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When will real estate recover?

WHEN I WROTE THIS COLUMN IN JANUARY, THE U.S. economy still was in a recession, but many observers were predicting a rapid recovery, perhaps beginning in the second quarter of this year. This optimism was based upon (1) recent signs of more economic activity; (2) the belief that the cumulative impact of the Federal Reserve's slashes in interest rates would soon take effect; (3) the sharp rise of stock prices since Sept. 21, 2001; and (4) the impact of increased federal spending in response to the events of Sept. 11, 2001.

But even if the general economy recovers quickly in 2002, how soon will commercial real estate markets emerge from their current overbuilt phase? As readers of this column know, the commercial real estate markets have three phases: the development boom phase, the overbuilt phase and the gradual absorption phase.

Clearly overbuilt

The current overbuilt phase probably began in late 2000. Its main cause was a rapid decline in the demand for existing space, especially office space. This decline is indicated by national rates of office absorption.

In fourth-quarter 2000, downtown office demand increased nationwide by 1 million sq. ft., according to Los Angeles-based CB Richard Ellis. It then fell by 2.5 million sq. ft. in first-quarter 2001, 11 million sq. ft. in the second quarter and 17 million sq. ft. in the third quarter.

Demand shrank much more in downtowns than in the suburbs. That shrinkage also stimulated the flooding of office markets with sublease space. And when corporations sublease, they slash rents.

Moreover, a substantial amount of new space came onto the market in 2001 or is about to do so in 2002. Total office space under construction in 49 major markets rose from about 18 million sq. ft. in third-quarter 2000 to 26 million sq. ft. in second-quarter 2001, and was still at 17 million sq. ft. in the third quarter, according to CB Richard Ellis.

According to Boston-based Torto Wheaton Research, 50 million sq. ft. were added to the national office supply in the first half of 2001, and another 77 million sq. ft. came on line in the second half. That means office vacancy rates are going to rise even more in 2002, perhaps by a lot. As a result, rents, which are already declining, are going to fall even more.

The net result is that most office markets are clearly in the overbuilt phase of the real estate cycle. Based upon data from 49 markets, the overall office vacancy rate increased from 7.7% in third-quarter 2000 to 12% in third-quarter 2001, according to CB Richard Ellis. Vacancy rates rose in 45 of those 49 markets. The overall vacancy rate rose from 6.2% to 10.4% in downtowns during the same time frame, and from 8.6% to 13.0% in the suburbs. Some spectacular increases occurred, such as the jump from 1.9% to 14.2% in the San Francisco area, from 1.1% to 12.1% in the San Jose area, and from 1.9% to 11.6% in the Boston area.

So far, these trends have not pushed office building values down much, mainly because uncertainty has greatly slowed the number of deals actually being consummated, and because property owners are not under pressure to sell at the low prices buyers are offering. But values should fall more in 2002.

Slow recovery

The industrial vacancy rate has risen too, but not by nearly as much. The rate was 7.7% in second-quarter 2000 in 42 major markets, and 9.5% in third-quarter 2001, according to CB Richard Ellis. But new construction declined from 50 million sq. ft. in second-quarter 2001 — the highest since before 1999 — to 22 million sq. ft. in third-quarter 2001.

The situation in hotel markets is worse because demand has shrunk even more there than in the office sector. There has been a slow recovery of hotel occupancy levels from their nadir late last fall. However, I do not believe travel will fully recover to the levels that existed during the 1990s boom for at least several years.

These statistics indicate that most markets for the types of property highlighted above are going to remain in their overbuilt phase throughout 2002 and probably well into 2003. That is likely even if the general economy starts expanding again in the last half of 2002. It will take a while for recovering businesses to start demanding more space, and additional time for that demand to become strong enough to turn rents upward.

Sometime in 2003, the overbuilt phase will give way to the gradual absorption phase. In that phase, demands for space are rising but have not yet driven vacancies low enough, or rents high enough, to stimulate new building. If the recovery then continues strongly, the gradual absorption phase should soon lead into the next development boom phase. But I do not anticipate that happy day occurring until 2004 or even later.

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