



e-merging directions

timely research on current commercial real estate topics

Commercial Real Estate Investment: The Sky Is Not Falling

There seem to be a number of “chicken little” types, in the print media and on the airwaves, harping about the downstream effect the subprime mortgage market difficulties will have on commercial real estate markets. However, a closer and more careful look should help one understand the sky is not falling.

Overview

Problems in the subprime mortgage market have caused a bit of uncertainty in other capital markets. The use of innovative and complex financial instruments, like Commercial Mortgage-Backed Securities (CMBS) and Collateralized Debt Obligations (CDO), has spread this uncertainty at the same time the risk was spreading.

It is certain there have been a number of these instruments which have contained subordinate tranches (levels) of debt security downgraded by a rating agency due to the subprime mortgage market, usually a small percentage of the pooled assets. However, it just as certain that these instruments are utilized primarily in purchases of marginal properties and have not been a part of the majority of commercial transactions.

Commercial real estate investors may indeed be worried about the reactions to the subprime mortgage losses. Nevertheless, they are not as worried about the market reactions as they are about the potential for government reaction, which would be an increase in regulations. Luckily, Ben Bernanke is Chairman of the Federal Reserve Board (FRB) and he has been very clear about letting the market correct itself and not letting the government react on an ad hoc basis. Chairman Bernanke is very much aware of the complexity of these financial instruments and the difficulties they present for effective regulation.

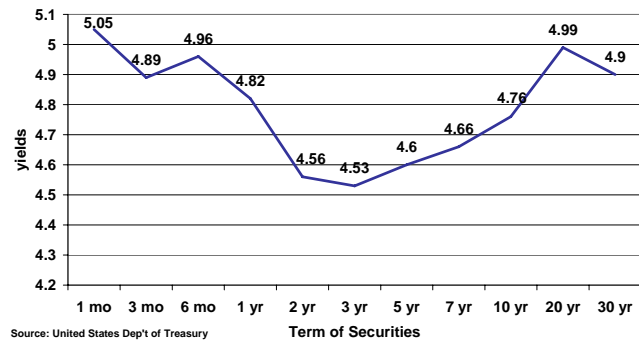
By property type, there is little impact from the subprime mortgage problems on Office, Industrial, or Retail (with the exception of an increase in the cost of capital through the CMBS market). However, the Multi-family Housing sector could see a boost in demand in some geographic areas. As subprime borrowers default on their loans, they could very well create an increase in demand for rental apartments.

The U.S. Economy and Commercial Real Estate Investment

The economy is maintaining modest growth and the problem areas continue to be the sale of new houses and new automobiles. Most other sectors are going strong and the one potential trouble spot continues to be energy costs. The yield curve continues its inverted shape (figure 1) as the returns on Treasury securities are higher in

the short-term (3 months to 1 year) than they are in the longer term (through 10 years). Many think the inverted yield curve is a sure sign of recession, but the economy has continued to grow, albeit at a slower rate. Thankfully, the FRB has been able to facilitate a soft landing and prevent inflation.

Daily U.S. Treasury Yield Curve Rates 8/1/2007



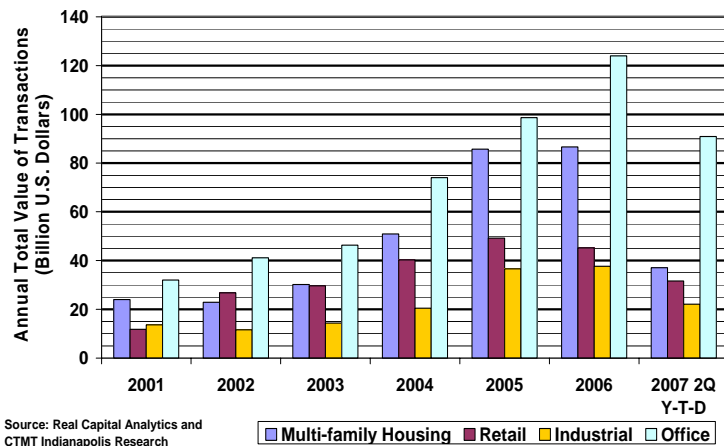
Studying the total amount of U.S. dollars which invested in commercial real estate over the past few years clearly indicates the increase in both the amount of capital available and the recognition of the stable returns emanating from this market.

Total investment transactions in 2001, among the following property types: Multi-family housing, retail, industrial and office, was 81 billion dollars (figure 2). By 2004, the total figure had climbed to 185 billion dollars, and by 2006, it had reached 295 billion dollars.

After just the first six months of 2007, investment transactions are greater than 181 billion dollars--nearly the total amount for all of 2004! The role of office

building sales as the leading investment property type is evident (figure 2). Office investment was 31 billion dollars in 2001, increased to 74 billion dollars by 2004, 98 billion by 2005, and 125 billion in 2006. In just the first six months of 2007 office investment transactions total over 90 billion dollars.

U.S. Commercial Real Estate Investment Transactions: By Property Type, By Year



Conclusion

With the end of 2007 less than six months away, all signs point to yet another outstanding year of commercial real estate investment transactions. Clearly, there is a great deal of buyer demand with no end in sight to the inflow of capital. Private buyers, institutional money, and a large trade imbalance, all are looking for a stable place to invest their U.S. dollars and earn a decent return. Much of the commercial real estate market offers that very environment to investors with each of the four property types this report covers.

Illiquidity has increased in marginal properties and this has clearly affected the capital markets. It is not clear that these issues will have much of an effect on private investments. Expect to see many commercial real estate investment markets continue to grow with new developments, continue to maintain strong market fundamentals, and continue to attract investors who are looking for market-priced, quality properties with stable returns.



TURLEY
MARTIN
TUCKER

Matthew C. Briggs, MBA, MIS
Research Director, Indianapolis