A Pause That Refreshes?
Interpreting the Fall 2006
SIOR Commercial Real Estate Index
By Hugh F. Kelly, CRE

Who among us hasn't heard – or passed on – that classic nugget of parental advice: "Patience is a virtue." That's a tough bit of wisdom to apply to today's incredibly fast-paced world of business, where it seems there is never enough time to get tasks accomplished, much less actually to *think* about them. Yet it often turns out to be a costly mistake to rush decisions under the pressure of time. Experienced principals in the property markets and elsewhere frequently observe that "the best deal is sometimes the deal you don't get to make," a deal that goes to an aggressive competitor so keen on 'winning' that he doesn't thoroughly think through risks and rewards and winds up in an unsatisfying position as a result.

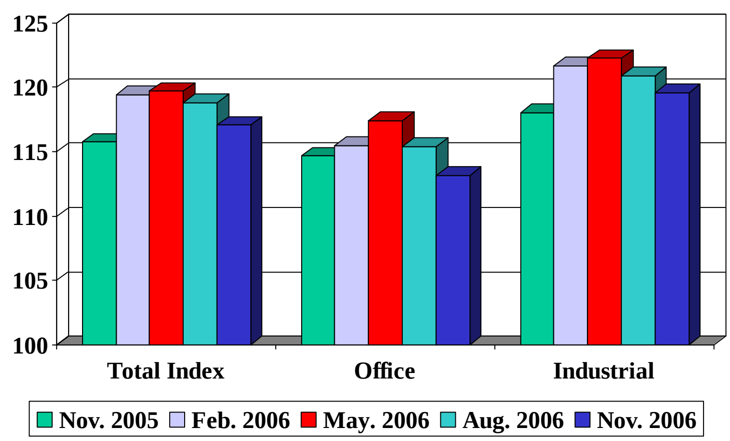
The Tibetan lama Tarthang Tulku wisely notes that "like spice in food, patience is the secret ingredient that makes life rich." He continues, "Nowadays we seldom associate the ideas of strength and reliability with patience. We may even consider patience a sign of passivity, weakness, or lack of intelligence. Technology has quickened the pace of our lives, and impressed us with the idea that all tasks can be accomplished, all problems solved, with little or no exertion." No one who has grappled seriously with real estate markets for long, of course, agrees with the notion that the job is easy, or that quick solutions are readily available. Under conditions of uncertainty, in particular, it is often a good idea to pause until an unclear situation comes into sharper focus.

Right now, the Federal Reserve is taking this wisdom to heart. After a round of seventeen interest rate increases that have raised the Fed Funds target rate from one percent to 5 ¼ percent, Fed Chairman Bernanke and his colleagues have taken a "pause" to assess the economic situation. They want to see how the energy and materials cost volatility of the past several years play out. They show concern about the impact of softening housing conditions on the balance of the economy. They want to consider what the recent sluggish performance of GDP (only 1.6 percent real growth indicated in the first statistical release for the Third Quarter 2006) means before deciding to either stimulate or retard growth. And, surely, they are uncomfortable about making judgments about the employment situation when the labor market data seems more questionable than ever – what are they (and we) to make of the Bureau of Labor Statistics announcement that its Current Employment Statistics revision for the year ending March 2006 is 810,000 jobs? Until BLS tracks down the source of such an enormous error, it is very difficult to make a decision about the true condition of the jobs' situation in America. Until then, prudent patience is a positive stance to adopt.

The survey of SIOR members completed in October 2006 suggests that, for similar reasons, the real estate markets may also be taking a "pause" as well. On balance, the commercial real estate markets across the United States continue to perform well in late 2006. A slower national economy and the uneven employment growth of the second and third quarters of the year have moderated the pace of improvement in the office and industrial property sectors. The national index slipped for the second consecutive quarter in October, falling 1.73 points to 117.07, down from its peak in February 2006 when the index stood at 119.40. Revenue is up for owners of commercial property, with stronger rents, less sublease space competing for tenancy, and more limited concessions being given in lease negotiations. Investment pricing has nudged upward since our last survey was released in August. Leasing activity, however, is less robust and the rate of vacancy improvement is moderating as well. Local economic conditions are rated less favorably this fall than earlier in the year, but the survey responses for national economic influences are unchanged since the summer.

Commercial Real Estate Gains Moderating

Fall 2006 SIOR Survey Shows

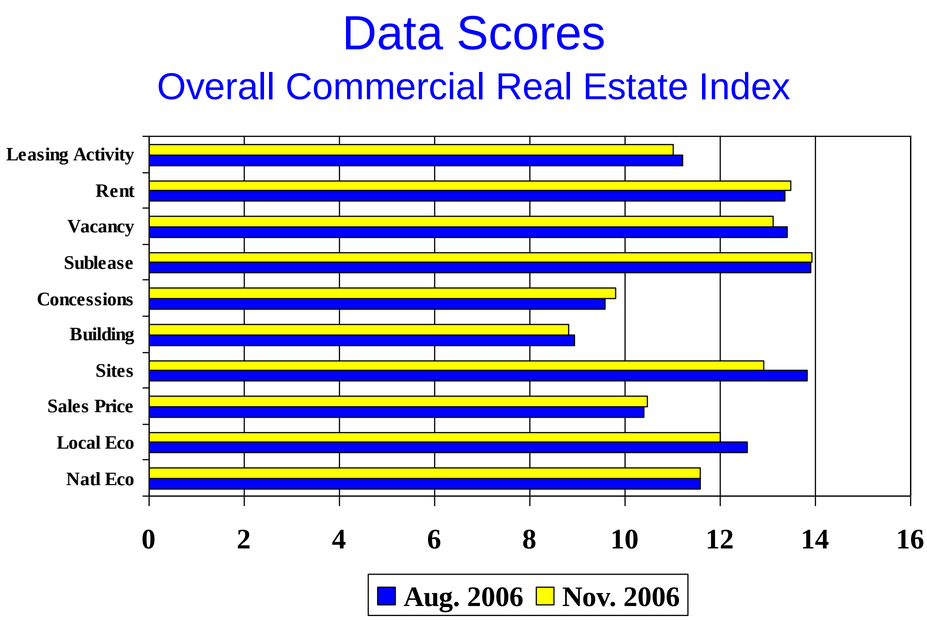


Source: Hugh F. Kelly Real Estate Economics for SIOR

Thomas J. Taylor, SIOR, Grubb & Ellis Co., Newport Beach, California, referring to Orange County, California, warns, “Landlords here continue a ‘true believer’ mantra of higher rents in the face of lackluster absorption and ongoing construction of new office product. But unless absorption picks up, these same owners are going to sound less like priests and more like sailors.” He is not alone in expressing concern. In Tulsa**, James D. Hill, Jr., CCIM, SIOR,** CB Richard Ellis/Oklahoma, reports, “The oil and gas sector continues to fuel demand for manufacturing facilities with overhead cranes. The question is, ‘When will higher interest rates as well as rising oil prices cut into economic growth and reduce demand?’” By the early fall, of course, energy prices had already begun to slip, and the economic tea leaves were getting harder to read.

Growth, of course, has its limits, and one of the harsh realities of market economics is that is good times are often self-limiting. For instance, Las Vegas offices are seeing “very unusual market conditions,” according to **Judi A. Woodyard, CCIM, SIOR,** Commercial Associates, Las Vegas, Nevada. There are “very low vacancy rates, but low demand because rents and tenant improvement costs are so high. Construction, land, and development costs are through the roof!" From the Midwest, **Cyndie W. O'Bryon, SIOR,** Trammell Crow, Cleveland, Ohio, reports, "While northeastern Ohio's office market has stabilized, the current economy has caused a significant slowing of growth from outside the market and virtually halted speculative development."

In the context of these comments, the pullback in the overall score for the SIOR Commercial Real Estate Index comes into clearer focus.



Source: Hugh F Kelly Real Estate Economics for SIOR

Property Type Sub-indexes

Industrials

The Sub-index for Industrial Properties dropped 1.34 points, from 120.92 in August to 119.58 in October**.** Of the 10 variables measured by the survey, only the volume of new construction was indicated as subpar; nine other variables demonstrated considerable market strength, led by the measures for sublease competition, asking rental rates and vacancy trends. Five of the 10 variables improved over the past three months, but five weakened. The evaporation of tenant concessions was the strongest advancing factor in the Index, and the softening of the "sellers market" for industrial-zoned land had the biggest effect in lowering the overall industrial index score.

National economic data supports an interpretation of the Industrial sub-index that might fall into the clichéd category of 'cautiously optimistic'. The Conference Board's Index of Leading Indicators was up in September (the most recent release as of this writing), although it has been down more often than up during 2006. The Conference Board's analysts see the behavior of the Leading Index as consistent with an outlook for “slow growth in the near term.” Manufacturing workers’ hours and new orders for consumer goods were negative in their September calculations, but positive consumer expectations and new orders for non-defense capital goods pushed the Leading Index upward overall.

Meanwhile, the Institute of Supply Management’s Purchasing Manager Index (PMI) for October 2006 registered 51.2, well above the benchmark level of 42 that indicates an expanding economy, but close to the breakeven point of 50 that suggests specific weakness in manufacturing. The PMI stood at 58.1 in October 2005, and so the overall plot-line is ‘things seem OK, but not as OK as a year ago’

The impact of national conditions was worrisome to more than a few SIOR survey respondents. “The Chicago market remains relatively healthy,” reports **Jeanne Rogers, CCIM, SIOR,** Arthur J. Rogers & Co., Chicago, Illinois. But she adds, “I think the skepticism that we have is mainly the result of the national news.” Sometimes the macroeconomic issue is quite specific. **James H. Coridan, SIOR,** Coridan & Associates, Columbus, Ohio, says, “Ohio is getting hit hard by the contraction of the Big Three U.S. automakers and their suppliers. Honda is our bright spot. Columbus is doing well in the bulk distribution market.” **Gary Joel Schacker, SIOR,** Long Island, New York, confides, “Our market has been strong with thin inventory for several years, but I smell transition in the air.”

Real estate cycles are shaped by “boundary conditions,” the constraints that push markets away from sustained equilibrium. More and more, we are seeing such constraints mentioned by SIOR’s survey panel. **Richard L. Vairo, CCIM, SIOR**, RCV Properties, in Ocala, Florida, indicates, “Industrial vacancy is at an all-time low in our market; however, rental rates have not increased enough to warrant spec building.” Complex dynamics affect the classic supply/demand equations and the length of time it takes to get projects done can exacerbate market imbalances. For example, according to **Wendell B. Stockdale, SIOR**, Commercial Prime Properties, Lancaster, Pennsylvania, “The Lancaster, Pennsylvania, industrial market is potentially ideal for expansion. Demand exceeds supply. But, unfortunately, not only is there a shortage of buildings, there is a shortage of land. If an acceptable site is found, it may take 12 to 24 months before all approvals can be obtained and construction started.”

Thus we find one of the advantages of a composite index over the simpler measures of asking rents and vacancies alone. We are able to look at variables as they approach boundary conditions and begin to experience constraints of cost or of time. The market’s attempt to maintain equilibrium is revealed to be dependent upon multiple factors, each amenable to analysis. It is the interaction of all the variables that makes for the rich complexity of real estate analysis.

INDEX SCORING NOVEMBER 2006

	National Index	Property Types: Industrial	Property Types: Office	Regions: Northeast	Regions: Midwest	Regions: South	Regions: West
Leasing Activity	11.01	11.26	10.67	10.20	8.67	12.66	12.17
Asking Rents	13.47	13.26	13.83	12.67	10.69	14.49	15.82
Vacancy	13.10	13.10	12.99	11.89	11.47	13.98	14.72
Subleasing	13.92	14.39	13.16	13.77	12.45	14.72	14.62
Concession	9.80	10.49	8.70	9.60	6.44	11.07	11.92
Development	8.81	9.35	7.96	7.27	7.98	9.95	9.62
Site Acquisition	12.92	12.96	12.89	12.77	10.91	13.27	14.67
Investment Pricing	10.47	10.77	10.04	9.58	9.52	10.46	12.19
Local Economy	11.99	12.38	11.42	10.62	9.79	13.66	13.41
National Economy	11.57	11.61	11.52	11.00	10.59	12.31	11.92
Index Totals	**117.07**	**119.58**	**113.17**	**109.36**	**98.49**	**126.59**	**131.06**

Offices

Similar complexity can be found in the results of the Office component of the survey. The Office Sub-index retreated to a level of 113.17, down 2.23 points from a (revised) score of 115.40 in August. Slow development activity and the persistence of attractive leasing concession packages for tenants in many office markets indicate that the recovery of this sector is not yet complete. As with industrials, gains in asking rent, lower vacancies, and favorable subleasing conditions provided the greatest contributions to the Office Sub-index. Seven of the component elements posted lower scores than in August, with local economies retreating the most. Only three variables had higher scores with investment pricing having the most important positive contribution: better revenue more than offset cost pressures, which are significant in this sector.

The Institute for Supply Management's index of business activity in the non-manufacturing sector was 57.1 in October 2006, with some acceleration seen over the summer months. This index was more than 60 for four months earlier in 2006, from February through May, and stood at 59.2 in October 2005. This is consistent with the SIOR Commercial Real Estate Index findings, which showed a May peak in the Office sector and a current reading somewhat below its year-ago level. But like the ISM measure, our Office Sub-index is still well entrenched in positive territory, indicating continued improvement over the coming months.

SIOR survey panelists generally provided upbeat comments in the office sector as they submitted data for the Index. Typical among those comments were the following:

- "While the overall Louisville office market remains fairly steady, we are beginning to see pressure on rental rates rising due to increasing tenant improvement costs." – **Jeffrey A. Dreher, SIOR,** Commercial Kentucky, Louisville, Kentucky

- “Rochester, New York, has seen a recent surge in tenants looking for space. Recent downturns at local employers such as Kodak, Xerox, and Bausch & Lomb are having less effect on the market as other companies are filling the void.” – **Daniel J. O’Neill III, SIOR,** NAI Pyramid Brokerage Co. of Rochester, Fairport, New York

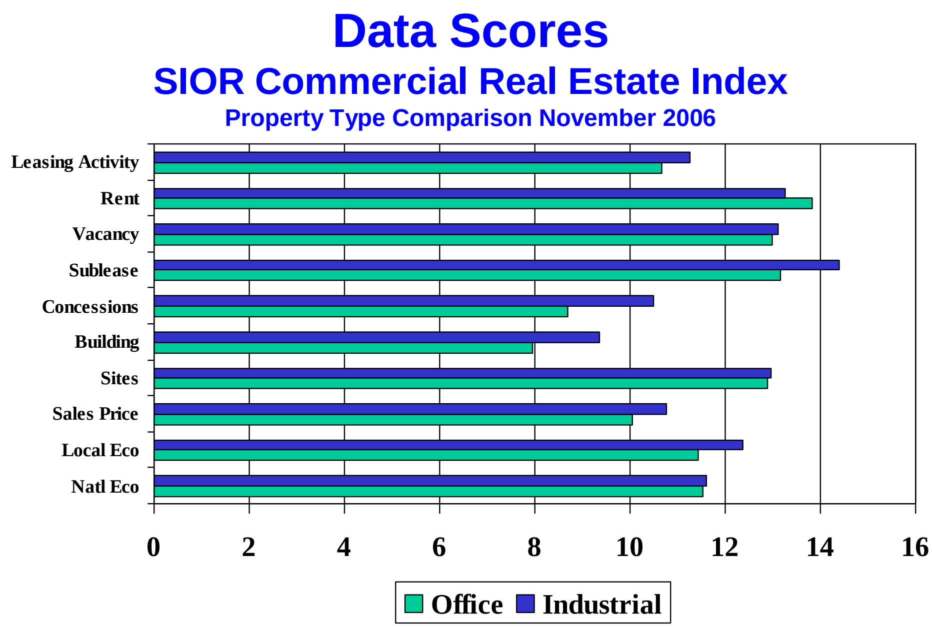
- “The Tampa Bay office market … is experiencing decreasing vacancy rates and significantly higher asking rental rates. This trend of overall positive office space absorption and increasing rental rates is expected to continue for the next 12 months.” – **Douglas C. Rothchild, SIOR**, CLW Real Estate Services Group, Tampa, Florida

Recovery is ‘in process’ in many markets, with SIOR office specialists seeing more time needed to complete a rebound from the economic shocks of the last recession. **Jeffrey S. Weil, CCIM, MCR.h, SIOR,** Colliers International, Walnut Creek, California, lays out the situation in the Oakland/East Bay office market in California. “Our market appears to be almost in balance,” he says, “after the significant overbuilding of the dot-com era and extensive vacancies between 2002 and 2005. It may still take several more years for rents to achieve the levels needed to entice new development. With high office construction costs and limited land supply, future office product will require dramatically higher rental rates than those achievable today.”

Change in other areas of real estate can impact office market conditions as well. In Boca Raton, Florida, for example, **Paul R. Lehrer, SIOR,** Lehrer & Feuerman, explains, “the residential free-fall has effectively halted rezoning of commercial and industrial land to residential. Commercial and industrial development will benefit, with prudent due-diligence periods and the potential for stabilization in material and labor availability.”

Indeed, there is a wide spectrum of prevailing market conditions. While most markets are on the upswing, it is still possible to see reports such as that submitted from Ft. Wayne, Indiana, where **Kathy Moses-Denig, SIOR,** CB Richard Ellis/Sturges, indicates, “Rental rates for larger Class ‘A’ suburban office buildings have been declining. We anticipate seeing changes in ownership of several Class ‘A’ buildings as a result of insufficient cash flow.”

For offices, then, improvement in local employment trends would seem to be the key. The supply side is quite controlled at this point, as rental rates are just starting their rebound in many markets and development costs have raised the bar for construction feasibility. Vacancy will almost certainly be declining, but the pace of improvement will be dictated by the job situation. The outlook for asking rents, sublease conditions, and concession packages all turn on whether the 2007 employment picture will continue to be a stop/start series of gains, or instead begin to build the kind of momentum that has marked previous economic cycles, yet has been puzzlingly hard to establish this time around.



Source: Hugh F. Kelly Real Estate Economics for SIOR

Regional Sub-Indexes

Northeast

"Our market appears to be in a state of deliberate caution," explains **John G. Skoglin, SIOR,** CB Richard Ellis, Baltimore, Maryland, "while trying to proceed on a positive note." This posture of 'watchful waiting' is shared by many in the northeastern states from New England to Washington, D.C.

The Northeast edged down to a sub-index score of 109.36, compared with 112.21 in August 2006, although it is ahead by a slim margin from its score of 109.00 a year ago. The region's best-scoring attributes were the fast-disappearing overhang of sublet space, strong rental growth, and a "sellers market" for building sites. On the other hand, development variables are still subpar as high building costs limit construction feasibility and tenants can still bargain for lease concessions in many markets.

Reports from the Federal Reserve's October 2006 Beige Book survey underscore the mixed signals in this region. The Boston Fed is concerned about housing market softening in New England, for instance. This anxiety is shared by **Kevin C. Geenty, SIOR,** the Geenty Group REALTORS, New Haven, Connecticut, who comments, "While residential sales have slowed dramatically, causing a buyer's market, the commercial/industrial market remains strong and somewhat vibrant. Often a downturn in the commercial/industrial sector occurs six to eight months after the downturn in residential sales. Will it happen that way this time? Only time will tell!"

But the Boston Fed also says that headcounts in the firms it surveys are increasing and that there is an emerging labor shortage in professional and technical workers.

Manufacturers, meanwhile, are increasing their capital spending. SIOR's respondents in our own Commercial Real Estate Index survey report similar observations. "Most of our office absorption can be attributed to financial services companies expanding within our region," says **George R. Walker II, SIOR,** Albert B. Ashforth, Stamford, Connecticut, in Fairfield County, Connecticut. In western Massachusetts and nearby Connecticut, **Mark J. Duclos, SIOR,** Sentry Commercial Real Estate Services, Hartford, Connecticut, notes that "overall market conditions for industrial properties remains strong. Overall, leasing is active, though there appears to be softness in the medium-range spaces of fifteen to forty thousand square feet. Large leasing transactions are at an all-time high."

Most of the regional signs point upward, as the Northeast's SIORs read prospective change in office markets. Syracuse's **John L. Clark, CRE, SIOR**, NAI Pyramid Brokerage Co., Syracuse, New York, reports that his suburban market is "steady and we expect rents to rise in 2007." New Jersey is benefiting from the "very low vacancies and rapidly rising rents in New York City," according to **Andrew B. Zezas, SIOR,** Real Estate Strategies Corporation, Kenilworth, New Jersey, but there is a counterbalancing "movement out of the state of certain job types where we have historically maintained a strong position." **Stan Kurzweil, SIOR,** Colliers Houston & Co., Somerset, New Jersey, provides some further detail in his comments: "Leasing of office space in central New Jersey has been significant amongst the existing firms in the financial services and biotech sectors. But new companies are going to other states with lower taxes and higher living standards. Higher end professional employees are leaving because of our high cost of living."

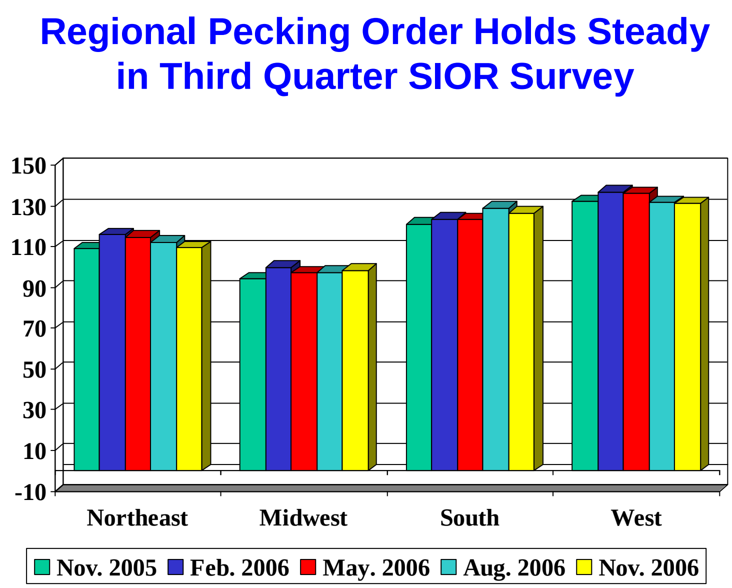
Pete Davisson, SIOR, Jackson Cross Partners, Wilmington, Delaware, is seeing a slowdown during the second half of 2006, remarking, "The first six months of the year were right 'on' the 10-year averages, but velocity is now off somewhat." Nevertheless, Davisson says, "Midyear vacancy rates in both CBD and suburban Class 'A' office buildings was 8.4 percent, considered good in any market and at any time."

Many outside observers considered the high prices paid for office buildings in and around New York City in the early 2000s to be speculative and possibly the real estate version of 'irrational exuberance.' From the perspective of the fall of 2006, though, **Jack J. Britvan, SIOR,** American Commercial Real Estate, Woodbury, New York, concludes that "the 'foolish' investors who purchased inflated Long Island properties in the last two years are now looking extremely smart. Office rents have gone up 15 to 20 percent, and sales prices have jumped accordingly."

Migration due to cost pressure is also helping to shape conditions in the industrial markets of the Northeast Region. **Amy Hawley, SIOR,** NAI Hawley Realty, Allentown, Pennsylvania, sees "an influx of companies from the metro-New York Region as well as the greater Philadelphia area. These companies view our area as an alternative to the higher operating expenses in the major metro markets."

Costs are in many ways a function of density, and the high density of the Northeast corridor carries favorable traits outweighing the nominal disadvantages of occupancy expense. **Scott D. Peck, SIOR,** Resource Realty of Northern New Jersey, Parsippany, New Jersey, see the enormous New Jersey industrial market this way: “Powerful retail demographics support our big-box warehouse facilities. Our density also allows for adaptive reuse of obsolete manufacturing facilities into retail, recreational, or residential complexes. New Jersey has tremendous logistical advantages. The challenge is to target growth along existing infrastructure.”

In late 2006, then, the Northeast can be described as coping with the problems of success. The revival of rental rates and sales prices that are prompting migratory trends would not be an issue, except for the stunningly swift rebound in this region after the September 11 events. Home to two of the wealthiest states in the nation (New Jersey and Connecticut), the vibrant New York City market and the very strong economy of the Washington, DC metro area, the Northeast has been a tremendous magnet for real estate capital investment in recent years and shows no signs of reversing that trend in 2007.



Source: Hugh F. Kelly Real Estate Economics for SIOR

Midwest

For the second consecutive quarter, the Midwest improved its regional score, gaining 1.01 points to reach 98.49. While this region remains the only area below the theoretical point of balance, at the Index level of 100, such progress should surely be recognized in a period when all other sub-indexes showed slippage. At this point, five of the regional variables are in “recovery” territory, and five are still climbing out of the cyclical trough. Vacancy, both direct and sublet, made the greatest contribution to the region’s overall score. But leasing activity is slow, concessions erode most of the gain in asking rent, and development is not likely to be resuming until demand fundamentals show a much more vibrant improvement. “Conditions are slowing getting better,” says **Michael Linder,**

SIOR, Grubb & Ellis/Adena Realty Advisors, Columbus, Ohio, “but demand for industrial space is still somewhat minimal.”

A review of the Beige Book reports from the Midwest Federal Reserve banks (in Cleveland, Chicago, Minneapolis, St. Louis, and Kansas City) are surprisingly upbeat, given the distress of the American automobile industry centered in this region. Virtually all the Fed reports summarize their districts as “expanding moderately.” And this is consistent with the results posted by the SIOR respondents in the Fall 2006 survey. Banking sources indicate measurable increases in deposits, particularly in certificates of deposit and money market accounts – an interesting statistic in view of the alarmist reports about a negative savings rate in the past year or so. Trucking and warehousing volumes seem to be up throughout the Midwest, particularly in the Chicago area. Corporate executives are reportedly optimistic about business conditions, and business spending is on the rise. Housing markets are weakening, but commercial/industrial markets are strengthening according to the Fed’s October 12th release. All in all, the economic vital signs here are at least in the “normal, healthy” range, even if not yet robustly vigorous.
The bland characterization of ‘moderate expansion’ may correctly depict the averages for the Midwest, but there are certainly some extremes to be found in individual markets. Some localities are desperately struggling. Detroit’s problems have been widely reported. **Gary P. Grochowski, SIOR,** L. Mason Capitani, Troy, Michigan, looks to international tenants, including auto suppliers, as a source of hope for the Motor City’s suburban market, but says “we are experiencing a stagnant leasing market with no net absorption. The majority of deals are tenants looking to downsize and/or save money.” In Indianapolis, Indiana, **Drew Augustin, CCIM, SIOR,** NAI Olympia Partners, sees suburban office owners “propping up rental rates through various leasing concessions to position themselves better eventually for the investment sales market.” Meanwhile, new construction in Indianapolis’ suburbs is active, according to **Samuel F. Smith II, CCIM, MCR, SIOR, SLCR,** Resource Commercial Real Estate, who notes “developments by Panattoni, Lauth, and Duke have been fueled by a ton of leasing activity.”

Bradford L. Kitchen, SIOR, Alterra Real Estate Advisors, says that Columbus, Ohio is witnessing “both record highs and record lows. Many large office buildings are being given back to the banks and sold at $35 to $50 per square foot at zero to fifty percent occupancy.” But, at the same time, “fully occupied buildings are selling for more than $200 per square foot, above replacement cost.” Vacancy rates are holding steady, as spec building is matching the pace of absorption.

Cleveland also presents an extensive compass of local office conditions. **Robert F. Redmond, SIOR,** CB Richard Ellis, lists a series of corporate mergers and acquisitions that have cost Cleveland in recent years—BP/Amoco; TRW/Northrup Grumman; Boise Cascade/Office Max. “We are one of the few metro areas not feeling the benefit of the national recovery since 2002,” says Redmond. But he points out that “there has been a very recent uptick in office investment, in a cap rate range of 8.5 to 9.0 percent, very attractive to national investors." Citing expansion in the legal, medical, and biotech sectors, Redmond concludes, "the outlook is more promising than the past few years."

The Cleveland, Ohio CBD is still a tenants' market, comments **Brian A. Hurtuk, SIOR,** CB Richard Ellis, but "landlords are expecting a swing to higher rents in the next 18 to 24 months." And the suburban market east of Cleveland is called the tightest in 20 years, with some submarkets 93 percent occupied and effective rents slated to grow five to eight percent by next summer.

Further west in the region, **Christopher R. Fox, CCIM, SIOR**, Gateway Commercial/ Cushman & Wakefield Alliance, St. Louis, Missouri, reports that suburban St. Louis offices lack large blocks of available space. "There are fewer options for tenants, which will escalate build-to-suit and new construction planning. Office sites that have remained dormant should finally get some consideration."

The Chicago suburbs are "still tenant-driven, with aggressive concessions," in the view of **Joseph J. Dvorak Jr., SIOR,** Colliers Bennett & Kahnweiler, Rosemont, Illinois. Change is afoot, though, according to **Geoffrey Kasselman, SIOR,** Op2mize, Northbrook, Illinois: "The overall market is showing signs of recovery, both in the Loop and the suburbs. This is stimulating tenant activity among users who had been attempting to time the market."

On the industrial front across the Midwest, similarly mixed results can be gleaned from the SIOR survey panel. On the positive side, the St. Louis bulk warehouse market is reported 97 percent occupied. **Allen P. Klippel Jr., SIOR,** CB Richard Ellis, tells of "high levels of big-box development by Panattoni, Duke Realty, and HSA Read providing expansion capacity for local firms. While the Ford plant is closing here, Chrysler is spending more than a billion dollars in renovating its St. Louis facility, resulting in job growth and space absorption from suppliers."

Michigan is hurt by cost-cutting in the auto sector, maintains **Robert L. Horn Jr., SIOR,** CB Richard Ellis, Grand Rapids, Michigan, but "we have started to stabilize with an increase in orders helping the locally-important office furniture industry."

Chicago, the nation's single largest industrial market, is turning around, observes **Ronald J. Behm, SIOR,** Colliers Bennett & Kahnweiler. "Vacancy rates have been reduced and cap rates remain low. Chicago receives a high level of investor demand from both local and out-of-town players. Land around hot areas like O'Hare is non-existent, and thus we are demolishing buildings to create sites pushing land value upwards to $20.00 per square foot." Peoria, Illinois, is also doing well, says **David M. Maloof, CCIM, SIOR,** Maloof Commercial Real Estate: "Our market has remained strong due to limited construction and strong local employment."

Jeffrey R. Bender, CCIM, SIOR, Colliers Turley Martin Tucker, Cincinnati, Ohio, indicates that Cincinnati is cooling after a record 2005, with industrial activity "down 65 percent on a net basis, but new construction up 56 percent. We are in a 'rebuild' phase, with landlords serving demand that last year absorbed nearly eight million square feet net. This is a very healthy market."

Indianapolis has also slowed between 2005 and 2006, according to **Jeremy G. Woods, SIOR,** Summit Real Estate Group, "Absorption last year in the Class 'A' product type exceeded 5.5 million square feet; 2006 absorption in this same product type is tracking at just $3 million square feet. Like the retailers, our industrial will be looking for the Holiday Season to make or break its year."

South

The South registered a regional score of 126.59, a truly excellent performance, despite a small retreat from its 129.08 level in the August survey. Commercial building in the region is very close to its historical norm, and for the South that means a pattern of vigorous development. The SIOR survey respondents credit both the local and the national economy for the demand-side boost that has lifted rental rates and sales prices, contributing to an optimistic outlook for 2007. A typical comment from the Southern Region comes from **Nora Hogan, SIOR,** Transwestern Commercial Services, Dallas, Texas, "The 'flight to new' proves that price is not always the driving factor. Dallas vacancy would be much lower, but for the new product coming on line."

The Dallas Fed reports some "recent cooling from very high levels" of economic activity. In general, business conditions throughout the South are strong, with the exception of the housing industry and related residential finance. A bullish attitude is conveyed for non-residential development in reports from the Atlanta and Richmond Federal Reserve banks as well.

Confidence is rising in most of the South's office markets. **Stephen B. Smith, SIOR,** Grubb & Ellis, The Furman Company, Greenville, South Carolina, indicates that "in the Greenville/Spartanburg, South Carolina area, Class "A" vacancy is less than seven percent and asking rental rates are near $20 per square foot on average." **Tim Strange, CCIM, SIOR,** Sperry Van Ness, Oklahoma City, Oklahoma, says, "We have seen seven consecutive quarters of absorption, with rental rate growth in all classes of office product. Investment opportunities are strong, with values still below replacement cost." And in Austin, **Ford Alexander, SIOR,** Colliers Oxford International, sees "growth from companies within the market while outside firms discover the low cost of housing, educated workforce, and lifestyle here, encouraging relocations to the area."

The exceptions appear to be in the Tennessee office markets. **Joseph L. Steffner, CCIM, CPN, SIOR,** Steffner Commercial Real Estate, Memphis, indicates that "if not for the absorption of one high profile vacancy building in the second quarter, the entire market would have had negative net absorption through the third quarter of 2006." Further east, in Knoxville, office leasing activity is called 'below normal' due to economic uncertainty and a strong bias toward purchasing.

For industrials, most reports are extremely enthusiastic. **Theodore R. Konigsberg, SIOR**, Konigsberg Commercial Real Estate, Hallandale, Florida, believes that Miami's absorption is at “an all-time high.” He says, “The lack of developable land, high construction costs, and lack of potable water has curtailed the number of permits for development. Reconstruction and repositioning of existing properties in secondary areas is becoming prevalent.” Tampa Bay’s **Robert J. Dikman ALC, CCIM, CRB, SIOR,** The Dikman Company, exults, “This is the best commercial/industrial real estate market in my lifetime!”

Upstate, in Jacksonville, **Jeffrey L. Graham, SIOR,** King Commercial Realty / CORFAC International, claims, “The market is as tight as I’ve ever seen. Vacancies continue to drop and lease rates have climbed 10 percent across the board since the close of 2005.” **Clifton R. Byrd, SIOR,** Wesjax Development Co., confirms this, and adds, “Existing buildings are increasing in value due to the shortage of industrial land and spiraling construction costs.”

Florida is not the only state reporting booming industrial market conditions. The large Texas markets are enjoying exceptional growth. Several industrial specialists contributed comments from the Dallas-Ft. Worth Metroplex.

- “We are experiencing one of the biggest industrial booms in our market’s history, with many significant (250,000 to 1,000,000 + square foot) transactions. Most of these have been new requirements to our market, not just expansions, although these have also been very active.” - **Chris G. Teesdale, SIOR,** Colliers International
- “The larger deals which had been almost non-existent are now back. And the number of medium-sized deals have picked up as well.” - **H. Allen Gump, SIOR,** Colliers International
- “We have significant, positive momentum currently. Vacancy has declined to about 11 percent, with roughly 8.8 million square feet under construction. We should see 10 million square feet absorbed by year-end 2006.” – **Kurt Griffin, SIOR,** Cushman & Wakefield of Texas

Plummeting vacancies appear across the map of the South. **Salvatore ‘Sam’ DiFranco, CCIM, CEA, SIOR,** Triangle Commercial Real Estate, Research Triangle Park, North Carolina in Raleigh/Durham, tallies warehouse vacancy in the Research Triangle as “going from almost 30 percent to just more than 13 percent within the past 18 months.” With just minimal speculative construction, “The Little Rock industrial market has occupancies around 93 percent” according to **Maury Mitchell, SIOR,** Rector-Phillips-Morse, Little Rock, Arkansas. In Nashville, Tennessee, developers need to catch up with strong user demand, says **Ben H. Goodwin, SIOR,** Knestrick Properties, but “the problem is that developable sites are few and far between. Big-box developers control most of the sites, and are not offering them for sale.” A similar mismatch is occurring in Louisville, reports **Stephen C. Lannert CCIM, GRI, SIOR,** Harry K. Moore Co. / Colliers, “The rapid rate of sales and leasing here in 2006 may soon outpace the ability of developers to construct new warehouses.” A year after Katrina, **Randall Walker, SIOR,** The Industrial Group, New Orleans, Louisiana, says, “I’ve never seen the New Orleans area industrial market have higher demand and tighter supply in 30 years of leasing and brokerage.”

And, in contrast to the Midwest, “Cars ‘R’ Us” is a positive attribute in the Southern markets. **Ogden S. Deaton, SIOR,** Graham & Co., Birmingham, Alabama, says, “The activity of new companies considering our market has increased due to the success of the automotive industry. There is a good deal of development in the pipeline.” And in Spartanburg, South Carolina, **Elizabeth C. Belenchia, CCIM, RICS, SIOR,** Carroll Properties Corp. indicates, “Surplus buildings are attracting manufacturers from outside the market. We are the number one destination for European direct investment, with BMW suppliers locating near the plant here.”

West

The West retains its ranking as the top region, with an index value of 131.06. We should note, though, that this was the third consecutive quarter in which the West’s regional score dropped, after reaching 136.90 in February 2006. The West scored 132.12 in our initial November 2005 survey. Nevertheless, this is modest slippage from a very high pedestal. By virtually all measures, the real estate industry is booming in the Pacific Coast and Mountain areas of the country. To put things in perspective, **William G. Kiefer, SIOR,** NAI Capital/Ventura County, in the Los Angeles area says, “Our economy is resilient and doing well. Maybe we are not as explosive as in 2004 and 2005, but we are still very strong.”

Here is what the San Francisco Fed recently had to say about the real estate economy in its district:

> “Demand for commercial and industrial space rose further in most areas, reducing vacancy rates and leading to further increases in rental rates; however, contacts in a few areas reported a recent reduction in the pace of demand growth. In areas where home demand has been resilient or commercial and public projects have grown rapidly, builders continued to face project backlogs and high costs.”

This is not just a California story, either. In fact, while some (not all) of the hottest Golden State markets may be tapering off a bit, other metros from Arizona to Hawaii are accelerating. Nevada, though, is resembling the California situation where a long, booming run seems to be catching a breath in late 2006.

Tucson, Arizona’s office market provides an excellent example of tremendous momentum. **Thomas S. Knox, SIOR,** PICOR Commercial Real Estate Services distinguishes a two-tier market, depending upon location. “Leasing and development are accelerating,” Knox elaborates, “and well-located properties are breaking through to new highs. Office rents have penetrated the $30 per square foot (gross rent) mark, and new for-sale developments are priced at $195 per square foot for cold shell…. 2006 will be a record year.” Fellow PICOR colleague, **Thomas J. Nieman, SIOR,** confirms the highs in pricing and rents, and further opines, “Investors have to accept lower returns to obtain a high-quality property, knowing that they will come out looking very intelligent in the end.” There is an echo here of the commentary we heard earlier from the Long Island market, where investors once were derided for paying ‘foolish’ prices, but now are sitting on significant gains.

“Salt Lake City, Utah, is booming,” enthuses **Gregory M. Gunn, SIOR,** Coldwell Banker Commercial, when describing the office market there. “Land pricing continues to be on the rise throughout the market; Class ‘A’ vacancy in the CBD is around two percent.” **Andrew D. Friedlander, SIOR**, Colliers Monroe Friedlander, Honolulu, Hawaii, takes the temperature in his market this way: “The CBD office market is hot and getting hotter. Several national players are active here, and rates will continue to rise as the cost to construct is prohibitive.” High costs are also cited in San Francisco, California, where **John E. Casey, SIOR,** Colliers International, writes, “The most significant obstacle to closing deals is not lack of demand or lack of space, but rapidly rising tenant improvement costs.” A hidden subtext in these comments is the on-going downtown business revival, even in Western markets where there is ample room to grow in the suburbs.

Perhaps the enthusiasm is slightly curbed in Sacramento, California. **Bruce E. Hohenhaus, SIOR,** Colliers International, shades his remarks with the comment that the California capital “typically does not experience wild fluctuations in vacancy and activity, just boring consistent growth.” Even so, he acknowledges his office market “is affected by the downturn in housing and increasing construction costs. The cost of new office construction makes it cheaper and easier to buy existing product, either vacant or fully-leased buildings.”

Also making the housing/office market link is Reno, Nevada’s **Tim Ruffin, CCIM, SIOR,** Colliers International. “The housing slowdown has started to affect the office market. Leasing activity has slowed, with fewer new office users looking to relocate to our market. On the opposite side of the coin, the Spokane area has had “steady growth” in the housing and retail sectors, according to **Jeff K. Johnson, CCIM, SIOR,** Tomlinson Black Commercial, who sees “the demand for office space strengthening in the first quarter of 2007 as a result of the steady growth.”

Spectacular numbers are emerging from some of the West’s industrial markets as well. We might begin with Phoenix, where **Anthony J. Lydon, SIOR,** Grubb & Ellis/BRE Commercial, counts about 10 million square feet of user demand for large space tenants (200,000 square feet or higher). But there is a “supply constrained market, with a shortage of solutions available in the short-term.” He believes this condition “will last through mid-2007, even though lease rates have risen 20 to 40 percent in the past eighteen months.” **Matthew G. Hobaica, SIOR,** Lee & Associates, chimes in, “The only negative impact on development has been the backlog in obtaining building permits. A typical permitting process is now four to six months, due to the heavy volume of applicants. The municipalities are overwhelmed and understaffed.”

From the LAX submarket in Los Angeles comes this challenge, via **Chris H. Stauff, SIOR,** Commercial Property Group, Culver City, California: “Industrial land is being eaten up by higher-density residential and commercial uses. Older industrial properties that went for $35 per square foot land value a decade ago are now $120,180 per square foot, or even more. Try getting your stock portfolio to match that!" Oakland's industrial corridor along I-880 has a 4.7 percent vacancy rate, the lowest level since 2001, says **Jeff Starkovich, SIOR,** BT Commercial Real Estate, Oakland, California. "Average lease rates are up approximately twelve percent from a year ago, and are expected to accelerate into 2007." Across the Bay, **Lawrence E. Hazard, SIOR,** Commercial Real Estate Associates, Pleasanton, California, also figures that low vacancies are pushing rental rates up and "sales transactions are dominated by user purchases with little investment turnover," a strategy of aggressive asset accumulation and protection against great rental increases in the future.

Fresno has a similar story to tell. As **Stewart D. Randall, SIOR,** Colliers Tingey International, Fresno, California, puts it, "Activity for all areas of industrial real estate are positive. Vacancy is declining, rental rates are increasing, and there are no new projects on the drawing boards." In the San Gabriel area, **James P. Center, CCIM, SIOR**, Grubb & Ellis, City of Industry, reports "strong demand for sale product, with evidence that prices are starting to peak. Leasing demand continues to increase, pushing up rental rates in an already tight market."

So where might there be chinks appearing in this formidable regional market? There are some to be found, upon careful inspection. **John R. DeGrinis, SIOR**, Colliers Seeley International, Encino, California, says that "the Los Angeles – North Region is seeing the beginning of change. Industrial users are no longer interested in purchasing facilities at whatever the sellers ask. We are seeing a shift as users consider the impact of a softening housing market and the warning signs of a slower economy." Simultaneously, the L.A. – South Bay market faces "a new tenant market dynamic," perceives **David A. Drummond, SIOR,** Colliers Seeley International, Torrance, California. "After a strong run over the past two or three years, the volume of lease activity recently tapered off. There is some resistance to higher rents and some uncertainty about the economy. Still, there is little new construction since there is little available land. Vacancy is just 2.4 percent. Everyone is hopeful that 2007 will maintain deal flow."

Finally, a word of caution issued from, of all places, Las Vegas. In an unattributed comment, one survey panelist warned, "The Las Vegas distribution market is very active, with numerous large-user prospects in tow. Speculative buildings abound, yet there is an undercurrent of uncertainty." High risk/high reward is a formula familiar to the high rollers in the casino. It is an interesting question as to whether it is an appropriate formula for the real estate business.

Where Do We Stand?

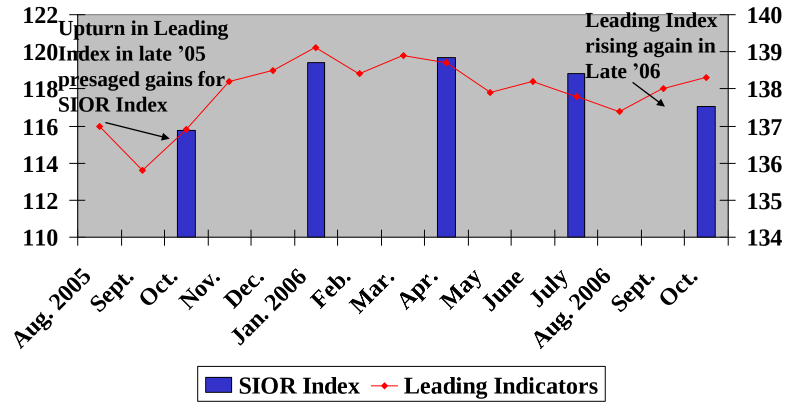
With a full year of experience now under our belts, what observations can we make about the utility of the SIOR Commercial Real Estate Index? It is very encouraging, I think, to see that the Index is showing sensitivity to intra-cycle pressures that do not always show up in grosser measures such as overall vacancies and average rental rates. Traditional measures of the market have what statisticians refer to as "serial correlations," that is, when rents or vacancies begin to show a trend, they persist in that trend for relatively long periods of time. That tends to look like markets are smooth and predictable, and one wonders why anyone would ever lose money in real estate! Experienced professionals, however, are well aware that market conditions are much more complicated and that there are lots of “wrinkles” in the trend lines.

It is also enlightening to see how the SIOR Index is matching up with established information sources, including the Fed’s Beige Book and the ISM’s Purchasing Manager Index. Although we do not yet have the frequency of reporting those two sources provide, it does seem that our Index is picking up for the commercial real estate sector many of the same nuances that the Fed is seeking at the macroeconomic level and the ISM is measuring for the corporate sector. At the level of the overall Index we are finding the ability to quantify relative conditions of strength and evaluate the industry’s segments, both by property type and region, within the national context.

As of late 2006, we are finding decelerating growth—not weakness, but a market where some of the elements of strength are starting to reach their limiting conditions. Both through the numbers and, importantly, through the interpretive comments from SIOR members active in the office and industrial markets, we reach some detailed understanding of market shifts. That detail is important, and should lead to better decision-making as it is better understood.

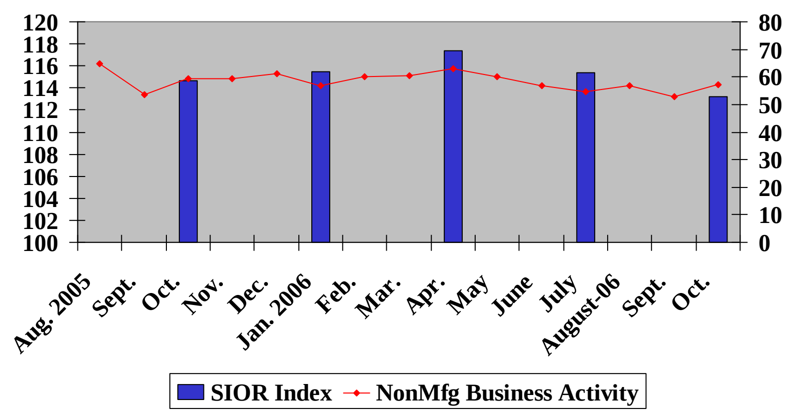
So if we are seeing a pause— brief or sustained— in the movement of the commercial property industry, we see that as potentially very useful information. Pauses can help us to recollect ourselves, to re-evaluate strategies and tactics, and to plan for the future. Like any tool, it needs to be applied with skill. And, in real estate as in any other business, that skill is not just technical, but it requires good judgment. If this means being patient for a while, that’s not such a bad thing. And if the pause to reflect patiently on the Index’s detailed information sets the stage for better decisions, then this may truly prove to be, in the word’s of an old soft-drink ad, a pause that refreshes.

Will "Leading Indicators" Foretell Renewed Strength for Real Estate into 2007?



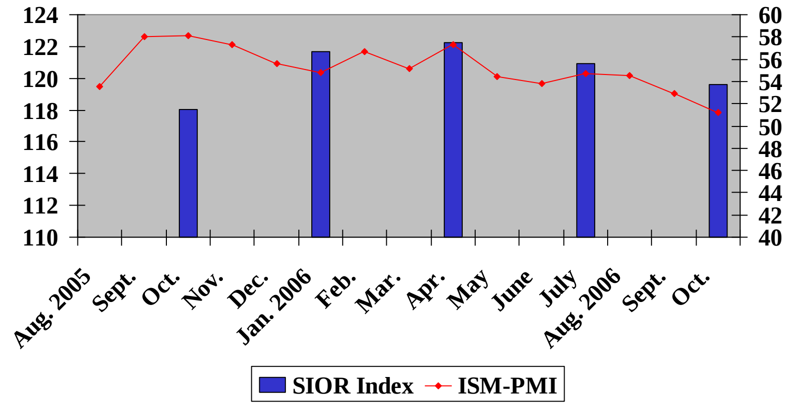
Sources: SOCIETY OF INDUSTRIAL AND OFFICE REALTORS (SIOR Index); The Conference Board (Index of Leading Economic Indicators)

SIOR Office Index and ISM Non-Manufacturing Index Both Slip Since Spring 2006



Sources: Society of Industrial and Office Realtors (SIOR Index); Institute of Supply Management (Non-Manufacturing Business Activity)

Both SIOR and Purchasing Managers Index Register Industrials Softening Modestly



Sources: Society of Industrial and Office Realtors (SIOR Index); Institute of Supply Management (PMI – Purchasing Managers Index)