REAL ESTATE RECOVERY: FACT OR FICTION?*

by Jane Holmberg Dorrel

**Data included in this article is provided by the in-house data banks at Westmark Realty Advisors in Los Angeles.*

The air is filled with talk of recovery. Optimism is finally returning in the commercial real estate industry. Is it warranted? Have the markets really recovered? What is generally meant by the term "recovery"? And, does this hopefulness apply to all land uses? While not all real estate is fully recovered, it is definitely "in recovery". This article will discuss the office, industrial and retail markets, and what has brought them into recovery. The future market conditions of these product types also are forecast, along with five-year projections of their NCREIF returns.

The Meaning Of Recovery

The term market recovery has many different meanings. The following lists some possible indications that market recovery has occurred:

1. Market vacancy has begun to fall.
2. Market vacancy has fallen to previous lows or to equilibrium.
3. Real rents have begun to increase.
4. Real rents have returned to previous peak levels.
5. Returns have increased significantly.
6. Returns have reached levels that were achieved before the decline.
7. Returns have reached 10 percent or 6 percent real.

All these indicators have merit. For our purposes here, full market recovery is defined as having occurred when market vacancies reach equilibrium and NCREIF returns (by land use) have rebounded to previous healthy levels. Therefore, the term "in recovery" implies that the tide has turned, conditions are improving, but full recovery has not yet been reached.

United States Office Market

Low Construction Is Key To Market Recovery

According to recent data, the national vacancy rate has fallen to 15.9 percent. This has made many in the industry increasingly aware that the United States office market is finally in recovery. The essential ingredient to this market's recovery has been the curtailment of new supply. According to building permits authorized, construction of office space is now near 1964 levels. It is reported that only 5.1 million square feet of office space was completed in the past 12 months. However, there has been a slight increase in the amount of space now under construction relative to one year ago. The 6.9 million square feet now under construction reflects an increase of 13.5 percent over one year ago, but it is

Jane Holmberg Dorrel is a senior research director at Westmark Realty Advisors in Los Angeles. She has been in charge of the company's in-house data banks (MIDAS, BASIS, SABRE) for the past 12 years. Dorrel earned a bachelor's degree in economics from the University of California, Santa Cruz and a master's degree in city and regional planning from Harvard University.

still very low relative to recent history and annual absorption. It is forecast that completions will remain at historic low levels for the next year, with slight increases in activity beginning in 1996.

Absorption Rebound With Economic Recovery
A second critical ingredient to the recovery of the office market has been the steady return of absorption. However, a resurgence in demand alone could not have corrected the office market. It should be remembered that despite very strong absorption in the mid-1980s, the national office market still had an average vacancy rate of 20 percent.

In 1994, over 59 million square feet of office space was absorbed. This is more than double the absorption experienced at the lowest point during the recession. Looking ahead, with continued employment growth in the major office sectors of the economy, national absorption should continue to expand, reaching approximately 75 million square feet in 1995. Over the next five years, the average absorption is forecast to be roughly 62 million square feet per year. In contrast, over the past five years (1990-94), the nation averaged 50 million square feet annually. During the peak period of 1984-88, absorption averaged over 107 million square feet per year.

Vacancy Rates Now At Ten Year Lows
Today, due to the rebound in absorption and very limited new supply, the U.S. office vacancy rate stands at 15.9 percent, down significantly from 20.0 percent three years ago. This is the lowest vacancy rate in over ten years. With new construction still expected to remain at historically low levels, any future demand will result in further declines in vacancy over at least the next two to three years.

It is expected that the U.S. will experience significantly declining vacancy rates over the next five years. If longer-term forecasts of future supply and demand come to pass, vacancies could be in the range of 7.5 to 12.9 percent by year end 1999. The nation has not had vacancies this low since 1983.

Suburbs: Where The Action Is
This past year has confirmed a major shift in a long-standing trend; the downtown office markets now have a higher vacancy rate than the suburban markets (17.0 percent versus 15.2 percent) for the second year in a row. In 1986, the suburban markets had a vacancy rate almost ten points above the downtowns; in the past eight years the gap between the two has steadily narrowed. One reason for this is the increasing share of absorption going to the suburbs. Over the past five years, the suburbs have accounted for over 75 percent of the nation's office absorption, well above their fair share of 58 percent. If recent supply and demand trends continue, the suburban markets will experience significantly declining vacancy rates while the downtowns will stagnate above 14 percent.

NCREIF Returns Projected To Reach 10 Percent By 1996
What will the decline in overall vacancy rates mean to the returns from office investment, as reported for the office component of the NCREIF Index? There is a significant correlation between these office returns and two factors: 1. the national vacancy rate (lagged one year); and 2. the real Gross Domestic Product (two year average). Using this relationship, it is forecast that the total returns for office space will have a sustained recovery, reaching 10.0 percent (nominal) by year end 1996 and 12.0-17.0 percent by year end 1999, depending on construction levels. The average annual NCREIF return is projected to be 10.8 percent for the years 1995 through 1999.

Office Conclusions—Full Recovery By 1999
The recovery of the office market continued to broaden and strengthen over the past year. In response to economic expansion and low construction, the nation has seen a steady increase in office demand, a rapidly declining vacancy rate and stabilizing and/or rising rents in select markets. With a continuation of these trends, the 1995 returns from office investments will reach levels not seen in ten years. The shift from a tenant's market to an owner's market is imminent.

United States Industrial Market

Rebounding Absorption Tightens Market
The national industrial market has gradually recovered from the devastating effects of the 1991-1992 recession, with the vacancy rate now standing at 8.7 percent, down from a peak of 10.5 percent at year end 1991. Historically, the industrial market has had tight market conditions, with vacancies generally in the 7 and 8 percent range. However, in 1991 when the recession wreaked havoc on the demand for industrial space, resulting in absorption of negative 16 million square feet, the vacancy rate soared to a peak of 10.5 percent. Fortunately, with the recovery in the economy, industrial absorption has rebounded from this collapse, averaging over 90 million square feet annually during the past three years.

In 1994, almost 146 million square feet of industrial space was absorbed, a 108 percent increase over 1993. This illustrates that industrial absorption is very sensitive to changes in general economic conditions. It is forecast that absorption of industrial space will moderate slightly in 1995, reaching 142 million square feet. Over the next five years, the average annual absorption is expected to be 127 million square feet. For comparison, during the

peak years of 1985 to 1989, the average absorption was almost 145 million square feet per year.

Construction Of New Space Expected To Increase
Reduced construction has helped drive the industrial market to a more normal vacancy rate. From 1991 to 1993, the volume of building permits in the nation was at 1962 levels. In 1994, the value of industrial permits authorized increased slightly (by almost 18 percent), and it is forecast that in 1995 there will be a significant increase of almost 45 percent. Currently, surveys indicate that 38 million square feet is under construction in 55 cities, up from 11.6 million square feet last year. It is expected that new development will remain at a moderately low level in 1995 but will more than double in 1996 and will increase to almost 125 million square feet in 1997 in response to low vacancies in 1996.

Vacancy Rates To Stabilize Near 7.5 Percent By 1996
In the short run, strong demand and moderate construction will result in a declining vacancy rate. The average vacancy should fall from the current 8.7 percent to 7.7 percent by year end 1995 and 7.3 percent by year end 1996. Healthy market conditions should begin to spur new construction in 1996, causing the vacancy level to stabilize. By year end 1999, the nation could have an average vacancy of 7.4.

NCREIF Returns To Peak At 12 Percent In 1996
The NCREIF Index for warehouse returns began to rebound in 1994 (+9.0 percent), after experiencing three years of dismal returns. Based on the relationship of warehouse returns to GDP and vacancy, it is expected that by year end 1996 the returns for the warehouse component of the NCREIF Index should reach 12.0 percent (nominal). The future returns are projected to average 10.5 percent per year from 1995-1999.

Industrial Conclusions—Market Recovered By 1996
The overall industrial market is the healthiest it's been in five years, and, in terms of recovery, is at least three years ahead of the office market. With absorption rebounding to pre-recession levels and completions near all-time lows, the average vacancy is predicted to continue falling over the next two years. However, these tightening conditions will spur new construction, especially in 1996 and beyond. This will stabilize the vacancy level and perhaps lower the NCREIF returns in 1997.

United States Retail Market

The Market Tightens
The national retail real estate market has clearly recovered from its market low experienced in 1991 (first quarter 1991 to first quarter 1992). In the past three years, real retail sales have increased 12.4 percent, absorption has grown by over 76 percent and the national vacancy rate has fallen from 11.2 percent in early 1992 to 8.7 percent in early 1995.

The retail market had been going through a period of significant change rocked by low retail sales, department store restructurings and bankruptcies, the strengthening of "value" retailers (such as WAL-MART), and the changing demographics and attitudes of the American shopper. Many of these factors will continue to impact the retail market for years to come.

Consumers Are Buying And Driving Demand
Overall demand for retail space is driven by changes in real retail sales. In 1991, during the worst of the recession, real retail sales declined 3.1 percent. This decline significantly eroded the absorption of shopping center space which fell to 38.9 million square feet. Total absorption had not been that low since the last recession in the early 1980s. In 1992, a national pick-up in retail sales helped absorption to rebound slightly. Most of this early rebound was due to increased activity by the "big box" value retailers.

In the past year, with real retail sales increasing 5.6 percent, demand increased to over 70 million square feet (a gain of over 12 percent). This caused the national vacancy rate to fall from 9.5 percent one year ago, to 8.7 percent today. Based on forecast retail sales, the absorption of retail space will continue to rebound in the coming 12 months and then will moderate, averaging 66 million square feet per year over the next five years. This is well above the 41.7 million square feet averaged during the recession, but is below the 82 million averaged during the 1980s expansion.

New Supply Is Being Revived
The overall vacancy rate would continue to decline if absorption were to remain strong while construction stayed at low levels. However, U.S. building permit data indicates that the nation could soon see a significant increase in construction of retail space. It is estimated that in 1995 the value of permits authorized (in real dollars) will increase 15 percent over the 1994 level, which increased 15.6 percent over 1993. This pick-up in permit activity is already reflected in the increased actual square footage under construction. As of early 1995, almost 50 million square feet of space was under construction, up 23 percent from 1994.

Historically, construction of retail space has been very cyclical. After the low number of completions in 1992, there has been a steady increase in the delivery of new space. It is expected that completions will increase further over the next two years and then slow. By 1999, an annual completion level of between 62 to 76 million square feet is projected.

Vacancy Rate Reductions To Continue At Slower Pace
It is estimated that the rebound in demand and the moderate increase in completions will result in either a slowly falling or stabilizing vacancy rate, depending on the level of construction. By the first quarter of 2000, the vacancy level should range between 6.2 and 8.4 percent.

Community/Neighborhood Centers Thrive At Regional Malls' Expense
The retail vacancy rate is significantly different when the data is segmented by center type. Historically, regional malls have had much lower vacancy rates than other centers, due to the constraint on development offered by department stores and mall developers. Today, regional malls have a 6.3 percent vacancy rate compared to 9.3 percent for community/neighborhood/strip centers. Both sectors experienced a 1.1 percentage point decline in vacancy over the past year (down from 7.4 percent and 10.4 percent respectively).

Interestingly, community/neighborhood/strip centers have a lower vacancy today than they had in 1990 (12.5 percent), while the average regional mall vacancy has increased (from 4.3 percent). In the past six years, the gap in vacancy between the two types of centers has steadily narrowed, going from a difference of 8.2 percentage points in 1990 to only 3.0 points in 1994 and 1995. One reason for this is the rapid expansion and absorption by several of the "big box" value retailers which primarily locate in community (power) centers. This expansion not only strengthens the demand for community center space but also weakens marginal regional malls by sapping their retail sales.

These different trends reflect some of the previously mentioned changes affecting the retail market, changes which have strengthened value (discount) retailing. Traditional retailing (i.e., regional malls) has lost a significant amount of market share to value retailing because of the latter's better price and customer convenience. In 1994, retail sales for traditional department stores only increased 4.5 percent (nominal), while discount department stores (WAL-MART, Target, etc.) increased 11.5 percent.

NCREIF Returns Soon To Be Double-Digit
The NCREIF retail returns turned positive again in fourth quarter 1993 after experiencing two negative years. In 1994, retail returns were 5.2 percent for the year. Using the relationship of NCREIF retail returns to the Gross Domestic Product and vacancy, it is predicted that by fourth quarter 1995 the annual return should exceed 12 percent (nominal). This suggests that retail should reach full recovery four years before the office market. Returns could range between 10.7 and 16.3 percent by year end 1999, depending on the level of construction. For the period 1995 to 1999, NCREIF returns are predicted to average 11.0 percent per year.

Retail Conclusions—1995 Recovery
The national retail market, which bottomed in 1991, should fully recover this year. The demand for retail space should remain strong over the next two years, causing the national vacancy rate to either stabilize or continue to fall, depending on construction. The future success of retail investment will become increasingly more dependent on choosing the right type of center and the right anchor tenants.

Conclusions
A recovery in the real estate market is definitely occurring. The office, industrial and retail product types are, however, rebounding at different rates and will reach equilibrium in different years. The trend in the NCREIF Index suggests that the industrial market was the first sector to show a significant rebound in returns, having experienced a positive return of 9 percent in 1994. It is forecasted to peak at 12 percent by 1996. Retail is forecast to have a major jump in returns in the coming year, increasing from 5.2 percent in 1994 to above 12 percent by year end 1995. After 1996, returns for both industrial and retail are projected to moderate with slight dips in 1998. The office market, however, should experience gradual accelerating returns, peaking at 14.6 percent in 1999.