



Measuring up

Commercial real estate comparable to early '90s



During this global economic downturn, Brad von Gillern has been getting some pretty heavy questions from his crews at Lueder Construction Company in Omaha.

“Am I going to have a job?”

Though some of the 65 or so employees are delaying retirement and the company’s competition with other general contractors is heightened, von Gillern answers that question with certainty: “Yes.”

Lueder Construction, a full-service contractor that does concrete work, carpentry, masonry, steel erection and more in the commercial market, isn’t laying off employees.

“We’ve had more work under contract now than we ever had,” says von Gillern.

Such activity in the commercial sector may seem surprising in light of the residential market’s state, but he says the majority of the projects his firm does, which include schools, medical facilities and churches, is doing better than retail—a sector of commercial real estate seeing high vacancy rates from overbuilding a few years ago when financing terms were looser and overall economic conditions were stronger.

“Everybody’s worried,” von Gillern says, but he thinks the commercial real estate sector

will ultimately fare better than the residential real estate market, which was the first domino to fall in the current global financial crisis.

During the summer of 2007 when the market for securities backed by subprime mortgages collapsed, uncertainty and fear resulted in illiquidity for any asset linked to subprime mortgages. Over time, the liquidity problems spread to other financial markets and severely affected some banks and securities firms. In real estate, home values have dwindled and foreclosure rates have soared. Commercial properties are feeling the effects of the subprime housing lending meltdown, too.

“There is some concern about the U.S. commercial real estate market and the impact it may have on financial markets and institutions,” says Alan Garner, professor of economics at Avila University and former assistant vice



PHOTO BY GETTY IMAGES

IN THE EARLY '90s, looser financing and stronger economic conditions led to overbuilding and high vacancy rates. Current commercial real estate doesn't seem to be overbuilt to the same degree.

president and economist at the Federal Reserve Bank of Kansas City.

This sector has slowed recently, and Garner says many effects are evident, including:

- An increase in the interest rate on commercial mortgage-backed securities compared to the interest rate on the safe haven of U.S. Treasury securities;
- Declining prices for commercial properties;
- Reduced lending from financial institutions;
- A slowdown in commercial construction activity and reduction in related jobs.

“Historically, commercial real estate has been subject to booms and busts,” Garner says. “Looking back may provide clues to how this current situation will play out.”

Not long ago

In his research, Garner compared the

current economic situation to the real estate bust in the early 1990s when the construction boom in the 1980s created a huge oversupply of commercial space and reduced the availability of funds loaned to small and mid-sized businesses.

In some respects, according to Garner, commercial real estate is less worrisome today than it was in the '80s and early '90s. This type of construction is a smaller share of economic activity, and buildings' vacancy rates are lower. But, the economy is still vulnerable to any weakening in this sector, which would add to the problems from the housing and energy sectors.

But on the financial side, Garner says commercial real estate may be more worrisome today. A major difference from the early '90s is the increase of commercial real estate

securitization, which may expose developers and investors to financial disruptions that originate outside the commercial real estate sector. Another significant similarity is that commercial banks currently have a large direct exposure to commercial real estate loans.

In commercial and multifamily real estate, construction booms and busts may reflect employment, market conditions and the like, but some factors that encourage overbuilding may be more specific to real estate. For example, long lag times and high expenses of a project may push a project forward even if there is evidence that market conditions are weakening. Also, real estate lenders may assess a proposed development based on the current or recent performance of the real estate sector rather than a realistic forecast of future prospects.

Garner says large fluctuations in commercial construction are not surprising from a historical perspective. Indeed, activity more than doubled from 1979 to 1985, and multifamily construction permits increased

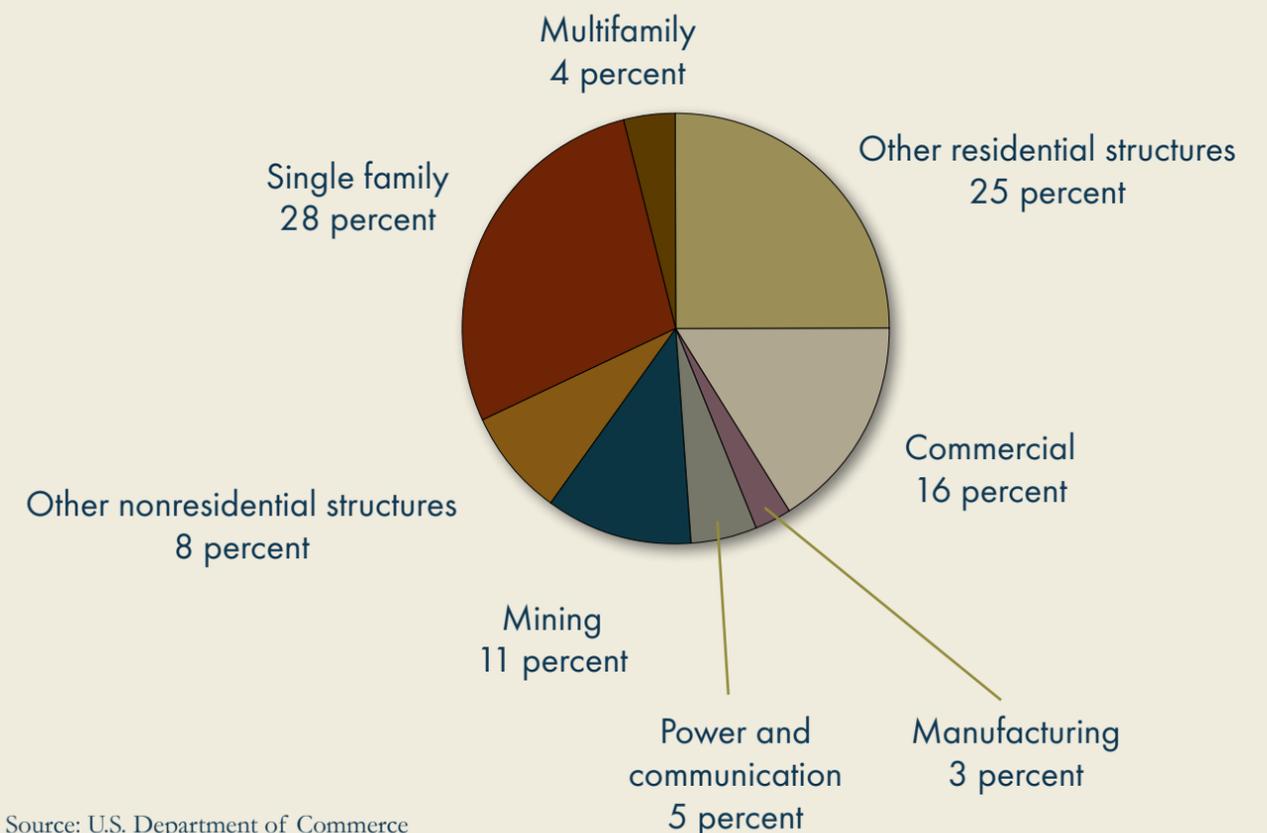
nearly 50 percent during this same time.

This boom was the result of many factors. Demand for office space expanded as a result of economic, structural and demographic changes—employment grew as more women entered the workforce and jobs shifted to services from goods. Changes in federal tax laws gave commercial real estate developers greater profits by lowering personal income and capital gains tax rates. Real estate lending by commercial banks grew strongly during this period because it was expected to be profitable. Savings institutions, such as savings and loans and mutual savings banks, also played an important role in this boom and bust when they were allowed to expand into commercial real estate lending.

“By the late '80s, supply surpassed demand,” Garner says, “and the consequences to the economy were becoming apparent.”

As a result of high vacancy rates and new tax law changes that reduced the after-tax return, commercial and multifamily construction

Components of U.S. private construction in 2007



Source: U.S. Department of Commerce



PHOTO BY GARY BARBER

LUEDER CONSTRUCTION CREWS IN OMAHA keep busy during the economic slow-down. The company president attributes this to the type of commercial projects they do, such as this church, which have fared better than retail projects.

slowed, but the reduction was too late to stem rising vacancies, which had climbed to nearly 19 percent nationwide by 1992.

“With such an excess of commercial and multifamily space, rent and property prices dropped and many real estate developers and lenders were hit hard with huge losses,” Garner says. “The decline in commercial real estate construction helped cause the recession in the early 1990s. And, overbuilding and the resulting losses by real estate lenders contributed to a sharp increase in failures of financial institutions.”

Current commercial real estate

“It’s difficult to predict whether the commercial real estate boom-bust of the late ’80s will be repeated today because the future supply and demand for commercial space is uncertain,” Garner says. “But there is some evidence that suggests the commercial and multifamily markets may not face excess supplies as large as in the early ’90s.”

Demand during the next few years is difficult to predict, and as of now, it’s definitely down at Millard Lumber in Omaha, says the company’s CEO Rick Russell, much of which he attributes to consumers’ confidence. Millard Lumber offers products and services for both residential and commercial projects, with most of its business centered on wood frames.

“People watch the news ... it bothers them,” Russell says. “The fundamentals are there, but the psychology isn’t.”

He can name a handful of already-financed projects that have been postponed due to nervousness. Many hope costs will drop—an attitude Russell calls “a terrible mistake” when prices, for lumber specifically, are at their lowest in years.

“Day-to-day, we’re trying to remain positive,” says Russell, who’s been in the business since the ’70s. “There’s so much uncertainty out there.”

Vacancies in existing structures also are a concern, but national office vacancy rates are

lower now than in the years before the 1990-91 recession. The national office vacancy rate was about 13 percent in early ’08, compared with 18 percent in 1989. At 9.4 percent in ’07, the industrial vacancy rate for warehouses and other light industrial structures was about the same as in 1989, though this sector was not as overbuilt to the same degree as office buildings.

Kevin Nunnink, chairman of Integra Realty Resources, which is a nationwide real estate valuation and consulting firm, has seen a dramatic slowdown in retail leasing, which he attributes to low consumer spending affecting the retail sector. Nunnink is also a member of the board of directors of the Kansas City Fed.

A major difference between the earlier real estate cycle and the present one is the level

the prices of commercial property appear to be weakening after a period of sharp appreciation in the last few years.

On the positive side, while the exposure of commercial banks and savings institutions to commercial and multifamily real estate loans is somewhat higher than in the 1980s, real estate lenders may have maintained higher lending standards than in the past.

Whether the commercial real estate sector will suffer as much as the residential real estate market, “the jury’s still out,” Nunnink says. “I believe that if the capital markets loosen up, the impact to commercial real estate will be softer.”

Back at Lueder Construction in Omaha, only one of the company’s pre-construction projects—a fitness center—has been put on

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of real estate securitization, Garner says. For commercial real estate, it grew from less than 2 percent in 1990 to more than 26 percent by the end of 2007. For multifamily mortgages, securitization grew from 11 percent to 31 percent during the same time period.

Securitization has both benefits and costs, Garner says. While it can stabilize real estate markets by evening out the flow of capital to the commercial real estate sector, providing more effective market discipline of developers, and spreading commercial property risk to a broader array of investors, securitization also can make the market vulnerable to financial shocks that had little effect on commercial property in the past.

Garner says another worrisome trend is that commercial and multifamily developers currently are relying more on debt to finance their projects than in the late 1980s. Commercial and multifamily mortgages were 24 percent of nominal output in ’07, up nearly 4 percentage points from 1988. In addition,

hold. Financing for new projects is available, although under tighter terms. Lueder is working to offset third-party risk from subcontractors it uses. And the company president is optimistic.

“We’ve seen it before,” von Gillern says, “and we’ve survived it before.”

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BY BRYE STEEVES, SENIOR WRITER

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“IS COMMERCIAL REAL ESTATE RELIVING THE 1980S AND EARLY 1990S?”

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