board of administration, saying, "Real estate is a very cyclical business, especially right now." This truism is remarkably telling about today's commercial real estate markets and about what we can expect in coming quarters. ■ Commercial real estate markets are cyclical. When property fundamentals are improving, developers see opportunities and deliver new space to the market. With multiple developers each trying to meet market demand, the space that comes online typically overshoots demand, creating competition to lease the excess space and putting downward pressure on occupancies and rents. The resulting hit to property incomes and values slows new development activity until rents and occupancies once again begin to firm and developers once more see opportunities. ■ That is the typical cycle. ■ The current down cycle in commercial real estate follows a slightly different path. Today's high vacancy rates and rent declines were caused by a withered economy rather than excess new development. ■ Even so, the depth of the recession of 2007/2008/2009 hit property fundamentals hard, and the resulting pullback in new-construction activity is setting up the next phase of a classic real estate cycle.

Property performance

Property performance is typically the driver of the real estate cycle. It was one of the first aspects of commercial real estate markets to decline during the recession, and it is now showing itself among the first to stabilize and recover.

The "Great Recession" had a profound effect on demand for commercial real estate. According to the U.S. Census Bureau, from peak to trough, more than 8 million jobs were lost, including more than 4.5 million services jobs; between July 2008 and July 2009, retail sales fell by 9.84 percent, the largest percentage decline on record; and in 2008 the number of households in the United States declined on a year-over-year basis for the first time since 1961.

The effects of these economic declines on commercial real estate were just as pronounced as overbuilding would be. According to Property & Portfolio Research Inc. (PPR), Boston, in 2008, 672 million square feet of more space came onto the market—through negative net absorption and completions—than was absorbed. In 2009, that number climbed to 815 million square feet. By comparison, in 2005, 305 million square feet more space was absorbed than came online.

The results of the excess space were spiking vacancies and plunging rents throughout 2008 and 2009.

As the economy and demand for commercial space fell, vacancy rates rose for all property types—most hitting record highs (see Figure 1).

Apartment vacancy rates rose from 5.7 percent in September 2006 to 8.4 percent in December 2009; industrial vacancies rose from 8.6 percent in March 2007 to 13.3 percent in March 2010; office vacancies rose from 14.5 percent in September 2007 to 19.6 percent in March 2010; and retail vacancies rose from 9.6 percent in June 2006 to 19.4 percent in March 2010.

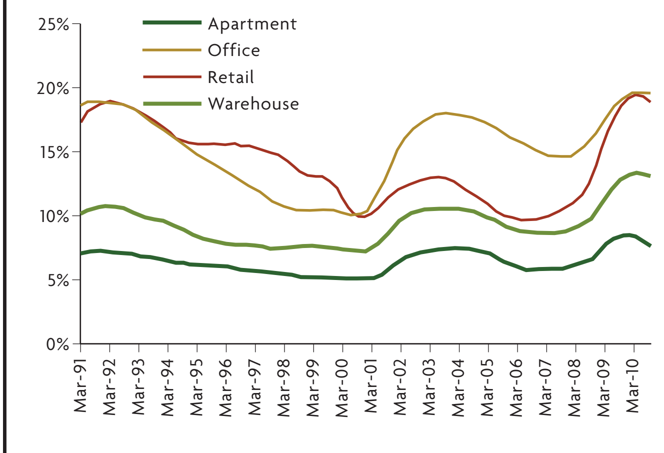
Similarly, asking rents fell hard. Peak-to-trough (or current), asking rents fell 7 percent for apartment properties, 12 percent for office space, 14 percent for retail and 15 percent for industrial.

Economic growth—albeit slow—is starting to eat into vacancy rates and stabilize asking rents. During the third quarter of 2010, every major property type saw a decline in vacancy rates—the first time that has happened since the second quarter of 2006.

In addition, apartments saw their second straight quarter of growth in asking rents, and asking rents for office, retail and industrial properties each declined by the smallest percentages since mid-2008.

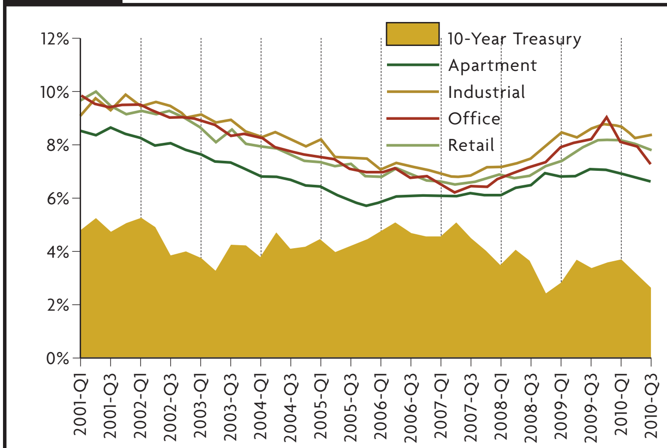
Lease terms are affecting how these conditions filter through to properties' bottom lines. Properties with relatively long-term leases, such as offices, have seen those

Figure 1 **Commercial/Multifamily Vacancy Rates, by Property Type by Quarter**



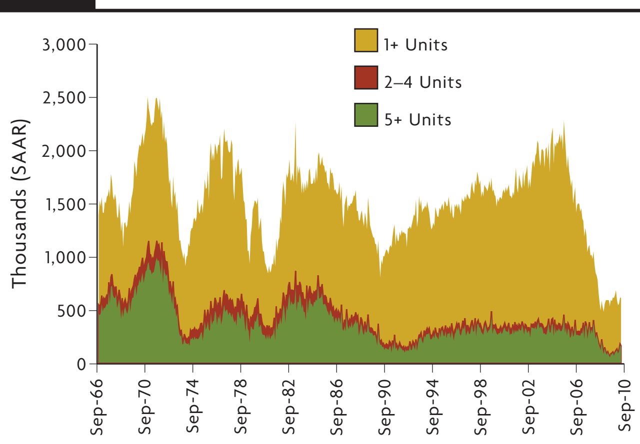
SOURCE: PROPERTY & PORTFOLIO RESEARCH

Figure 2 **Commercial/Multifamily Capitalization Rates, Properties and Portfolios $5 Million and Greater**



SOURCES: REAL CAPITAL ANALYTICS, FEDERAL RESERVE BOARD

Figure 3 **New Privately Owned Housing Units Started**



SOURCE: U.S. CENSUS BUREAU

longer terms provide some protection to net operating incomes (NOIs), as only a portion of leases roll and are repriced to lower levels during the depths of the recession. Property types with shorter leases, such as hotels and multifamily, saw more immediate NOI effects from the recession and are now seeing more immediate improvements.

Property values

Like property conditions, property values tend to react at the leading edge of the real estate cycle. Property values began to cycle downward in 2007, as the credit crunch and recession started to show themselves in earnest.

The Chicago-based National Council of Real Estate Investment Fiduciaries' (NCREIF's) Transaction-Based Index (TBI) peaked in the second quarter of 2007 and began a steady descent whereby it declined by 40 percent, peak-to-trough.

New York–based Moody's Investor Service's REAL Commercial Property Price Index (CPPI), which tracks prices on a different profile of properties, has followed a similar course, falling 45 percent peak-to-current.

Different property types experienced similar peak-to-trough declines, with apartments falling to 60 percent of their peak values; retail to 61 percent; industrial to 63 percent; and office to 64 percent. The timing has differed, however, with second-quarter 2010 prices up 15 percent from their lows for apartments, up 8.5 percent for offices and up 3.3 percent for retail, while industrial property prices in the second quarter marked a post-recession low.

Cap rates for most property types bottomed at the same time prices peaked, and began to climb in concert with property price declines, according to Real Capital Analytics Inc. (RCA), New York. Cap rates for all major property types peaked in the fourth quarter of 2009 (see Figure 2), with apartment cap rates rising 132 basis points from their low, office cap rates rising 171 basis points, industrial up 201 basis points and office cap rates up 273 basis points. Perhaps more telling, the spread between the yield on a 10-year Treasury grew from 126 basis points in the second quarter of 2007 to 490 basis points at the end of 2008.

As the cycle has rolled on, greater optimism among investors, declining NOIs (on which cap rates are based) and falling returns on alternative investments such as Treasury and corporate bonds have all served to pull cap rates back in. In the first three quarter of 2010, cap rates have fallen 39 basis points for apartments, 44 basis points for industrial, 46 basis points for retail and 173 basis points for office.

Data based on property sales should be viewed with a heavy dose of suspicion at present, given the small volume of transactions and differences in the composition of properties trading hands during different periods. This is compounded by the fact that down-cycle sales tend to be dominated by two types of properties that command lower cap rates—high-quality, stabilized properties that command low cap rates for their solidity, and distressed properties that command low cap rates for their growth potential.

Even with such caveats, it appears clear that the sales cycle has reversed. Prices appear to have stabilized—per the downward trend in cap rates and the Transaction-Based Index hitting a low in the fourth quarter of 2009—and the forward-looking nature of investment pricing means that property prices should tend to be a leader in an up cycle in commercial real estate markets.

New construction

The stabilization, and in some cases improvement, in property fundamentals and values is already starting to draw out talk of new development. The (record) high level of vacancies and the painful recent experience among construction lenders may stave off new activity for a bit longer, but the cyclical nature of commercial real estate coupled with the (record) low levels of current construction activity almost guarantee that in the not-too-distant future, new construction activity will return in earnest.

Multifamily construction activity is perhaps the clearest symptom of the real estate construction cycle.

In 1966, the Census Bureau measured the seasonally adjusted annual rate of new multifamily construction starts at 192,000 units (see Figure 3). As vacancy rates dropped, from 7.4 percent, construction activity rose. By March 1973, with vacancy rates down to 5.8 percent, multifamily starts had risen to a seasonally adjusted annual rate of one million units. The cycle turned, and by 1975 second-quarter vacancy rates had risen to 6.3 percent and June starts had fallen to 157,000 units.

The cycle continued, with demand exceeding supply, and vacancy rates fell and new construction returned. By 1978, vacancies were down to 5 percent and April starts peaked at 544,000. May 1980 saw the next trough in starts—190,000—and a vacancy rate of 5.6 percent. The mid-1980s saw construction activity climb, to a rate of 733,000 units despite a rising vacancy rate, but as vacancies continued upward, construction ground downward to an annual rate of just 90,000 units in December 1991.

Throughout most of the 1990s and the 2000s, starts hovered in a range of 200,000 to 300,000 units per year and vacancies rose as households were drawn to the growing homeownership market. With the recession of 2007/2008/2009, however, construction activity has fallen to new lows—a rate of just 49,000 units per year in October 2009.

The construction cycle does not apply only to multifamily development. A similar pattern can be seen in the value of new commercial construction put-in-place tracked by the Census Bureau.

The rise in office market construction activity of the 1980s was followed by a major contraction, which was followed by a new surge in the late 1990s and early 2000s. Then, that too was followed by a contraction, another surge and another contraction. Following the cycle, the surge comes next, likely held at bay until market fundamentals and competition for yield wear away a reluctance among banks to re-enter the market for all but the most conservative construction loans.

Mortgage performance

Commercial mortgage performance is also part and parcel of the real estate cycle, although usually on a more muted basis.

During the mid-2000s, the strength of property fundamentals, pricing and lending all led mortgage delinquency rates to extraordinarily low levels. At the end of 2007, the Mortgage Bankers Association's (MBA's) quarterly *Mortgage Delinquency Rates for Major Investor Groups* report showed that 0.02 percent of the balance of commercial mortgages on the books of life companies were 60 days or more delinquent, as were 0.08 percent of the balance of multifamily loans at Fannie Mae and 0.02 percent of Freddie Mac's balance (see Figure 4).

Commercial mortgage-backed securities (CMBS) loans had a 30-plus-day delinquency rate of just 0.39 percent and banks had a 90-plus-day delinquency rate of just 0.85 percent (up from 0.53 percent at the end of 2005).

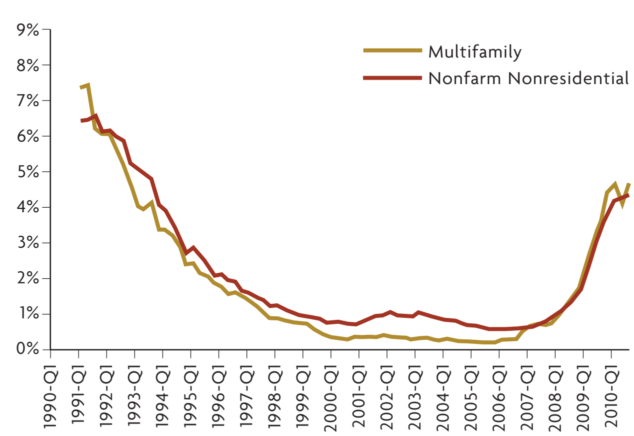
As commercial real estate's down cycle took hold, delinquency rates responded, although not uniformly. The 30-plus-day delinquency rate for CMBS climbed from 0.39 percent at the end of 2007 to 8.58 percent at the end of September 2010, and the 90-plus-day delinquency rate for banks/thrifts rose from 0.85 percent to 3.92 percent.

But the 60-plus-day delinquency rates for life companies and Fannie Mae and Freddie Mac have remained relatively low—at 0.22 percent, 0.65 percent and 0.35 percent, respectively, which is well below their levels in the early 1990s.

A first-lien mortgage's preferred status in the capital stack and the relatively long-term nature of most loans leads to loan performance that often doesn't see the same level of ups and downs as other aspects of the commercial real estate market. Coming out of the Great Recession, property prices and fundamentals have seen stress rivaling or surpassing that of the early 1990s, while commercial mortgage performance has, for most investor groups, been stronger during this downturn than during that prior period.

Like other aspects of the commercial real estate markets, at the end of the third quarter of 2010, delinquency rates for commercial/multifamily mortgages are showing stabilization and nascent improvement. The rates of

Figure **4** **Bank and Thrift Mortgages (Percent of Balance 90-Plus-Day Delinquent or in Nonaccrual)**



SOURCES: MORTGAGE BANKERS ASSOCIATION (MBA), FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC) increase in delinquency rates among CMBS and bank/thrift-held loans have slowed considerably, and rates among life companies and Fannie Mae and Freddie Mac remain at very low levels.

Stability and reductions in delinquency rates among CMBS and banks/thrifts could produce reinvigorated interest in lending, and fit right in with the up cycle for the sector as a whole.

Mortgage lending

Working hand-in-glove with the cycle of supply and demand for commercial real estate space is the cycle of supply and demand of commercial real estate capital. After tightening considerably during the recession, commercial lending is now constrained as much by a lack of demand for mortgages as by a lack of supply of mortgage debt.

During the 1980s, the run-up in construction activity was accompanied by a dramatic increase in the level of mortgage debt outstanding. At the end of 1984, the level of commercial mortgage debt outstanding as reported by the Federal Reserve Board was 20 percent higher than it had been the year before.

The real estate crash of the late 1980s and early 1990s brought contraction, and by the fourth quarter of 1994, the level of mortgage debt outstanding was 12 percent below its 1991 cycle peak.

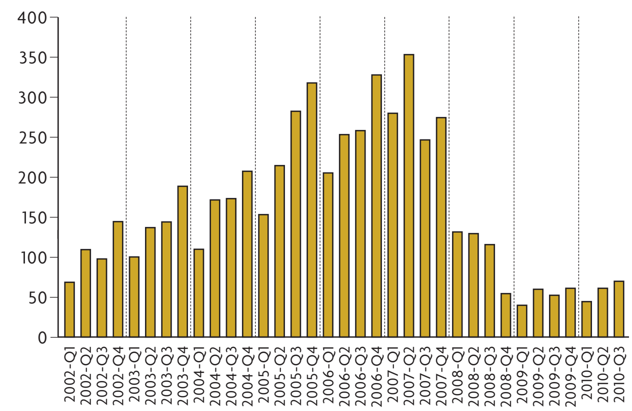
During the 2000s, commercial/multifamily mortgage debt outstanding was again growing strongly, with a peak year-over-year growth rate of 15 percent in the first quarter of 2006. As of the second quarter of 2010, it has fallen 5 percent from its 2009 cycle peak.

A key reason for these ups and downs in lending is that loan demand and supply generally track the real estate cycle. In the aftermath of the 2001 recession and the stress it brought to office, hotel and other property markets, a survey by the Federal Reserve of senior bank loan officers found that 50 percentage points more respondents reported falling than rising demand for commercial real estate loans. That marked the peak of a 14-quarter period from 2000 to 2003, during which each survey found more loan officers reported declining loan demand than reported increasing demand. The tide eventually turned in the mid-2000s, and between 2004 and 2006 more loan officers reported demand increasing than decreasing. With the credit crunch and Great Recession, however, demand again weakened.

The numbers here include a portion of banks' overall construction lending, which means the ups and downs are heavily influenced by the rise and fall in construction lending for both single-family and commercial and multifamily properties. The fluctuations in mortgage debt on existing properties are much more subdued, but are also influenced by property fundamentals, by increases and decreases in borrower demand for loans, and by changes in the credit standards used by lenders—all of which track the broader real estate cycle.

MBA's survey of commercial mortgage bankers' origination volumes shows the trend clearly. From 2002 to 2007, commercial mortgage originations almost tripled, increasing by 174 percent (see Figure 5). Then, between the peak (second-quarter 2007) and trough (first-quarter 2009) of the lending market, originations fell 90 percent.

Figure **5** **Commercial/Multifamily Mortgage Bankers Origination Volumes (Index: 2001 Average Quarter = 100)**



SOURCE: MBA

More recently, through the first nine months, 2010 originations were running 15 percent higher than 2009 levels—a level that remains well below recent years and even 36 percent below 2002 levels.

Such low current volumes shouldn't come as much of a surprise, given where we are in the real estate cycle (see my January 2010 *Mortgage Banking* article, "Drivers Wanted!"). Given the evolving real estate cycle and increasing loan maturities over coming years, origination volumes are likely to shift slowly and steadily upward.

What's ahead?

The recession of 2007/2008/2009 kicked off one of the most significant commercial real estate down cycles in memory. Like down cycles in the 1970s and late 1980s/early 1990s, it brought with it rising vacancies, falling rents, falling values, increasing mortgage delinquencies, decreasing borrowing and lending, and a steep fall-off in new-construction activity. As the cycle continues, we can expect a coming period where demand burns through excess supply, and cash flows and values climb, eventually drawing out new-construction activity.

Given the depth of the recession and the extraordinary pullback in new construction, the intensity of the up cycle could be significant, first for property fundamentals and values and then for new-construction activity. Individual markets will clearly vary, but the strength of the overall up cycle will be dictated by the rate of economic growth (and its impact on demand for space and property cash flows), the strength of investor sentiment (and its impact on property valuations), and the timing and size of new-construction activity as it kicks back in.

Commercial real estate remains a very cyclical business. Especially right now. **MB**

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