

The Effect of the Housing Market on Commercial Markets

We all know that real estate is a market of markets. What happens in one city might be completely different than what happens in another. However, certain basic dynamics, such as credit and general economic conditions, impact everywhere. The extent to which they impact some cities compared to others depends on each community's specific economic circumstances. Thus, when we ask how the disarray in single family housing will affect commercial properties, the answer is that it depends.

The Impact Will Vary by Area

While the impact will vary, overall it will be negative. It will also be exacerbated by the fact that the U.S. is either in, or near, a recession. Given the current dynamics of the economy, GDP growth and job creation over the next six months to a year will be mediocre at best. However, some cities will be negatively impacted more than others. Those commercial markets that already have relatively high vacancy rates, a significant amount of construction in the pipeline, and a significant over supply of housing, will be hurt the most.

The four states that had the most significant housing bubbles in real estate, (California, Arizona, Florida and Nevada), will be negatively impacted because the job creation in those markets will be weak, as will population inflows. Weak or declining employment means lower or negative absorption for office and industrial space. This will be especially true in suburban office markets.

Furthermore, slower population inflows and significant declines in single family building activity mean significant declines in retail absorption. In the markets where this is accompanied by vacancy rates that are already above normal, the outlook becomes downright bleak in the near- to intermediate- term. On the other end of the spectrum, those cities and states that are doing relatively well, mainly because of resource related economic activity, and have only moderate vacancy rates, should survive with far less pain. However, they will not escape the overall downward economic trends plaguing the country.

The Impact Will Vary by Product

Retail Markets: The old adage of retail chasing rooftops is correct. Retail chases income in a community and if there is sufficient income, retailers will show up. However, if there are fewer rooftops you will see a retrenchment on the part of retailers until they are sure the demographics are there to justify the building. We are now moving in that direction.

Office: Vacancy rates in office in many markets have been increasing. This is partly because there was a lot of previous construction when commercial real estate was much stronger. Substantial lead-time in construction of office space now that is presently under construction will be coming on stream during a national recession and early stages of recovery. Thus, we are facing a situation where absorptions are going to slow and

vacancy rates are going to be higher. This suggests that in many markets there will be downward pressure on rents.

Industrial: A lot of industrial space, especially small industrial space, is used by construction related businesses that will be contracting. In addition, it is just a matter of time until wholesalers and retailers need less warehouse space. On top of that, vacancy rates are trending up in this market as well.

Multiple Industries Will be Impacted

Since commercial markets live and die by factors such as employment and population growth, we are in a period where retail, office, and industrial markets are likely to become overbuilt in many areas. Some markets will return to equilibrium before others. In these markets, a return to normal conditions could take as little as a year or two. In other markets where the imbalances between supply and demand are more out of line, it could take three to four years to return to normal.

The aforementioned impact can actually be quantified. For example, according to Implan multipliers for the Greater Phoenix area, for each 1,000 fewer homes that are built, 4,000 fewer jobs will be needed in the economy. This includes direct, indirect, and induced employment. Thus, in this market where single family permits fell from 63,000 at the peak to under 20,000 in the current year, significant job declines will be expected across many industries.

For some perspective into the extent of these impacts, consider the following. According to Implan, the bulk of the job losses (56%) will be in construction; not only the workers in the field but also persons in the home office. However, another 10% of the lost jobs will be in trade; 5% in finance, insurance and real estate; and almost 20% in services. Also affected are manufacturing and transportation industries. Thus, these declines will affect absorption in office and industrial as well as retail and, if these declines are not offset by growth in other areas, absorption will be negative.

On top of that, most markets have a fairly sizeable inventory of commercial properties under construction at a time when the absorption outlook is less than sanguine. High vacancy rates combined with weak absorption is the formula for declining rents, regardless of construction costs. This will add additional problems to the market.

Lack of Capital

Furthermore, one only has to look at the current credit crunch to see that less money is being circulated for purposes of making business loans. Debt coverage ratios will be more difficult when pro forma's show rents are declining (or certainly not increasing), and higher vacancy rates are more prevalent. Down payment requirements are likely to be higher at a time when less money is available to loan.

Remember, the same overbuilding and credit crunch conditions affected the housing market as well. These financial factors have created an environment where individuals are having a hard time selling their homes and moving to other parts of the country. In

areas where population inflows have been negligible, the impact is not as pronounced. However, for fast growing states, population flows are likely to slow in the next year or two. This will be even more pronounced in markets that realized the greatest oversupply of housing. Thus, for the Arizona, Nevada, Florida, California, and the other growing and overbuilt states, population flows will slow compared to historical trends. Thus, this is a cycle that is fueled by many components and will not end anytime soon.

Other Relevant Factors

There are also other factors to consider that will merely exacerbate the problem. Not all of the pending weakness in the commercial markets it is due to the oversupply of housing. Consumers are currently being plagued by low savings rates, high levels of debt, the negative wealth effect of a flat stock market, declining housing prices, and increases in food and oil prices. This puts substantial pressure on consumers' ability to spend. This, in turn, will fuel even more job losses and further weakens commercial real estate conditions.

Despite the listed concerns, one needs to continue to keep in mind that real estate is a market of markets. Therefore, applying the overall generalities of the national real estate market to individual communities is, at best, problematic. But, while one must look at each market on its own, the over all picture is not good. This is not expected to be a bad as 1988 through 1992. However, many markets (especially those with significant housing oversupplies) will find themselves in difficult situations.