

## **Commercial Real Estate Braces for Roller Coaster Ride as we Head Into 2008, According to Colliers International**

*As companies sit on their hands and adopt a “wait-and-see” approach, the economy poises itself for a resolution: How deeply will the rollicking financial markets affect the everyday economy?*

**Boston, MA, December 12, 2007** – 2007, and the last 100 days in particular, have been times unlike any other. For this reason, in lieu of its annual year-ahead forecast report – since projections have never been more difficult to make – Colliers International has focused its thinking on key themes to watch in 2008 – and how the commercial real estate sector could be impacted.

With a fifty percent chance of a recession, according to many economists, we are all about to become experts on defaults, delinquencies, foreclosures and write-downs. Retail and consumer spending is tenuous at best, job growth is down and this negative trend is almost certain to continue. The effect of skyrocketing oil prices is more psychological than real, but consumers and businesses will surely become more violently vocal about rising energy bills as 2008, and winter, draw near.

“While many economists indicate a 50/50 chance of a recession, Colliers International sees little evidence that a recession will occur,” said Ross Moore, senior vice president and director of market & economic research at Colliers. “We keep close watch on four important indicators: employment, industrial production, personal income and consumer and business sales – and we believe each of these will remain in positive territory as 2008 unfolds. Indeed, as the November jobs report has shown, the employment climate seems to be holding up in the face of challenges in financial markets.”

Three key determinants for next year’s commercial real estate market will be the supply and pricing of credit, the single family housing market and energy prices. That said, the downward movement in the U.S. dollar is causing concern around the globe and is something that could be a catalyst for further uncertainty. On the plus side, the weak U.S. dollar is beginning to call into question the whole trend towards offshoring – as it’s becoming more difficult for U.S. companies to justify setting up operations overseas for cost reasons.

While a good number of key sectors of the economy will be trading water at best, growth areas in 2008 will include exports, health care, education, telecom/multimedia

and hospitality and tourism (specifically for destinations sought out by overseas visitors). Indeed, foreigners are expected to feast on anything American – most notably real estate, consumer goods and colleges/ any type of advanced education.

As the economies of Asia, the Middle East and Russia become increasingly strong, we have seen a schism in America – particularly, a divergence between gateway cities such as New York, Miami, Los Angeles and the “Rest of America”. Look for this trend to become more pronounced with a handful of cities showing surprising strength against a fairly sluggish economy.

With regards to commercial space, retail is most at risk, followed by, multi-family, suburban office and then industrial. Central Business District (CBD) office space in top tier markets will be the most stable.

“On a positive note, as we all know, 2008 is an election year – and you’d have to go back more than a quarter of a century to encounter a recession during an election year,” remarked Ross Moore. “This time around, the key is the credit markets – and we watch this very closely. If lenders pull back on all fronts, we’d change our viewpoint and could almost guarantee a recession. Credit is the economy’s lifeblood, but we predict the subprime fallout will neither infect the larger economy nor drag the commercial real estate markets down into the red.”

## **Regional Notes**

As is always the case, the real estate scene nationwide is marked by regional differences. This is particularly amplified when comparing gateway cities to the “Rest of America” cities. Notable regional highlights include:

- In most cases, a depressed local housing market stems from a sluggish local economy. This is not the case in Florida, Arizona, Nevada and parts of California – where the housing market will continue to be negatively impacted by speculators exiting the market and the resulting oversupply.
- Gateway cities such as New York, Boston, Washington, DC, Los Angeles, San Francisco and Miami will all remain surprisingly strong when it comes to housing.

- The Pacific Northwest will remain stable with regards to office and industrial. Companies like Boeing, Microsoft, Costco, Nintendo and Starbucks are going strong and are expected to keep the demand for commercial space relatively high.
- The west, including certain areas of California, will struggle in terms of the office and industrial market, including the Inland Empire, Orange County, San Diego and parts of the Bay Area. Denver, however, is expected to stay relatively strong.
- The Northeast Corridor (Boston to Washington) will remain relatively strong. Wall Street, technology and a strong government presence will continue to support commercial real estate in this region.
- The Southeast U.S. will be mixed, with many watching the Florida real estate market for signs of further deterioration -- but in-migration and increased activity in port cities such as Savannah and Jacksonville, and of course tourism, will keep the region relatively stable.
- The Midwest will struggle as the domestic auto sector faces further setbacks, but the agriculture and all those involved with exports are expected to enjoy another very robust year.
- Texas deserves special mention with the three primary cities; Dallas, Houston and Austin, all expected to outperform the nation for different reasons – Dallas for transportation and corporate headquarters, Houston for energy and Austin for technology

As for absorption of commercial space, 2008 should bring a decrease in demand, but absorption will not go negative. Unlike the dotcom bust of 2001-2002, absorption should stay in the black for the year. As a result, and much to the relief of tenants, rents are not expected to increase much more than the rate of inflation.

### **Investment Sales – Key Findings**

Since the onset of the credit crunch in mid August, the investment sales market has slowed significantly. What was expected to be a minor blip has turned into a major

event. Following the credit woes in August, the immediate reaction by many was that things would almost certainly get back to normal post Labor Day, as the Federal Reserve and other central banks intervened and provided the required liquidity. To some extent markets did begin to function as they had done earlier in the year, but there was also a sense that the "other shoe had yet to drop."

As writedowns continued and debt became more difficult to source – and more expensive once found – markets nationwide began to see deals collapsing or falling out of contract as buyers fully digested the turmoil gripping credit markets around the globe. While underlying leasing fundamentals hadn't changed significantly, the capital markets were offering very little good news and deals that had looked highly attractive just a few months ago were now nowhere near meeting required rate-of-return thresholds.

The central issue remains debt, both the availability and price. Until the credit markets settle down it is highly unlikely the investment sales market will return to anything resembling normal. The following are issues which need addressing.

- If you can't price money, how can you price real estate?
- If everybody is sitting on their hands, how can a market function normally?
- Banks, pension funds, and insurance companies have lots of money to lend, but without the CMBS market operating at normal capacity, transaction levels will be severely reduced.
- Treasury yields are going lower, but spreads are increasing at a greater rate keeping borrowing costs high.
- Top tier markets are still attracting multiple bids, but many of the rest are nearing a "no bid" environment.
- If the consensus view is prices will be lower a year from now, why not wait? - even for well capitalized investors.
- What will be the impact of an influx of foreign investors? - U.S. real estate priced in USD is starting to look very cheap.
- Will the "smart money" lead the market down? - Locking in returns and buying back into the market 12 or 18 months from now.

- How will REIT's react? - Many are in a position to acquire but a sinking stock price makes acquisitions more difficult
- What role will mezzanine financing play? – It should bridge the gap between equity and debt and possibly keeping values up.
- How should vacancy be priced? - It used to be a positive, but not so anymore.
- How will the different product types (office, retail, industrial, multi-family and lodging) react to a slower economy?
- What event will move the market?
- Will the real estate veterans of the 1980s and early 1990s react differently to the younger generation who haven't seen a down market before?

Peering into 2008, it looks as though the first quarter, and increasingly likely the second quarter, will be very quiet with no privatizations or large portfolios trading and significantly less single asset sales. Sellers will be reluctant to sell and buyers still highly cautious. For the balance of 2008 much will depend on the Federal Reserve, both in terms of setting monetary policy and providing reassurances that the banking system is sound and credit still available. And lastly, all eyes will be on the occupier market to see if net operating income (NOI) can offset almost certainly rising cap rates. Hopefully the economy will come to the rescue.

Ross Moore  
Director of Market & Economic Research  
Colliers International USA