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Despite Sluggish Economy, Commercial Real Estate Demand Steady

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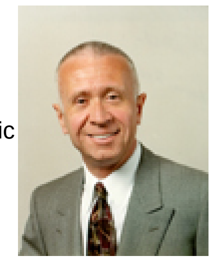

This year should be sluggish for commercial real estate, but fundamentals will remain strong and U.S. economic growth will be enough to keep leasing markets stable, noted forecasts released today by Grubb & Ellis Co. and Jones Lang LaSalle Inc.

With many economists predicting a 50/50 chance of an economic recession, "our outlook is realistic and hopeful that the economy can avoid a recession," Bob Bach (pictured), Grubb & Ellis's senior vice president & chief economist, told *CPN*. "But this is with the caveat that it is possible." Overall, the Grubb & Ellis Co.'s 2008 Global Real Estate Forecast notes that we should expect a decline from 2007's exuberance.

Buyers will return to the investment market in greater numbers this year, as all-cash and low-leverage buyers, including institutions, REITs and foreign investors, step up with purchases, Grubb & Ellis' report said. Jones Lang LaSalle's Capital Markets Research report added that these buyers will continue to be attracted to solid fundamentals, paired by the need to place ambitious real estate allocation targets and the weak U.S. dollar. == However, transaction volume is expected to be up to 25 percent less of 2007's record, noted Grubb & Ellis. Capitalization rates are likely to increase up to 100 basis points, with Class A properties in supply-constrained costal markets at the low end and Class B and C properties in secondary and tertiary markets at the high end.

Jones Lang LaSalle was a bit more somber, noting that total investment value can slide as much as 35 to 40 percent over 2007, omitting entity-level transactions. It expects 2007 year-end U.S. total investment sale transaction volume to close at a projected $375 billion, a 4 percent increase over full-year 2006 volumes. However, the report noted that such decreases would still provide total transaction volumes roughly equal to the five-year 2002 to 2006 annual average.

The subprime mortgage turmoil inserted a lack of confidence in the capital markets that will continue throughout this year, noted Earl Webb, CEO of Jones Lang LaSalle's capital market group. He predicted that more than $50 billion of five-year, full-term, interest-only loans in the market written at very aggressive loan-to-value ratios can turn to defaults at a significant level if the loans cannot be refinanced in 2008, and that there will be a refinancing frenzy of investors searching for equity infusions next year.

Jones Lang LaSalle also noted that the Federal Reserve's continuing interest rate easing cycle should provide some much-needed support to consumer and corporate confidence. However, the Fed's interest rate actions will provide little short-term relief for the credit crunch, as the CMBS and broader asset-backed securities markets need to first absorb current pipelines, which will be an extended process.

The office market is also expected to experience a decline, absorbing approximately half that of 2007's at 36 million square feet, noted the Grubb & Ellis report. The company also expects approximately 55 million square feet of space to be added to existing office inventory, increasing the amount of sublease space and pushing office vacancy up by 20 basis points to 13.2 percent over the course of the year. It forecasts that Class A rental rates will increase 3 percent for CBD space and 2 percent for suburban space this year, and that effective rates will be under pressure as landlords increase concessions to fill their building.

Bach noted that while the biggest downside risk to the office market is a recession, the possibility exists that the current credit crunch will be confined to Wall Street, allowing Main Street to move ahead relatively unscathed. Given these dynamics, the Grubb & Ellis' report noted that the West Coast will be at the top for office investors.

The industrial market is also poised to weather this year's slowing economic conditions, experiencing equilibrium between supply and demand, Grubb & Ellis noted. Increasing supply in the new year will push vacancy modestly higher, especially in the first half of the year, ending at a predicted 7.8 percent by year's end. This figure is an increase of 20 basis points from year-end 2007. Net absorption is expected to be 120 million square feet in 2008, down 14 percent from last year.

However, continuing demand, moderately tight market conditions and new construction charging premium rental rates may push the average asking rental rate for warehouse and distribution space up 2 percent, Grubb & Ellis said. However, fuel costs, infrastructure issues and the overall economy will drive the logistics markets this year.

Retailers may trim expansion plans and critically look at underperforming stores with the weak economy, Bach noted. Space completions will increase slightly to 35 million square feet, and vacancy is expected to change very little. Growth will come from financial institutions, massage and day spa chains, fitness centers and ethnic retailers. Lifestyle and mixed-use centers will remain popular, especially projects built in downtowns and around sports complexes.

And the ongoing downturn in the housing market will continue to be a boon for the rental market this year as more people are forced to rent, Grubb and Ellis' report concluded. Markets and submarkets that have been overbuilt with condos or have experienced high foreclosure levels will see an increase in "shadow supply."

Overall, prices paid per square foot are up more than 70 percent over the last six years, and growth in 2008 values will moderate significantly and be increasingly driven by underlying property fundamentals and cash flows, the Jones Lang LaSalle report added. Fewer active buyers in the market and a constrained supply of higher-leverage, low-cost financing will cause and upward drift in cap rates.