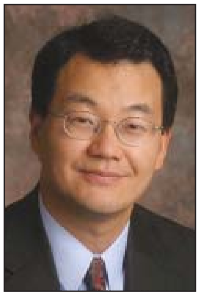

SIOR Index – Office and Industrial Conditions Maintain Updward Momentum in the Third Quarter 2010

Lawrence Yun is Senior Vice President and Chief Economist at the National Association of Realtors®*. He writes regular columns on real estate market trends, creates NAR's forecasts, and participates in many economic forecasting panels, including Blue Chip and the Harvard University Industrial Economist Council. He received his undergraduate degree from Purdue University and earned his Ph.D. from the University of Maryland.*

George Ratiu is an Economist with the National Association of Realtors® *in Washington, DC. He specializes in mortgage finance, foreclosures, and commercial real estate. Mr. Ratiu produces NAR's* Commercial Real Estate Outlook, *which provides quarterly forecasts for the office, industrial, retail, and multi-family sectors. He received his undergraduate degree from Campbellsville University and earned his graduate degree in Economics from Western Kentucky University.*

NAR Economic Overview

As we approach the holiday season looking for some joy and good cheer, the economy offers some hopeful fare. The third quarter activity maintained the moderate positive momentum. Consumer spending continued to surprise with its resiliency in the face of stubbornly high unemployment. But questions about the direction of the economy remain, as evidenced by the Federal Reserve's second round of quantitative easing measures (QE2) as well as the condition of commercial real estate.

Based on the Bureau of Economic Analysis's first estimate, gross domestic product (GDP) rose 2.0 percent in the third quarter. Mirroring the second quarter's patterns, all major components—except net exports—advanced. The gains were driven by double-digit growth in business investments, along with sustained expenditures by consumers and government. Business spending increased 12.8 percent during the quarter. While taking a slower pace compared with the first half of the year, businesses continued to spend on equipment—software and transportation were up 12.0 percent and 42.0 percent, respectively. On another hopeful note, after eight consecutive quarters of declines, business spending on commercial real estate ticked up 3.8 percent.

The major economic driver, consumer spending stayed the course, gaining 2.6 percent during the third quarter. Consumers increased their spending on both goods and services, particularly for recreation and recreational goods, home furnishings, transportation and health care.

International trade expanded during the quarter, as well. The balance of trade remained negative, however, as imports grew by 17.4 percent and exports by 5.0 percent. In the face of growing deficits, government spending moderated its growth, gaining 3.3 percent, mostly at the federal level.

After a strong first half of 2010, employment trends took a dive during the third quarter. Businesses, while still spending, are doing so more targeted and not on jobs. While corporate profits are back up to their peak before the recession, companies are just sitting on cash and not actively pursuing expansion plans. The number of payroll jobs declined by 53,000 for the period. The decline was somewhat offset in October, when the economy added 151,000 jobs. But, employment conditions remain mired in uncertainty. The first-time unemployment insurance claims have been stuck at around 450,000 per week. The figure needs to fall below 400,000 per week to ensure a meaningful, consistent job creation. In addition, the number of people drawing unemployment benefits stayed above 4.5 million. Not sur-

prisingly, the unemployment rate has been fixed at 9.6 percent for three months.

Given the tepid pace of recovery and the employment picture, consumers remained uncertain. In addition, the mid-term elections provided an added measure of volatility to consumers' mood. The two main measures of consumer confidence and sentiment mirrored these trends. The consumer confidence index compiled by the Conference Board—a measure that considers respondents' general feelings about the job market and their finances—declined from a high of 62.7 in May to 48.6 in September, the second lowest value for the year. More troubling, consumers' expectations are also on the decline, after a burst of optimism during the first half. Meanwhile, the University of Michigan survey of consumer sentiment also declined during the third quarter, to close at 68.2 in September. It has risen slightly to 69.3 during November, but remains well below the 100 value typical of economic expansions.

Meanwhile, the housing market is attempting to find its own route to recovery in the absence of any federal stimulus. Existing-home sales (actual closings and not contracts) rose to 4.5 million units (seasonally adjusted annualized rate) in September, a solid 17 percent cumulative gain over two months following the big tumble in July when the tax credit was no longer in effect. The home price bubble has been fully deflated.The cost of constructing new homes is measurably higher compared to buying a nearly identical existing one. Home sales in relation to total jobs are back to normal. Home price to income ratio is slightly below historical trends, signaling a slight overcorrection. The recovery, however, will not be a straight upward path. September's pending home sales (i.e., contract signings) took a step back after two consecutive months of increases. The underlying fundamentals of rising demand are present in the forms of compelling affordability conditions and from job creation. But while investors appear eager to "get in" as well, they are being hampered by very tight mortgage availability for non-owner occupancy loans. In addition, the hiccups to recovery will also arise from market swings in economic data and from a flow of foreclosed/REO properties reaching the market.

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The tight credit conditions are also evident in commercial real estate. While investment capital appears ready to deal at the high-end of the market, the smaller size investments and businesses are still finding little room to maneuver. The commercial markets are starting to experience a bifurcation along property values. With fundamentals on an upward trend, larger properties in stronger markets are attracting investor interest. At the same time, smaller properties in slower markets continue to display signs of distress.

Commercial Realtors cite lack of financing as the main obstacle to a broad market recovery. Commercial loan originations are down 83 percent from peak, lending standards remain stringent and, faced with other investment alternatives banks remain wary of commercial transactions. The QE2 attempt to keep long-term rates lower, which may or may not be working, is inconsequential to the market compared to the importance of returning lending standards to normal from their overly stringent current rules. For now, cash is king. Buyers with cash are facing few, if any, competitors in bidding for a building.

SIOR Index Results

These factors notwithstanding, office and industrial markets are showing encouraging signs of stabilization. The September 2010 SIOR Index representing third quarter 2010 data, advanced 1.6 points. Given the still low index value, it remains clear that fundamentals in office and industrial markets remain difficult—elevated vacancies, low prices and hardly any new construction. Yet, as the rise in the index shows, there are areas of the country where respondents are experiencing an increase in leasing activity following improvements in local economic environments.

The national index, based on 10 variables pertinent to the performance of U.S. industrial and office markets, moved up to 42.6. The index reveals improvements in the office and industrial sectors—

the office index rose 0.7 points while the industrial index gained 2.3 points. Geographically, all four regions recorded growth, with the South leading the way.

SIOR Commercial Markets

September's SIOR Index marks the fourth consecutive quarterly gain, indicating that SIOR markets are beginning a slow rise from the lows of the past two years. In a telling sign, most market indicators for the quarter posted improved figures.

Leasing activity continues to be modest. Practitioners indicate that traffic from potential clients is improving in certain areas. However, vacancies remain elevated and tenants continue to have the upper hand in negotiations.

The third quarter experienced an uptick in investment activity. Respondents continue to indicate that prices are low and present opportunities for available buyers. Yet, with credit conditions unchanged from the first half of the year, many investors in need of financing remain on the sidelines. Meanwhile, new construction is still very limited.

With the national economy on a moderate growth path, SIOR members expect markets to improve in the next quarter. Regionally, the South and Northeast are finding economic conditions improving at a faster pace, as mirrored by the regions' relatively stronger values.

SIOR Outlook

The third quarter survey mirrors a weak-yet-hopeful commercial real estate market. While the economy grows, high unemployment continues to figure prominently in the minds of both consumers and businesses, driving spending decisions. With the knowledge that the midterm elections brought changes in Congress and major legislative issues are still pending, the fourth quarter will likely give a clearer indication of what lies ahead, especially looking at 2011.

METHODOLOGY

The SIOR Commercial Real Estate Index is constructed as a "diffusion index," a very common and familiar indexing technique for economic measures. Other examples of diffusion indexes include the Index of Leading Economic Indicators, the Consumer Confidence Index, and the Institute of Supply Management's Purchasing Managers' Index. In the SIOR Commercial Real Estate Index, a value of 100 represents a well-balanced market for industrial and office property. Values significantly lower than 100 indicate weak market conditions; values significantly higher than 100 indicate strong market conditions. The theoretical limits of this Index are a low of zero, and a high of 200, though it is unlikely that such limits would be approached as long as the property markets are operating efficiently.

The Index is based on a survey questionnaire with ten topics. The topics covered are (1) recent leasing activity; (2) trends in asking rents; (3) trends in vacancy rates; (4) subleasing conditions; (5) levels of concession packages in leases; (6) development activity; (7) site acquisition activity; (8) investment pricing levels; (9) the impact of the local economy on the property market; and, (10) the effect of the national economy on the property market. Survey respondents are given five choices. For each topic, five choices are provided, corresponding to conditions that are very weak, moderately weak, well-balanced, moderately strong, or very strong.

For each question, answers are tallied and the percentage of responses for each of the five choices is calculated. If survey panelists indicate "very weak" conditions (the "a" choices in the questionnaire), the answer is assigned 0 (zero) points; "moderately weak" ("b" answers) earn 5 points; an indication of "market balance" ("c") receives 10 points; "moderately strong" indications ("d") score 15 points; and "very strong" ("e") responses receive a maximum 20 points. Thus a score of 10 for a given question can be earned if responses are evenly distributed across all five choices, if all responses were "c", or if the answers form a "bell-shaped curve" centered around the "c" choice. The total index value is derived by summing the scores for all ten questions. Index values for each of the two property types are similarly calculated.

The survey was developed by Hugh F. Kelly, CRE, clinical professor at New York University, who worked with SIOR on research projects from 1989.