

Real Estate in a Business Cycle Recovery

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Real estate recovered from its cycle in the 1990s. Office buildings slowly filled their empty floors, hotels boomed, and the multifamily market consigned the ugliness of the 1980s to the past. Warehouse properties had a mild downturn, but they tend to be more responsive to the business cycle so were not as affected as other property types. Warehouse vacancies rose in 1990, peaked in 1991, and returned to single digits as the economy recovered from the 1991 recession. Retail properties suffered more at the hands of their tenants' relentless cycle of format innovation and chain expansion and cannibalization of existing locations. But what does a well-balanced real estate market do as it endures a business cycle recession and enters a recovery phase in the economy at large? How does each property type react? Which property types will benefit first, and which will be last? How can we know *when* the recovery is beginning to affect real estate positively? Those questions are the focus of this research piece.

Was This Time Really Different?

Real estate professionals took pains to point out to all who would listen that "this time it's different." They were referring to the real estate cycle and the fact that supply shocks like those seen in the late 1980s would not occur. New information sources, the concerns of institutional investors, public market attention, and

regulatory oversight of the banking system all combined to bring some measure of discipline to the supply side. And the real estate professionals were right. This time was different. This time there was a demand shock.

A supply shock occurs when too many suppliers enter the market at the same time in the belief that they will find demand to meet their product at its completion. This time, the bubble was fueled by venture capital investments in *companies* rather than buildings. The demand shock consisted of venture capital funding start-ups that hired people at a rate far beyond any level justified by their revenue. The shock was fueled by telecommunications firms bulk-ing up to take dominant positions in a market that could support only a few large-scale winners. Internet-related start-ups hired employees and leased space at a tremendous pace, leading to a *leasing panic* that induced firms to lease space well in advance of need just to be sure of having it. Then there was the Y2K phenomenon, which persuaded corporate executives to focus on their technology infrastructure in a way that they never had before. Frantic spending on the Y2K bug meant that people took the opportunity to go through their systems and modernize them at the same time they were dealing with the bug. Large enterprises sprang up to deal with those needs, but few considered the outlook for 2001, after the party was over. And business service firms of all types grew rapidly alongside their clients, leading to a generalized overleasing by office-using firms.

Finally, the bubble was deflating at a rate that was rapidly accelerated by the terrorist attacks of September 11, 2001. Faced with hugely increased uncertainty and fear of more attacks, some firms responded with layoffs as a defensive measure and others, such as airlines and hotels, laid off thousands in the hope of surviving the aftermath of the terrorist attacks.

Real estate suppliers did a good job of rationally meeting the demand caused by the bubble. Unfortunately, when the bubble burst the demand went away with the jobs. So we have to ask the question, When

will the demand come back? Another way to phrase it is, Who will recover first?

Let's look at each property type. Remember that the bubble affected nearly everyone in some way. Some people were hired to work in growing industries, some were focused on playing the stock market as tech stocks pulled the whole market up, and some were merely forced into paying higher rents as others competed for available space.

Multifamily Property

Multifamily property is currently the most sought-after real estate in the institutional community. Multifamily is assumed to have the best defensive characteristics in a downturn of all property types. Figure 1 shows the relationship between the rate of absorption of newly completed rental units and the rate of job growth. Although existing units tend to retain their occupants during a downturn, new construction delivered in a recession has tougher going. Figure 1 shows that when the quarterly rate of job growth fell below the median rate for the period from mid-1990 to mid-year 2001, the share of new units absorbed within 90 days fell below its median for the same period. Job creation fills apartments. As of early May 2002, there were signs that the U.S. economy is beginning to add jobs again at a modest pace. Given that the U.S. apartment occupancy estimate stands at 94 percent, the apartment market is expected to be the first to firm up.

Pricing in the apartment sector has raised concern of late due to the sector's popularity with investors. Although anecdotal data abounds, the most consistent series representing institutional investor expectations is the PricewaterhouseCoopers/Korpacz survey. That survey shows that apartment cap-rate expectations have not changed in the past five quarters by more than 2 basis points (8.56 percent in first quarter 2002 versus 8.58 percent in first quarter 20021). Clearly, substantial amounts of capital are directed toward the multifamily market, but the data suggest that investors are not creating a pricing bubble but are buying based on the economics of the property type. If the market is about 94 percent occupied and cannot achieve much more than 98 percent occupancy, the marginal revenue growth that can be expected is somewhere between 2 percent and 3 percent. This potential short-term gain is not likely to send buyers into a bidding frenzy. Potential rent growth will also influence pricing. Current pricing suggests an expectation of 3 percent annual growth, not

Figure 1: Absorption of New Units versus Employment Change

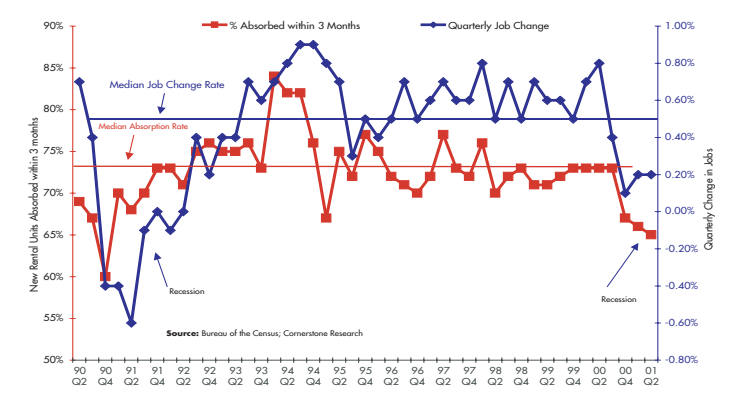
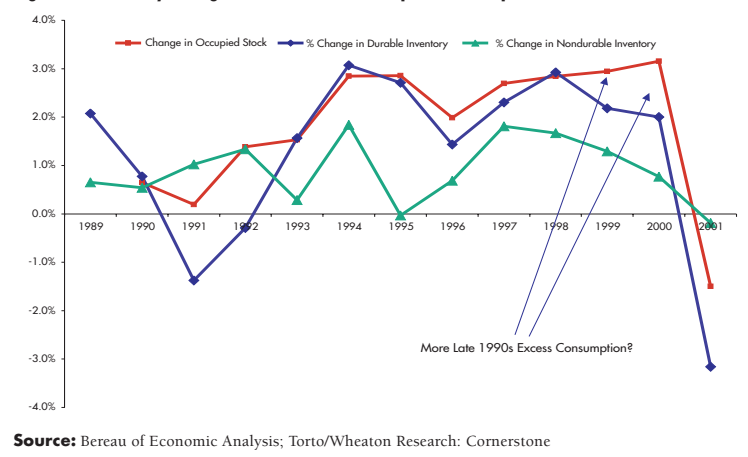


Figure 2: Inventory Changes versus Warehouse Space Consumption

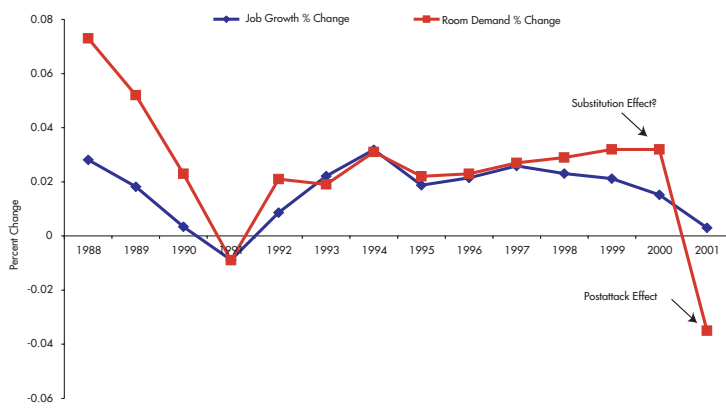


much different than at any other time. Thus, there likely will not be a price correction in the multifamily sector.

Warehouse

The current recession is clearly marked as a manufacturing downturn. Midwestern and southern manufacturing regions have been hit harder than all other markets except the tech markets. Tech markets are specialized types of manufacturing economies. Consumption of capital goods fell precipitously in 2001. The relationship between warehouse demand and the production of physical goods is a fairly close and synchronous one. Figure 2 shows the rate of change in occupied warehouse stock versus the rate of change in inventories. The relationship between the change in durable-goods inventories and warehouse usage is extremely close, and the change in nondurable-goods inventories is also close to the warehouse series. However, during 1999 and 2000, firms continued to take up warehouse space and inventory growth was slow-

Figure 3: Job Growth versus Room Demand



Source: BLS; Smith Travel Research; Cornerstone

ing dramatically. During the period 1992 through 2000, sales of durable goods averaged a 6.5 percent increase each year. In 2001, there was no growth in sales of durable goods. Sales of nondurable goods spiked in 1999 and 2000, well above trend. But they grew more slowly than expected in 2001. The result was excess take-up of warehouse space because of unmet expectations of demand for goods. U.S. manufacturers spent 2001 focusing on reducing their inventories by laying off production workers and slowly emptying their warehouses. As a result, warehouse vacancies have risen from 7 percent to nearly 10 percent in less than two years.

Warehouse occupancies will not recover as quickly as some may believe because of another trend in the U.S. economy, a falling inventory-to-sales ratio. The ratio of inventories to sales fell by 12 percent between 1992 and early 2000, rising only as goods began to back up from slackening demand. Inventory practices are expected to go back to trend as the economy recovers. Despite media focus on “just in case” instead of “just in time,” firms will not likely be willing to tie up capital in idle inventory to a meaningful degree.

When will the warehouse sector be robust? When inventory needs rise sufficiently to absorb 4 percent to 5 percent of the stock, driving occupancies above the 90 percent mark. One of the unusual features of this sector is that the physical product has changed dramatically over the past two decades, growing taller and encompassing ever-larger footprints. As a result, costs per square foot fell on a real basis throughout most of the past ten years. More dramatic, however, was the decline in costs per cubic foot, given taller clear heights, advances in racking and retrieval systems, and the larger building mass. As a consequence,

when the supply-demand equation is in balance, building new buildings rather than renting existing buildings can be more efficient. Thus, the warehouse sector can be expected to recover occupancy between now and 2004, as the recovery fills warehouses with inventory at a 2 percent to 3 percent growth rate.

However, significant rent growth is not expected after that event because of the structural changes in the product discussed above. As the warehouse continues to evolve as a key factor in the supply chain, building new structures will generally be more efficient once the market is in equilibrium.

Warehouse property is another current favorite of institutional investors, evidenced by favorable attention in the business press and new fund offerings. The Korpacz survey data, however, show a slight increase of 17 basis points in industrial cap rates over the past five quarters. If the sector recovers as forecasted, a return to earlier cap rates would provide a modest value increase, but it would not be sufficient to compensate for the carry over the next two years.

Hotel

Hotels and all travel-related businesses were the hardest hit by the events of September 11. Hotel demand was declining before the events of September 11, however. As firms began to feel the oncoming slowdown in early 2001, travel budgets were the first opportunity for belt-tightening. Leisure travelers also cut back, as talk of a recession loomed larger in their thinking. The third leg of the hotel business—meetings—took an early hit, as sales-incentive meetings vanished along with the decline in final sales. Final sales in the U.S. economy had grown at more than 5 percent from 1992 through 2000, but that rate fell to 2 percent in 2001. Final sales of durable goods had no growth in 2001.

Sales-incentive meetings are cancelled in the face of flat or declining sales. Training meetings are cancelled when hiring freezes are in effect. Individual firms cut back or prohibit attendance at industry or association meetings when things are slow. The hotel business was in a typical business cycle slowdown in 2001 when the terrorist attacks occurred. Post-September 11 travel came to a complete halt for several weeks and was very slow to resume.

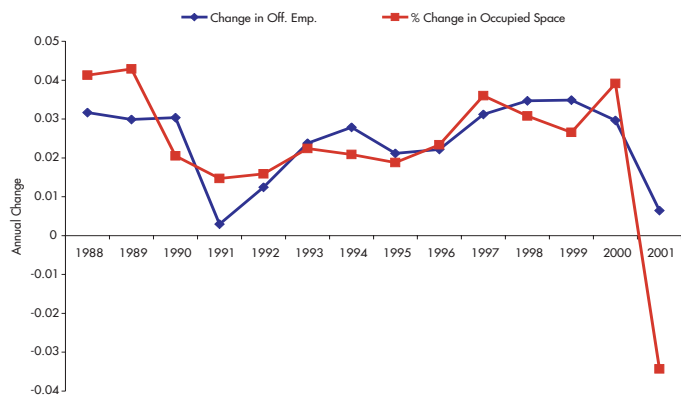
Now that air carriers are beginning to come back to full capacity and leisure and transient business travelers are back on the road, the hotel sector lacks recovery only in the meetings business to come full circle. Figure 3 shows an interesting anomaly, however. Economic growth evidenced by job growth is a

linear driver of hotel room demand. But during the late 1990s, they began to diverge. A declining job growth rate was met with an increasing room demand growth rate. Some would explain this as an affluence effect. People increased their leisure travel to reflect rising incomes and the stock market gains they had enjoyed for a decade. That may be true, but there may have been another factor at work. During the latter part of the expansion, the labor force was more than fully employed, and hiring was difficult. Probably, there was what economists call a “substitution effect.” Unable to hire additional staff, firms had to increase their travel to accomplish everything they had to do. (For example, unable to hire a person for the San Francisco office, a New York manager spent more time on the road.) If this is true, this effect will not likely continue in a recovery simply because the pressure is off the labor force and additional hires will be available when needed. Therefore, the likely path of hotel demand—like demand in most sectors of the economy—is to recover to a level of business on trend with 1999 rather than the bubble year of 2000. As of late March, hotels had come back to within 2 to 5 points of occupancy compared to the same period in 2001.

With U.S. hotel occupancy currently at 59.5 percent and upper upscale occupancy at 64.6 percent, the forecast growth in the economy should lead to occupancy growth of 2 percent to 3 percent per year for the next two years in all segments. At the upper end, occupancy is recovering faster than rate, so the upper upscale Marriotts, Hiltons, Sheratons, and the like will fully recover in another year. Occupancy level in upper upscale hotels is approximately 5 percentage points down from 1999’s occupancy level and about 7 percent on rate. The wild card in the equation is the return of the meetings business that upper upscale hotels depend on for up to a third or more of their demand, since a large portion of the meetings business involves training, sales incentives, and association business. Although there are signs that the meetings business is picking up, the economy will have to be at full strength before the business is fully recovered.

The hotel sector is the only area in which pricing expectations have made a dramatic shift. The Korpacz survey suggests that over the past five quarters investors have raised their going-in yield expectations by slightly more than 100 basis points. Hotels are the only sector in which fundamentals are improving at a rate sufficient to make discounted purchases attractive. Here, as in other property types, however, there

Figure 4: Office Employment Change versus Office Space Consumption



Source: Torto/Wheaton Research; Cornerstone

are few motivated sellers, a condition that might change quickly for owners nearing financial distress.

Office

The office sector saw the biggest bubble in 2000, especially in tech markets that saw leasing panics and space rents bid up to staggering levels. Office consumption was decoupled from job growth and actual space needs. During 2000, tenants absorbed approximately twice as much space as was actually needed. Working off this excess will take another year or more. Modest job growth will return in 2002 and strengthen in 2003. In order to put the office market back on a path to meaningful rent growth, occupancies need to rise to the 90 percent level. As seen in Figure 4, office occupancy generally increased in line with office employment growth between 1988 and 1998. In 1999, employment grew faster than occupancy, giving rise to extremely tight markets and the leasing panic that occurred in 2000. In 2001, as the tech bust played out and tenants gave back space or offered it for sublease, occupancy shrank by 3.4 percent, sending markets into double digit and mid-teen vacancies for the first time in five years. How long will it take to get back to those single-digit vacancies?

Labor force growth and the secular trend to office employment suggest occupancy growth between 1.25 percent and 2 percent in each of the next several years. The supply pipeline has enough potential product to deliver twice that much space over the next two years. Projects not out of the ground now are expected to be abandoned or postponed for some time, moderating that potential. Given current vacancy rates upward of 14 percent, the office market should begin to come into equilibrium in late 2003 and early 2004, with occupancies rising to 90 percent

Unlike pricing in multifamily and retail, suburban office pricing shows the effect of the recession a bit more clearly. Over the past five quarters, the Korpacz survey suggests that investors have raised their cap-rate expectations by about 50 basis points. But the persistent feature of the institutional property market today is a wide bid-ask spread and the likelihood that owners won't sell if the gap can't be closed. Given the availability of low-cost mortgage debt, the fact that owners will not sell at higher yield rates unless forced to by financial distress makes sense. If that behavior persists, there will be no meaningful short-term gains to be made in suburban office.

Retail

Retail properties behave differently as a function of the credit of their tenants. Regional malls and power centers are a collection of national and regional players in the tenant rosters, and neighborhood grocery-anchored centers rely on the credit of food and drug chains while feeling the effects of the business cycle through their in-line noncredit tenants. Fortunately, consumers have held up during the recession, and retail sales have not been off as much as expected. Growth in sales has been focused on warehouse clubs, discount stores, and drug chains. Apparel, footwear, and department stores have consistently trailed year-ago performance for many months. On a national level, there are no meaningful changes in the retail sector's condition, except for the large amount of space the K-Mart bankruptcy will give back to the market. At best, given the weak sales numbers for apparel, footwear, and department stores, there does not seem to be any potential for meaningful rent growth.

Neighborhood retail is another currently favored investment area. The Korpacz data suggest that there has actually been a slight increase (17 basis points) in cap rates since the first quarter of 2001. Again, there is little evidence of a pricing bubble in this product type.

Summary

The economy is in an early business cycle recovery. That means rising sales and inventory levels, a return to job growth, and increased consumer confidence. Those factors will affect real estate sectors differently. Apartments at 94 percent current occupancy will benefit first, as job growth leads to household formation and new-unit absorption. Business travel and leisure travel will continue to recover, and the return of the meetings business over the next year or so will bring the lodging sector back to health. Warehouse demand will begin to recover quickly, but the historic high levels of vacancy will take up to two years to dissipate. If inventories come back to a 5 percent to 6 percent annual growth rate, it will happen sooner, but that is not likely. Office tenants have a substantial amount of excess space in their leased premises as a result of excess consumption and layoffs during 2001. Three or four quarters are needed to work this space off, and another year is needed to bring the markets back to something like equilibrium in 2004. Retail properties have held up because of a strong consumer demand during the slowdown but, as a result, don't have a strong recovery to look forward to.

Figure 5 shows the forecast for the recovery periods in four of the property types discussed above and at which point each should be in supply-demand equilibrium with appropriate rent growth expectations. Retail is not included because of the factors discussed above. The shaded areas represent the time span during which occupancies will recover to a level sufficient to generate real rent growth.

In the capital markets, there is a persistently wide bid-ask spread in property sectors that are temporarily weakened, such as suburban office and hotels. Market segments whose fundamentals have only softened, such as multifamily and warehouse, do not show any meaningful price concessions, and investor expectations appear to be on par with their historical levels.

With the exception of hotels, widespread discounting of assets with subsequent short-term capital gains for savvy buyers will probably not occur. The market appears to be cognizant of the difference between a supply shock and a demand shock and is patiently waiting for the business cycle to continue in its normal pattern. ■

Figure 5

