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REAL ESTATE EQUITY  
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US Real Estate Fundamentals: The Silver Lining?

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Overview:

While there has rightfully been much discussion lately about the scarcity of debt capital and its impact, we would like to set that aside for a moment and focus here on another critical, but presently overlooked and possibly misunderstood aspect of real estate: fundamentals. Fundamentals, or the supply and demand for physical space, drive rental rates, occupancy, and income, and are at least as important in determining real estate prices as cap rates, though they may get less air time.

Watching financial markets cascade down globally, it is hard to focus on much other than the pending recession. Slowing economies will mean slowing commercial real estate fundamentals. But how far fundamentals fall will, to a great extent, depend on where they start. In that respect, there is cause for cautious optimism. Commercial real estate fundamentals in the US are generally quite healthy. In most markets, for most property types, supply and demand are in equilibrium. While there are exceptions, they go both ways. Real estate markets are in the strongest position we could hope for given that we are likely to experience a drop in demand due to a weakening economy. Good fundamentals at the outset put us in a good position to weather the storm. They don't guarantee that we won't suffer damage; we expect an economic downturn to reduce tenant demand, perhaps significantly. Whatever comes, the solid starting position means that income will be more resilient and will recover faster than if we were not in equilibrium now.

This is particularly good news to investors who may wind up holding assets longer than they expected given the slowdown in the exit markets. As we've discussed elsewhere, as long as you have husbanded your capital well, an important advantage of real estate is that if you don't like today's price, you can wait to sell until you do like the price. This is true because you can earn an attractive income stream (NCREIF income average over 30 years is 7.5%, unleveraged) while you are waiting, so it's helpful to know income is as healthy as it can be, all things considered.

Fundamental misinformation:

We think this ray of sunshine is worth mentioning for two reasons. One is to give hope to those perched on high window ledges (we hope there are not too many of you). Two is to counter some of the misinformation that is circling. Presumably because bad news sells papers, lately the business press has taken to making dramatic declarations such as 'space is emptying out' without much consideration of actual facts. There is also some confusion between the single-family

housing market, which is grossly oversupplied at present, and commercial real estate, which is at a very different, much tighter place in the cycle. Finally, while fundamentals are good, they are not what some investors hoped they would be. Peak pricing assumed peak rental growth, and that is not likely to come to pass in the current environment.

Consider San Francisco as an example of this last point. San Francisco Class “A” office vacancies are now 8%, which is less than half of what they were four years ago. Rents were up 21% in ‘07 and 6% in ‘08 – a nice pop. Robust as they are, those rents are not hitting the underwriting that justified recent top pricing (we’ve heard of 10%+ rental growth assumptions for each of the next few years). As one of our local managers pointed out, 83% of the Class “A” stock in San Francisco traded hands in the past four years; while they didn’t all overpay, that still leaves a lot of folks out there who are complaining about ‘lousy’ fundamentals.

### Some numbers:

So where exactly do we stand? Let’s take office as an example since it represents the largest slice of our portfolio and the investment universe value (industrial and apartment actually have better stories that we’d be happy to address offline). According to Cushman & Wakefield (“C&W”), Central Business District (“CBD”) office vacancies were 10.6% at the end of the third quarter versus 10.2% at the end of the prior quarter. They are ticking up; there is “negative absorption”. Not surprisingly, C&W attributes most of this in the last quarter to increased sublease space in markets with a high concentration of financial tenants. Anecdotally, another big contributor is slower decision making. We have heard across the country that tenants are putting off decisions in the hope of lower rates and are more conservative or uncertain about their growth needs. In general, leases are taking much longer to get done, but there is a good deal of activity, which is an important indicator of market health.

So what does 10.6% vacancy mean? First, the markets are still quite tight in practical terms. This is evidenced by the fact that rents remain strong. CBD asking rents per C&W averaged \$49.15 in the third quarter, essentially flat to the prior quarter and well up from a year ago. Rents in most cities have risen dramatically in the past couple of years, still on the rebound from the trough in ‘03 after the dot com correction. Second, current vacancies are quite tight in historic terms. The trough of the last major real estate cycle in the early ‘90’s saw vacancies more than twice the present level. That was a downturn caused by commercial real estate overbuilding. In this cycle, commercial real estate is not the villain; we are simply suffering collateral damage. At present, one of the worst hit markets is Orange County. Unusual for this cycle, the market was overbuilt, which unfortunately coincided with a major retrenchment in tenant demand due to many failing residential mortgage lenders and homebuilding companies. Our sources tell us present vacancy there is 20%; in the early 90’s it was 30%.

It is also true that average vacancies mean nothing since real estate is fundamentally a local market. Before we go down that road, let’s note that the average is fairly well balanced at this point. C&W reports that 19 of the 30 CBDs in their index report that vacancies are up, and 11 report declines while most markets have flat or rising rents. While we do expect dampening demand to impact vacancies in more places and more severely than we’ve seen thus far, many markets are still seeing a lot of leasing getting done, albeit at a slower pace.

Specific market differences will emerge and increase. We can't do our job of portfolio construction, nor can our managers select properties, without carefully considering them. The challenges in predicting both supply and demand, as well as the typically divergent performance of local markets, highlight the importance of a diversified portfolio. In general, cities with a concentration of financial market tenants – New York, Charlotte, Minneapolis, et al. – will see bigger drops in demand earlier due to the nature of this economic cycle. Energy cities – Houston, Denver – remain quite strong, and thus far Tech and BioTech – Seattle and the Bay Area – demand has been unaffected and remains solid. More diversified economies, such as Los Angeles or Atlanta, will also weather the storm better, as will the deeper, more liquid markets in the biggest cities. Also, back to our main point on fundamentals, the cities with the tightest supply will be in the best position. While New York will be hard hit on the demand side, midtown vacancies got down to 2%, and there is little land left to build out. Given its importance as a leading global financial center, it will recover nicely in due course. On the west coast, West Los Angeles is out of space, and demand—which continues virtually unabated—is overflowing to surrounding areas.

Another interesting number is the new supply in the pipeline, which is virtually nil. Given the strong fundamentals we've described, most markets have been ready for new supply but they will continue to go unfulfilled. Construction financing is simply not available. It has not been for most of the year, so new construction projects are not being undertaken. The uncertainties regarding tenant demand further postpone the arrival of new supply. It takes roughly two years to build a new office tower. The fact that the pipeline is turned off has very positive implications for rental rates when demand does recover.

#### Final thoughts:

Fundamentals matter and they are strong now. Owners and buyers are in a more resilient position to get through what may come with the economy. Commercial real estate is in a better position for recovery when the economy turns the corner, as it ultimately will, however painful the recession may be. There is not a cure-all, but there is a silver lining.