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Recovery? YES— and No

By Steve Bergsman

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When the Society of Industrial and Office Realtors® posed the question to its members, "are you seeing the beginning of a recovery," the percentage of respondents who answered yes or no gave a slight nod to the optimists who felt their local markets were on the verge of a comeback. This is reflected in early results of the 1st Quarter 2010 SIOR Commercial Real Estate Index as 48 percent of respondents predicted a 1–5 percent improvement in commercial real estate conditions over the next quarter and 16 percent anticipate a 6–10 percent improvement.

Some SIOR members are seeing a pick-up in local leasing activity (and sales) because pricing has declined to levels that, in some markets, have not been seen in a decade. While the business of brokering tenant-landlord contracts has become busier, it could be that many of the markets in which SIOR members operate are not yet healthy and may experience more pain before real gain.

The cities where optimistic SIOR members reside and work were spread from one end of the country to the other, and in both big cities and smaller markets, thus proving once again that it is difficult to judge real estate trend lines from a national perspective and, in fact, it's all about locale, locale, locale. This survey report will start with California and move east.

California—Good News from Bakersfield

A high proportion of the SIOR members who felt market recovery wouldn't be happening in their regions for another year or two resided in California cities. However, one of the optimists was from Bakersfield, located in California's famed Central Valley.

Wayne L. Kress, SIOR, First Vice President of the CB Richard Ellis office in Bakersfield, likes to refer to his market as an island. Bakersfield is not a city surrounded by other cities.

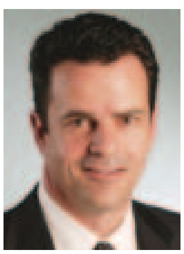
Although it became an alternative industrial market to Inland Empire locations like Ontario for a while, it is somewhat isolated. If it were just an overflow industrial location, Bakersfield would be suffering mightily, as is Ontario, but the city is not only surrounded by agriculture, there is a strong oil industry in the region as well.

Normally, Bakersfield absorbs about 1.7 million square feet of space a year. That total fell to 918,000 million square feet in 2009. The weird part of that last number is that more than 400,000 square feet—almost half of all last year's absorption—came in the fourth quarter. "We had a rebound in the fourth quarter that was the best in four years," says Kress.

This is not just a vulture market. Lease rates on industrial properties in Bakersfield had not fallen that much, says Kress. "We may actually have seen rates climb a bit recently."

Bakersfield, Kress asserts, "is in recovery. We are definitely going in the right direction and the bottom is behind us."

Hayward—Some Optimism, but Rental Rates Still Dropping



Stephen C. Kapp, SIOR, a Senior Vice President with Cornish and Carey Commercial, works the Hayward, California, market, located as he says, "about 30 minutes from everywhere," but actually halfway between San Francisco and San José. It is the largest industrial market in the Bay Area.

Kapp is sanguine about his market and thinks it is at the beginning of recovery. Kapp's optimism is based on the volume of leasing activity, which has picked up significantly since the end of 2009.

In the first quarter of 2010, plenty of new leases were signed because "tenants now have a good idea if they are going to make it through this thing and are actively looking to lock in attractive rates," says Kapp "We are in early recovery because we see decisions being made and empty spaces being leased."

However, much of the movement comes from firms that were downsizing, taking new leases at 75,000 square feet, but giving up 100,000 square feet.

More significant is the movement of rental rates, which Kapp admits still hasn't found a floor. "I don't think we have seen the bottom of the rental market, which may not come for another two years," he says. The problem in Hayward is the same elsewhere and it is why recovery won't come too soon. Buildings were bought three to five years ago based on higher rents. Those rents are coming due and to keep tenants, landlords are slashing, slashing, and slashing.

"It will take two to three years to go through all that," Kapp adds.

Inland Empire (Ontario)—Prices Have Not Stabilized

Down in the Inland Empire, **Paul R. Earnhart, SIOR,** a Senior Vice President and founding Principal with Lee & Associates in the city of Ontario, has experienced the same uptick in leasing that Kapp did in Hayward, but Earnhart has stepped back from calling it a recovery. He says it's a "reaction," his word referring to leasing deals getting done because prices have gotten so cheap.

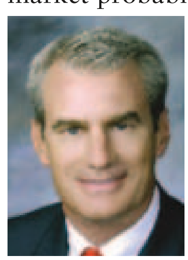
"We have not seen prices stabilize," says Earnhart, "but we have seen prices drop to the point where buyers and tenants are starting to come out of their shells and look to do deals."

Ontario is an industrial market, and prices for land have dropped 50 to 70 percent, building values have fallen about 50 percent, and lease rates have declined 40 to 50 percent. "There was a project that ProLogis did at the Ontario airport that was originally renting for $0.45 a square foot, but that went down to the high $0.20 a square foot," Earnhart says. "Buildings that were selling for $135 to $140 a square foot have gotten down to $70 a square foot."

While the business of brokering real estate and leases has resumed, Earnhart says he won't know whether Ontario is in recovery until he sees how this year plays out.

Orange County—Values and Rents Will Drop to Pre-Boom Levels

Farther to the south, things are a little tougher. Orange County, California, once ground zero for the subprime mortgage industry, boasts fairly large industrial and office submarkets, all of which remain weak, with the office market probably in for a very long haul.



"There is a sense that things have bottomed out, that you won't see any more systemic problems," reports **Stan Mullin, SIOR, CCIM, CRE, FRICS,** with California Real Estate Receiverships and former President of SIOR. On the other hand, he adds, CMBS delinquencies had the highest monthly increase in March (2010) since the summer of 2009 and are now at 7.61 percent, national CRE N.O.I. is expected to drop by another 15 percent by mid 2011 (when it is expected to turn the corner) and it is unlikely that the Orange County market will see a substantial increase in value anytime soon. Indeed, office buildings that once sold for $380 a square foot recently sold as low as $175 a square foot. In recent remarks, BNY Mellon Chief

Economist Richard Hoey estimated that industrial and office building values nationally will return to values before the boom. Mullin believes Orange County, California, will follow that trend line as well. “Prices and rents will likely continue to recede to the levels of eight years ago,” says Mullin, “which was before the dramatic expansion of debt capital.” “A jobless recovery does little to help commercial real estate absorption.” The good news is that the bid-ask spread has reduced dramatically and the velocity of transactions has increased substantially.

Oregon—the Picture Begins to Brighten in Portland

Portland’s industrial and office markets were hit hard as early as 2008, but now “it has seen a turn and is poised for recovery,” says **Donn M. Sullivan, SIOR,** a Senior Vice President with Grubb & Ellis Co. in Portland. “The industrial market has seen a return of demand and we should see vacancy drop in 2010.”

As for office, downtown Portland’s vacancy rate stands at just above seven percent, Sullivan adds. “If you have someone who wants 40,000 square feet of Class A office downtown, we have only one option in Portland right now. If you want 20,000 square feet of Class A space downtown, you might have three or four possibilities.”

…a key weakness in the Salt Lake City office market, the lack of Fortune 500 companies, became its strength!

The Portland economy is still the “pits,” says Sullivan, “but clients are coming back and starting to plan for the future. The amount of people looking for office and industrial space has increased quite a bit since the fourth quarter 2009.”

Utah—with No Fortune 500s, Salt Lake City Avoids Huge Layoffs

Also in the West, SIOR members in Salt Lake City like the portents.

Ironically, a key weakness in the Salt Lake office market, the lack of Fortune 500 companies, became its strength. With no “national” layoffs, the unemployment rate in the city rose no higher than six percent.

Despite the moderation in unemployment levels, the local office market did take a hit in 2009 as office vacancies climbed to 17 percent, rental rates fell 10 percent, and concessions increased.

Since the end of 2009, the market has started to re-emerge, says **Gregory M. Gunn, SIOR,** a Senior Vice President with Coldwell Banker Commercial NRT in Salt Lake City. "There seems to be momentum, depth, and velocity on all sides of the market, whether it is 10,000 square feet or 100,000 square feet," he says. "Less space is coming on the market and sublease space is going out."

For example, says Gunn, in one of our new Class A suburban office projects—300,000 square feet of space in two buildings—vacancy was 80 percent in November 2009 and by April this year, it was 80 percent leased. In some Salt Lake City submarkets rents have already come off bottom pricing and concessions have dropped. Where are the tenants coming from? Not from the Fortune 500, says Gunn. "For the most part they are local firms that have grown."

Texas—Business Picking Up in Houston

In Houston, **Keith K. Edwards, SIOR, CCIM,** specializes in commercial land sales for Caldwell Companies. As could be expected, 2009 was not a good year to be in the commercial land business. Edwards, with a lack of understatement, simply says, "Commercial land was dead last year." And Houston is a city that has not been hard hit by the recession; more homes were sold in 2009 than in 2008.

This year, Edwards is busy again for two reasons. First, prices on raw land have dropped so low they have become attractive. Second, buyers are taking advantage of Small Business Administration loans to finance land purchases.

"We are finding some retailers are back, but also looking to buy are churches and daycare centers," Edwards says. Recently, he sold 167 acres to an investor. Currently on Edwards' plate are deals for a restaurant pad site, retail gas station, and five acres for an industrial user.

"Business in February and March picked up substantially," says Edwards.

Iowa—Cautious Optimism in Des Moines

Kevin J. Crowley, SIOR, has been working in commercial real estate for the past 30 years and as he observes, "this is the hardest cycle I have ever seen." But, Crowley, an industrial and office specialist for Iowa Realty Commercial in Des Moines, Iowa, thinks the bottom is finally in the rearview mirror. "Toward the end of January I told my agents I felt the economy was at a tipping point, and the worst was behind us," he says.

The week Lehman Brothers went bankrupt in 2008 was the day the faucet was shut off, Crowley recalls. "We had five or six significant transactions fail. While 2009 was quiet, 2008 was a painful year."

In the first three months of 2010, Iowa Realty did as much business as it did in all of 2009. "It was like a dam bursting," says Crowley. "It was all building up because no one did anything through 2008 and 2009, and just by sheer demand we have done a number of transactions that should have been done 2009, but didn't happen until 2010."

Des Moines remains a Midwest city that has quietly thrived. It is the third largest insurance market behind New York and Hartford. Nationwide Mutual Insurance Co. has taken a million square feet of space over 12 years and has a recently added a 300,000-square-foot addition. So, Des Moines at least had a cushion.

"I am cautiously optimistic," says Crowley. "It will be a slow, steady climb. We will continue to work our way out of this."

Missouri—Trend Line Flat in Springfield, but Growth Dynamics Remain in Place

Smaller markets in places like Springfield, Missouri, are stranded on the same road as the national trend. "Rents in the Springfield area are about where they were six to seven years ago," observes **David C. Murray, SIOR, CCIM,** Executive Vice President of the R.B. Murray Co. in Springfield.

The good news from southwest Missouri is that the market may have hit bottom.

"I don't think things will get worse," says Murray. "I would say we are flat. There is no glut in industrial, but no demand either. The market has not recovered by any means."

The most recent sale brokered by Murray's company was in the fourth quarter of 2009 for a 260,000-square-foot building. Asked if that was that harbinger of things to come, Murray demurred. "There haven't been enough sales to give you a trend line. If you want to know what prices are today, go back to 10-year historical sales data and you can come up with an idea."

Still, Murray remains optimistic. "Springfield has been the largest creator of jobs in the state for a significant period of time," he says. "The dynamics that allowed this area to grow are still there. Once consumer confidence begins to grow again, the things that brought us to where we are today will put us in a better position than a lot of areas throughout the country."

Illinois—Chicago—Still in the Long Tunnel before Recovery

Less optimistic is **Steven H. Podolsky, SIOR,** a Principal with Podolsky Northstar CORFAC International in the Chicago metro town of Riverwoods, Illinois.

Podolsky, who has been a SIOR member for 35 years, says 2009 was the single worst year he could remember in a very long and active commercial real estate career.

"I believe there is a light at the end of the tunnel, but it is a pinpoint in a significantly long tunnel," he says. "I don't believe we are in a market recovery."

This is not to say there hasn't been leasing activity in the Chicagoland industrial market, but Podolsky claims it is mostly being driven by blend-and-extend.

"Tenants who have 18 to 24 months left on their lease are renewing early and giving the landlord security of additional lease terms," Podolsky explains. "In exchange for knowing they won't be getting space back in 2011, the landlords are reducing leases down to current market levels and giving concessions, free rent, tenant improvement, whatever they want. You don't want to lose a tenant in 2011 or even in 2012, so the landlords are offering significant incentives to their tenants ensuring they won't get the space back."

What does this mean for the market?

"I believe we hit bottom in 2009," Podolsky says, "but, it will be two to two-and-a-half years before we have reached full recovery."

Connecticut—after Long Dry Spell, Phones Ring Again in New Haven

"Our values were not hit too badly in the recession; it's just that leasing and sales activity stopped for about 16 months," reports **Kevin C. Geenty, SIOR,** Vice President of The Geenty Group Realtors® in Branford, Connecticut "We didn't have a lot of inventory in the greater New Haven area in office or light industrial, so values weren't depreciating very much, maybe 10 percent."

Geenty recently sold a 40-year-old industrial building at a very healthy $80 a square foot.

Rents in the New Haven area also are stable. "I own a bunch of buildings and my rates didn't go down," Geenty says.

The biggest problem was lack of activity, but Geenty adds, "As far as I can see, business has started again. Every one of my sales people says the phone is ringing more. I've been working seven days a week."

Maryland—in Salisbury, Low-cost Real Estate Is Attracting Entrepreneurs

Like New Haven, the small city of Salisbury, which services the northern Maryland/southern Delaware area with several industrial parks, avoided being crushed by the recession. Also, like New Haven, the problem during 2008 and most of 2009 was lack of activity.

That all changed around December 2009, when outside companies began looking for space in the region. And in the first two months of 2010, four industrial sales have gone to settlement, says **Henry H. Hanna, SIOR, CCIM,** a Senior Advisor with Sperry Van Ness/Miller Commercial Real Estate in Salisbury.

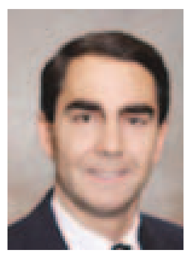
Of the four properties that were sold, three were bought by users, Hanna explains. "They were entrepreneurial companies, not publicly traded, and in each case, the managers said they believed their industry would rebound in the next 12 to 18 months."

Another big attraction was the cost of real estate, which remains 50 percent less than what it would cost to build a similar building.

"Our industries here are diversified," Hanna says. "We don't seem to be tied into any of the sectors that were hurt the most in the recession. The sales have been to companies tied to healthcare equipment, defense, and recycling, and these areas seem to have the ability to grow and expand."

Virginia—Richmond Begins Bumpy Recovery

After a miserable 2009, the Richmond, Virginia, industrial market has suddenly come alive.



"In 2009, we saw more than two million square feet of net loss absorption," says **David M. Williams, SIOR, CCIM,** Managing Director and CEO of Grubb & Ellis/Harrison & Bates in Richmond. "This year may not be up, but just being flat will be a win."

The turnaround came in the fourth quarter when deals that had taken root earlier in the year finally came to fruition, Williams says. "Our firm had a very good fourth quarter but the deals had been in play for six to 12 months prior."

Two key trend lines are forming in Richmond, Williams explains. First, local companies are moving, sometimes expanding, trying to take advantage of cheaper rents, and, secondly, out-of-town firms have also begun showing interest.

"We have bottomed out," Williams says. "As the year progresses, the recovery will be bumpy, but when we look at the end of the year, we will see things on a much better footing."

South Carolina—Strong Signs of Recovery in Charleston

Charleston, a beautiful South Carolina metropolis, has been an important port city since the eighteenth century, and its future only looks brighter, particularly because its port boasts the deepest water south of Norfolk, and that will be important when larger ships start moving through the Panama Canal.

Although port traffic declined during 2008–2009, the port was still busy enough to moderate the effects of the recession. Now those declines are leveling off. In addition, military contractors such as SAIC continue to absorb industrial space says **Hagood S. Morrison, SIOR, CCIM,** Director of Industrial Real Estate for Colliers Keenan in Charleston. Construction of Boeing's 900,000-square-foot 787 production facility is underway. The effects of Boeing and its suppliers have not yet been realized.

"As of the end 2009, the vacancy rate for industrial was 13 percent, but by March that had already decreased," notes Morrison. "On the lease side, there are two major transactions totaling 300,000 square feet in process right now, and that would take out two of our available industrial buildings."

Charleston's standard warehouse space saw lease rates soften over the past two years, but the space designated for bulk imports held steady and is back to 2006–2007 rental levels. Transaction activity has even picked up, Morrison reports. A Canadian supplier bought an 850,000-square-foot facility and a replacement tire distributor signed a deal for 1.1 million-square-feet.

"Knock on wood," Morrison concludes, "all indications are there for a recovery."

Florida—Orlando Is Still Reeling from the Housing Crash

Tourism may be the most important driver in the Central Florida economy, but construction isn't far behind.

"Housing is to Orlando, like cars are to Detroit," says **Charles McNulty, SIOR,** a Principal in the McNulty Group Inc. of Orlando. That's a big problem because housing in Central Florida is off 70 to 80 percent from its peak.

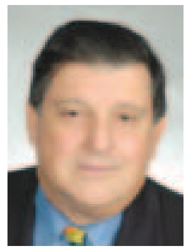
Call McNulty a crazy optimist, but he believes Orlando is poised for a comeback. Yet he, too, is staring at a pinpoint of light at the end of a very long tunnel.

"Knock on wood...all indicators are there for recovery."

— Hagood S. Morrison, SIOR, CCIM

"The housing market will pick up when vacant homes get sucked up and foreclosures get off the market," he says. And the timeline for that? Another two years!

In Miami, Prices Have Plummeted; Bottom Fishers Are Buying



If there is one market in Florida doing worse than Orlando, it's Miami.

The vacancy rate for industrial properties in the Miami area sits around 12 to 13 percent, observes **Daniel G. Zelonker, SIOR,** an industrial specialist with Mizrach Realty Associates in Miami. "Brokers with big properties at the bottom are quoting $1 NNN leases. It's hard to compete with that."

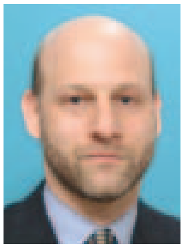
Miami is the country's most overbuilt condo market and that has affected industrial real estate prices. As the city re-urbanized, condo developers bought into formerly industrial zones, pushing up average industrial prices to $138 to $140 a square foot. Even dedicated industrial properties, such as those near the airport, were going for $100 a square foot. Recently, Zelonker undertook a survey of industrial deals near the airport, and prices had dropped to under $50 a square foot. Zelonker figures industrial buildings are being sold at about 60 percent of replacement value.

The only good news is that prices have gotten so low, bottom-fishers with liquidity have moved in. "My last three sales were to people with cash to buy," he says.

Zelonker's best guess as to a turnaround? "We keep losing jobs. It will be 2012 before the Miami industrial market stabilizes." "Recovery will come soon after that, but it is all dependent on non-government jobs being created."

An International View—Two Tales from the Far East Tokyo—Rents Will Bottom Out in 2011 or 2012; Investment Will Pick Up in 2010

One of the more interesting facets of the global recession is that a number of large non-U.S. cities have tracked very closely to the trend lines in North America. For example, Tokyo commercial real estate, especially the office market, has not performed much differently from the average big city in the United States.



After the Japanese economic bubble burst about 20 years ago, real estate had bounced along with no defining direction until 2004, when in hit rock bottom, reports **James R. Fink, SIOR,** Senior Managing Director for Colliers International in Tokyo. "Then we had a massive real estate, stock, and general economic rally like everywhere else until the summer of 2007 when it all started to drift sideways. In 2008 and 2009, all markets collapsed."

The global recession was not so big a shock in Tokyo since the economy had been struggling for a long time. Still, lease rates have dropped about 30 percent, which, says Fink, puts them close to post-bubble lows of late 2003 and early 2004.

Has the market hit bottom then?

"The floor will be reached when we get close to early-2004 lows," Fink answers. "Whether prices start to recover, well, we are more pessimistic."

In 2008 and 2009, the new supply of Tokyo office space was low, but vacancies increased because the demand was shrinking, Fink explains. "Now we are starting to shift into a supply crisis due to new construction, and that is why rents are unlikely to go shooting back up anytime soon."

Here are Fink's predictions: Vacancy rates will peak in the next 18 months, rents will bottom out in 2012 or early 2013, and the investment market will pick up in 2010, but will not get very interesting until 2011 and 2012.

The one big difference between the United States and Japan in terms of commercial real estate is that on this side of the ocean, institutional-grade office buildings were treated like baseball cards, flipped willy-nilly, thus creating an inflationary spiral of value, which has since deflated like a balloon pricked by a pin. In Japan, really good real estate assets seldom come to market.

"I don't think anyone believes the Tokyo market is a strong buy," says Fink. "But it is such a big market that interesting deals will pop up, often because someone will have to refinance."

Shanghai—Pent-up Demand Will Pour onto the Office Market in 2010

One foreign market poised for a very quick recovery is the huge Shanghai, China, office sector.

"Before the global financial crisis, Shanghai would build three to four million square feet of Class A office space every year on spec and then would lease it all," says **Chris Cuff, SIOR, MCR,** Colliers International's Regional Director for Asia in Shanghai. "Vacancy fell to 2.7 percent in 2007."

Then, of course, the financial crisis hit; companies stopped expanding. The trouble is, the developers didn't stop building those very large buildings, so vacancies quickly rose to 20 percent and may go as high as 23 to 24 percent in 2011. Even rents are off and could slide another five percent this year.

That's not a worry to Cuff, because, as he sees it, demand is back. Unlike the United States, the problem in the Shanghai office market wasn't a cessation of demand; it was too much supply.

"The most common story we heard, even at the peak of the crisis was, 'We (tenants) have hit our numbers, but we can't get approval from home office to grow,'" says Cuff. "If you go into a Class-A office building here you'll recognize most of the names. These are multinational firms, so the decision making in a lot of cases was back overseas."

In 2010, that pent-up demand has now burst upon the office market. "If you are a tenant, you are absolutely in the market looking to expand," says Cuff. "It was never so bad, but now you are full steam ahead. We had positive absorption last year of two million square feet of space. It's not the four million we are used to, but not bad."

Cuff concludes, "If we hadn't built too many buildings, rents would still be going up." Oh, and the outlook for Shanghai construction? Cuff guesses, approximately seven million square feet a year for 2010, 2011, and 2012. That's almost twice the level it was before the financial crisis.