Spot Light

Commercial Real Estate Investment

U.S. Financial Woes Taking a Toll on Texas Industry

As financial markets turned gloomy in August 2007, Dallas Fed business contacts began to note postponed commercial real estate deals, with scattered reports of lenders backing out, especially on larger transactions. Most of the executives expected credit disruptions would be brief and lending and investment would rebound in a short time.

Any hopes for transitory troubles in credit markets were dispelled as conditions worsened in 2008. The nation saw widening interest rate spreads and further reductions of liquidity in the securities market, which through 2007 had financed a growing share of the commercial real estate industry's investment in office, industrial, retail and apartment properties (*Chart 1*).

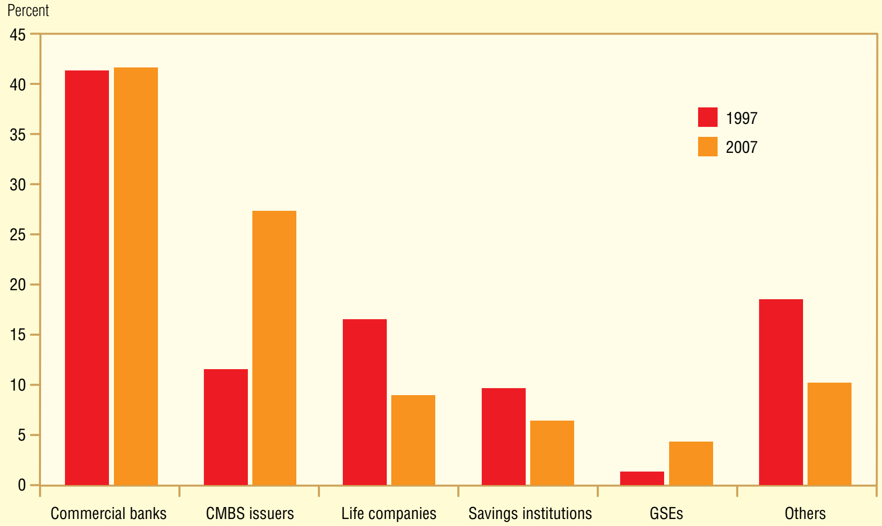
The commercial-mortgage-backed securities (CMBS) debt market has virtually dried up in 2008, creating a difficult situation for real estate investment activity. Global CMBS issuance fell to $28.1 billion through mid-October, compared with $315.4 billion for all of last year. Meanwhile, U.S. CMBS volumes shrank to $12.1 billion from $230.2 billion.[1]

Other lenders took up some of the slack in the first half of 2008, with commercial real estate loan volumes rising 4.7 percent for commercial banks and 3 percent for life insurance companies. More recently, however, banks have become wary of adding real estate to their books, and life insurance companies have approached predetermined annual investment limits.

With credit much more difficult to obtain and investors of all types demanding higher risk premiums, transactions have slowed significantly. Through August, annualized sales of commercial properties in Texas plunged to $14 billion, down from $31.6 billion in 2007.[2]

The recent falloff in the state's investment activity is broad-based across sectors and major metros. Office, retail and industrial property purchases are nearly a third of their 2007 levels, while multifamily sales have declined 38 percent. In San Antonio and Houston, year-to-date investment in commercial real estate is running 58 percent behind last year's pace (*Chart 2*). Austin and Dallas are down 54 percent.

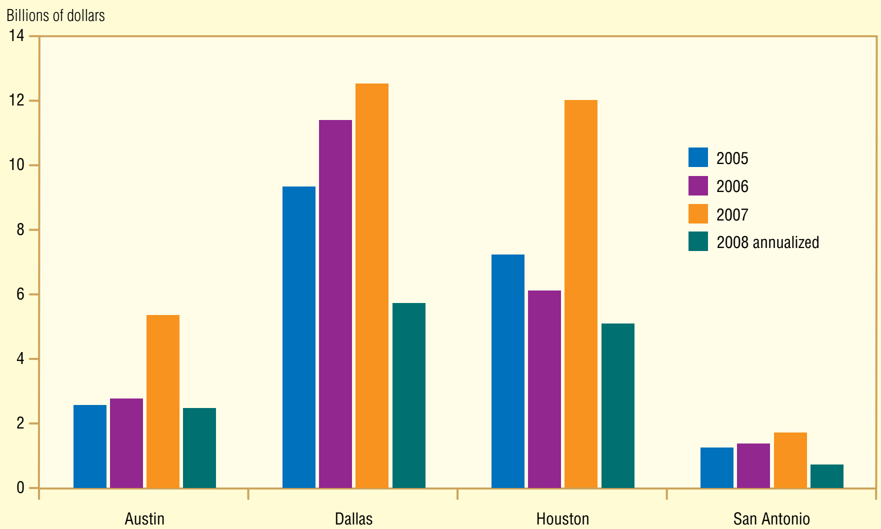
Chart 1
Sources of Commercial Mortgage Funding Shift to Securities Markets



NOTES: CMBS stands for commercial-mortgage-backed securities; GSEs are government-sponsored enterprises. Data include office, industrial, retail and apartment transactions.

SOURCES: Flow of funds data, Federal Reserve Board; Compendium of Statistics, Commercial Mortgage Securities Association.

Chart 2
Commercial Real Estate Investment Plunges in 2008



NOTES: Data include office, industrial, retail and apartment investment. Data for 2008 are through August and have been annualized for comparison purposes.

SOURCE: Real Capital Analytics.

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The Dallas Fed's October Beige Book, an anecdotal report on regional economic trends, found continued strain in commercial real estate. Investors and financial institutions are beginning to reevaluate their real estate holdings. Property values are difficult to determine as buyers grow more cautious and sellers find bids too low.

Even with this year's reversals, markets appear to be in better shape in Texas than in other areas of the country. Real Capital Analytics data suggest Houston and Dallas were still among the best-performing commercial investment markets nationwide through August.

Moreover, the recently released "Emerging Trends in Real Estate" report from the Urban Land Institute and PricewaterhouseCoopers ranked Houston and Dallas–Fort Worth real estate markets in the top 10. Indeed, Dallas Fed business contacts report that values for well-located, quality properties are holding up better in Texas than in the rest of the nation.

The Good Times

The recent slowdown comes after several strong years for commercial real estate in Texas. The state's fast-growing economy helped fuel the boom.

Trade and transportation sector job growth averaged a bit less than 3 percent in 2006 and 2007, spurring demand for industrial space. Service sector jobs grew slightly more than 3 percent, boosting office space absorption. In addition, the state's strong population growth supported demand for retail and apartment space.

Office vacancies in Houston declined from 17.1 percent in 2005 to 11.6 percent in 2007, buoyed by strong job creation in the metro's booming energy sector.[3] Over the same period, industrial vacancy rates in the Dallas–Fort Worth area—the state's trade nexus—fell from 12.5 percent to 10.7 percent as trade and transportation payrolls expanded 2.5 percent.

With strong demand and falling vacancies, office and industrial rents began to climb across the state. Among Texas' major metros, Austin recorded the largest percentage and nominal increases in office rents between 2005 and 2007—29.2 percent, or $5.49 per square foot. Office rates rose 21 percent in Houston, 14.8 percent in Dallas–Fort Worth and 5.3 percent in San Antonio.

Texas added 1 million residents between July 2005 and July 2007, more than doubling the pace of U.S. growth. Multifamily vacancy rates in Austin, Dallas and San Antonio declined from 2005 to 2007, while an influx of new supply led to slightly higher vacancy levels in Houston in 2007.[4] At the same time, rents rose, with Austin outpacing other metros, in part due to its rapid population growth—the fastest in the state.

The retail market saw healthy rent appreciation, spurred by robust growth in retail sales. Between 2005 and 2007, rents rose 11.4 percent in Austin, 6.1 percent in Dallas and 5 percent in Houston.[5]

With rental market fundamentals positive, investors took note. Commercial property sales held up well in 2006, rising 6.2 percent from the prior year, compared with the nation's 7.5 percent increase.[6] The next year, Texas investment activity surged 46 percent as price increases in coastal markets made the state and its healthy markets attractive.

For instance, the state's office properties averaged $132 per square foot in 2007, half the price for comparable investments in California and less than a third of the going rate in New York.[7]

Dallas led the pack in investment, accounting for 40 percent of the state's total. Activity grew 96 percent in Houston and 94 percent in Austin. The surge was largely due to expansion in the two cities' office markets, which saw sales triple from 2006. Increases were more modest in San Antonio at 25 percent.

What Lies Ahead?

The current credit market turmoil is adversely impacting Texas' commercial real estate markets. The buying and selling of commercial properties is likely to remain subdued for some time.

The rental market will be sluggish as well. Beige Book respondents note that leasing activity for office and industrial properties has recently dropped off as businesses reevaluate their plans in light of the uncertain financial and economic environment.

Demand for retail space began to slow in 2008 as the Texas housing market weakened. Apartment leasing benefited from the housing downturn, but tight credit conditions are likely to diminish prospects for purchases and project starts.

At the same time, worries about overbuilding are subsiding as fewer development deals are funded.

A cloud of uncertainty hangs over the real estate investment market. However, the economic drivers that attracted investors to Texas' commercial real estate markets in the past several years remain in place and should benefit the state when the credit situation stabilizes and economic activity rebounds.

—D'Ann Petersen and Laila Assanie

Notes

1 CMBS issuance data are from Commercial Mortgage Alert and the Compendium of Statistics, Commercial Mortgage Securities Association.

2 Texas data are the sum of four cities: Austin, Dallas, Houston and San Antonio.

3 Office and industrial vacancy and rent data are from Torto Wheaton Research, a unit of CB Richard Ellis.

4 Multifamily vacancy and rent data are from M/PF YieldStar and Torto Wheaton Research.

5 Retail rent data are from Torto Wheaton Research.

6 Investment data are from Real Capital Analytics.

7 Property price data are from Real Capital Analytics.