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FOCUS: Real Estate

Commercial property in a world of hurt

Retail sector leads the decline, with vacancies at a 12-year high; office vacancy rates also beginning to rise

By Frank Byrt

Even if bank executives are right when they say we're halfway through the credit crunch, it would mean that there is just as much pain still to come for the economy as it has experienced already. The commercial real estate industry will likely bear a good share of that torment, given the declining fundamentals seen in the first quarter and the tough economic conditions predicted for the rest of the year.

Indeed, the commercial real estate industry is facing its most challenging period in years. The loss of thousands of office jobs and the reduction in consumer spending have resulted in shrinking demand for office and retail space nationally for the first time in five years. Meanwhile, retail vacancies have spiked to their highest levels since 1996.

As a result, "the markets are swinging in the direction of tenants," said Robert Bach, an economist with the real estate firm Grubb & Ellis. "Tenants definitely have more leverage than they did a couple of quarters ago, and if I were a landlord I would think about locking in my best tenants now." That's potential good news for corporate finance executives in need of more space. And yet many owners—under increasing pressure as a result of the leverage used to buy properties—still aren't budging on terms. The winner of this standoff will largely be determined by the length and depth of the looming recession.

Retailers reluctant to sign new leases, shuttering shops

Perhaps no real estate sector has been hit harder than retail. The declining value of homes and retirement nest eggs, coupled with ever-rising fuel and food costs, have zapped consumer spending over the past two quarters. That contributed to a 0.2% rise in the vacancy rate at neighborhood and

community shopping centers for the first three months of this year, to 7.7%—the highest vacancy rate in 12 years, according to real estate market research firm Reis. It also marks the 12th consecutive quarter of flat or deteriorating retail occupancy at the national level.

However, waning demand doesn't immediately translate into lower rents, because terms on most leases are locked in for years. In fact, rents held steady in the first quarter, rising 0.1%, to \$17.62 a square foot. Still, if it weren't for inflation, retail rents would have fallen over the past year, Sam Chandan, chief economist at Reis, said on a conference call earlier this month.

Retailers are showing increasing reluctance to sign new leases given the uncertainty, as indicated by a decline of 1.2 million square feet in net absorption of vacant space during the quarter, the first negative quarter for absorption since the beginning of 2003. In contrast, retailers gobbled up 8.6 million square feet in the fourth quarter of 2007.

The retail sector has also seen a steep rise in store closings and a spate of bankruptcies that will exacerbate weakening fundamentals. The International Council of Shopping Centers said two weeks ago that it is holding to its earlier forecast of as many as 5,770 store closings this year, up 25% from 2007.

Even healthy retailers are being aggressive about closing their underperforming stores. Starbucks recently announced it will close 100 of its underperforming outlets in the U.S., after reporting a 1% decline in domestic same-store sales in its first quarter. Home Depot's recent 66% drop in first-quarter profit, to \$356 million, included a \$543 million charge to close 15 underperforming U.S. stores and scrap plans for 50 new stores.

"Basically, everybody's pulling back," said Ivan Friedman, chief executive of RCS Real Estate Advisors in New York, which includes

supermarket and restaurant chains in the retail category.

Other retailers are asking landlords to renegotiate their leases, or are seeking approval to sublease space, Mr. Friedman said. His firm is marketing over 850 leases for companies that are in bankruptcy reorganization or in the process of liquidation, or for healthy companies eager to shed underperformers. "That's a lot of stores right now. And it's going to get worse before it gets better. I just don't know how much worse."

Regional malls have fared better than community and neighborhood malls, but they've also seen vacancies climb 10 basis points in the first quarter, to 5.9%, the highest rate since the fourth quarter of 2002.

Some corporations see opportunity in the downturn. In March, Wal-Mart announced plans to open 80 of its supercenter stores in the first quarter and 170 this year, down just slightly from the 195 supercenters it opened last year. Likewise, Walgreen, the country's largest drugstore chain, has set an aggressive goal of opening 550 stores this year, adding to its existing 6,000 locations in the U.S.

Standoff in the office space

The office segment, too, is feeling the pinch. Demand has slowed markedly, with net absorption for the first quarter at a negative 1.7 million square feet, meaning there was more space coming on the market than there were takers for the first time since the second quarter of 2003.

Falling demand pushed the vacancy rate to 12.8% for the first quarter, up from 12.6% at year-end. Of the 50 or so major metropolitan areas, Dallas, Detroit and Austin, Texas, had the highest projected vacancy rates for the first quarter, at 21.4%, 20.7% and 17.7%, respectively, according to the National Association of Realtors and CBRE Torto Wheaton Research. Meanwhile, rents inched up 1.5%,

to \$24.99, the lowest growth rate since the fourth quarter of 2005.

The projected growth in office rents for 2008 looks even worse (or better, depending on your point of view) for many major cities. Rents are expected to decline this year in New York, Washington, Chicago, Los Angeles, Seattle, Miami and Denver, according to CBRE Torto Wheaton. Only Raleigh, N.C., is expected to see rent increases of 4% or more, while Las Vegas is expected to see 3% growth. Charlotte, N.C., Dallas and Pittsburgh are among the cities where rents are expected to rise between 2% and 3%.

Mr. Chandan of Reis explained that landlords' ability to consistently raise rates for new leases or leases that are being renewed is clearly slipping. He cited the growing disparity between the asking rate and the figure that actually goes on the lease, known as the effective rate.

Even New York, which has seen some double-digit increases in office lease rates in the past few years, is now experiencing a pullback thanks to the woes in the financial services industry. "Sublease space will increase substantially in the next quarter," said Mr. Chandan.

Given the outlook for continued weak economic conditions and little or declining job growth, Reis expects the office vacancy rate to balloon to 13.4% by year-end, although it predicts rents will continue to rise at an annual rate of 3.9%, to \$25.58 a square foot.

Joseph Lerner, a Chicago broker representing tenants for the real estate firm Studley, said there's a standoff going on between tenants

and landlords in many markets because they have different perceptions of the marketplace. Tenants, well aware of the many layoffs and rising vacancies, think they can name their price, but landlords aren't ready to give discounts just yet because they expect the economy to recover within the typical office lease period of five years.

As a result, tenants are slow to renew leases and are seeking more concessions, such as free rent or property improvements paid for by the landlord. "So there are a lot of people shopping and not a lot of people signing on the dotted line," said Mr. Lerner.

Mr. Chandan said limited construction of new offices in most markets has kept supply in check, which helps put a floor under rents. He added, though, that there may be some significant problems on the horizon for investors who bought office properties between 2004 and 2007 using high leverage based on an expectation that ever-higher lease rates would cover debt payments. Some of those investors' cash flow projections now appear unreasonable, and refinancing the loans will be tough given the limited availability of credit. This could lead to a number of high-profile defaults or foreclosures in the office sector in the months ahead.

Better news for industrial real estate, especially near major ports

Much less dramatic change has occurred in the industrial real estate segment, which is increasingly dominated by the warehouse and

distribution centers used for international trade. Research firm Reis predicts industrial vacancies will rise slightly this year, to 9.7%, from 9.5% in 2007. Rents are expected to increase 2.1% from last year, to \$4.80 a square foot.

Still, net absorption in the industrial space is expected to fall 19%, to 49.7 million square feet this year, the lowest since 2003, as weaker consumer spending and slowing foreign demand for U.S.-made goods trim the need for warehouse space at major ports.

CBRE Torto Wheaton said the industrial market has been characterized by eroding fundamentals since the third quarter, including rising availability rates and slowing rent growth. Going forward, however, rents are expected to stabilize in the majority of markets. Because new construction has been scrapped or postponed, new supply remains contained relative to historic levels, the firm explained in a May 2 research note.

And certain markets, especially those near major ports in such places as Riverside, Calif., Houston and New York, will continue to see solid demand. Mr. Chandan of Reis explained that in many areas, a pickup in exports has offset the slower growth in imports that weakened demand for warehouse space. "Capacity utilization in key deepwater port cities remains exceptionally high," he said. **FW**