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Expanding economy equals good news for real estate industry with some caution

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The renewed job growth from our expanding economy has been an important driver to improved real estate property values, rents and transaction levels. Earlier this year US labor markets finally surpassed the "pre-recession" peak of February 2001. The US economy has created more than 3 million jobs since May 2003 when employment bottomed out. Most recent data indicates the rate of growth may have slowed, but it is still very much positive. In fact, the slower pace is actually beneficial as it will encourage the Fed to rethink its efforts to raise interest rates. What is especially comforting with the current recovery is that our industry has generally not rushed out to over-supply this fledgling expansion. Could this possibly mean the real estate industry has actually matured and no longer susceptible to booms and busts? Stay tuned.

One sector experiencing the most improvement has been the office market. Here many landlords have responded to the new dynamics in job growth as much of the new employments have been in companies with fewer than 50 employees. Office owners have reacted by offering multi-tenant floors in buildings previously reserved for large block corporate tenants. As a result, many money managers, boutique law firms and other smaller service companies are able to enjoy prestigious addresses heretofore unavailable to them. Landlords have responded enthusiastically as their risk to very large users has diminished. With large tenants, landlords have to worry about rent concessions, the ever-present risk of losing a large block of space to a competitor building or corporate consolidations. Conversely, after the initial trauma in lease-up to smaller tenants, the landlord's risk in the above areas is significantly reduced. Lenders who have historically favored large "credit" tenants are also warming up to multi-tenant office buildings. Perhaps due to favorable experience with apartments, these lenders now appreciate the value of having diversified revenue sources.

Another sector enjoying the rebound is the hotel industry. Many observers expect hospitality to finally approach its peak occupancy and revenue levels of 2000. Much of the occupancy growth will be driven from 1) an absence of new supply and 2) by a surge in lost hotel rooms that are being converted to condominiums. Through the 1st Quarter of this year, Smith Travel reported RevPar was up almost 8%. More importantly, this growth was mostly from higher room rates verses higher occupancy. This indicates operators are finally enjoying greater pricing power. Clearly the expanding economy is driving more travel.

Condo fever, while mostly limited to Chicago and the coasts, remains a concern for the industry. While most experts do not foresee a wholesale meltdown as some "bubble bursting", prognosticators profess, there are several localized trouble spots. Unfortunately, a major adjustment in any condo market could disrupt the multi family markets as cap rates suffer. This could reburverate across sectors especially in a rising interest rate environment.

The capital markets continue their love affair with real estate. The level of commercial/multifamily mortgage debt outstanding continued to grew again in the first quarter, according to Mortgage Bankers Association (MBA) analysis of Federal Reserve Board Flow of Funds data. At the end of the first quarter 2005, $2.35 trillion in commercial/multifamily mortgage debt outstanding was recorded by the Federal Reserve, an increase of $55 billion or 2.4 percent from the end of 2004. Multifamily mortgage debt outstanding stood at $607 billion at the end of the first quarter - an increase of $7.5 billion or 1.3 percent from the end of 2004.

In the first quarter, commercial banks saw the largest increase in dollar terms in their holdings of commercial/multifamily mortgage debt - an increase of $28 billion, or 3 percent, which represents 51 percent of the total $55 billion increase. CMBS issuers increased their holdings of commercial/multifamily mortgages by $21 billion, or 5 percent - representing 38 percent of the net increase in commercial/multifamily mortgage debt outstanding.

Real estate collateralized debt obligations, introduced only a few short years ago, have jumped in issuance. Observes expect CDO's to exceeds the entire 2004 volume of $8.3 billion by mid 2005. These CDO's are typically secured by mezz debt and lower tranche CMBS. The dramatic growth of this sector demonstrates the overall liquidity in the real estate capital markets.

In summary, the mid-2005 report is cautiously positive. The improving economy is helping several real estate sectors emerge from a series of very weak years. With continued abundant capital flow, and the absence of some traumatic event, the real estate industry should enjoy several strong quarters.

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