



Boston's Economy Remains Strong in Face of Hesitant Credit Market

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The "credit crunch" that has unfolded since the start of the second half of the year has caused a slowdown in transaction velocity along with an underlying feeling of apprehension about the level at which pricing will eventually settle. While stricter loan standards have decreased the ease and leverage with which buyers can finance, the Boston commercial sales market is healthy, as local rents remain strong and overall capital abundant. Many forecasts predict a 10 percent pricing adjustment but, provided the net operating income for buildings continues to increase, the impact of a cap rate expansion would be muffled. According to Real Capital Analytics, national office and industrial sales totaled more than \$15.9 billion for Aug. 2007, double the amount over the same period a year ago. While that sale volume is not necessarily indicative of the current market sentiment, because many of the deals occurred before the implications of the debt market were realized, it is nonetheless an encouraging sign of the continued strength in the fundamentals of the commercial real estate market.

Despite the healthy appearance of the commercial real estate market, it is difficult to ignore the general sense of unease that has accompanied the recent deceleration in the market for debt capital. Yet, few experts point out the potential benefit more traditional, less aggressive lending practices can have on an industry that has largely discounted risk out of its pricing model. In the housing market, exotic, subprime mortgages saddled homeowners with looming debt obligations beyond their means. The result was defaults and foreclosures that have crippled the mortgage industry and forced lenders to adopt stricter underwriting for their mortgages.

In the commercial sector, however, rating agencies took proactive measures to reassess the risk associated with commercial mortgages before any significant defaults began to occur. Commercial loan defaults remain extremely low, demonstrating that despite the aggressive underwriting, rent appreciation and effective value-add asset management have enabled owners to continually meet their debt obligations. Provided defaults remain low in the near future, recalibrated pricing of current CMBS (commercial mortgage-backed security) offerings will reach equilibrium, releasing the bottleneck on the unsold securitized loans. In turn, this will lead to increased confidence for banks to create and sell more loans, once again releasing the flow of this portion of capital into the sector. Concurrently, more conventional portfolio lending will likely find itself back in demand as buyers look for more ways to finance acquisitions.

Real estate fundamentals, the supply and demand distinctly separate from the financing side of the market, are influenced by local and national economic factors. Boston's local economy remains diversified and strong in the face of a hesitant credit market. Regardless of the degree to which financing affects individual deals from being leveraged at previous levels, persistent national and local economic prosperity will continue to push vacancy down and rents up. The state Department of Labor and Workforce Development reported four consecutive quarters of positive job creation, lowering the unemployment rate to 4.5 percent, below the national average of 4.6 percent and its lowest level since Dec. 2005. Significant gains in employment by professional, scientific and business service sectors are excellent signs for future office space demand. Massachusetts' GDP grew at an annualized rate of 3.6 percent, a further sign that the state economy is weathering the effects of residential housing troubles on the economy.

Such economic success has translated into the need for office space. Class A rents for office property throughout the Greater Boston market increased 6.2 percent over the last quarter and 22.8 percent over the last 12 months, while rents for industrial space have continued their upward trend as well. Vacancy throughout the suburbs has also declined as tenants seek more affordable alternative space. From a supply perspective, additional space for the Boston market will not become available for the next few years until office space in areas like Fort Point and Russia Wharf complete construction. Generally, Boston's geographic constraints along with rising construction and debt costs limit substantial new construction, helping to further insulate the market from a dramatic price correction.

In addition to positive economic factors contributing to the demand for commercial space throughout Greater Boston, it is worth noting that the amount of capital needed to be placed has never been higher. Despite its recent difficulties, the market for CMBS and property derivatives has emerged as a more transparent, efficient form of capital. The number and size of private equity funds, the sector's new source of capital, have also increased markedly over the past two years. According to a survey conducted by Ernst & Young, the average size of funds raised from 2005 to 2007 is up more than 75 percent from the preceding four years. Add to that the increase in the sheer number of funds and it is clear that a new type of buyer has emerged with plenty of market clout. The more leveraged financing employed by private equity investors has enabled them to force cap rates downward and increase sale prices to record levels, which has consequently priced many buyers out of the market. Yet the capital that has been unable to be placed at required return levels remains and is now more likely to be invested, as deals require more equity and covenants in their financing. Many investors have been waiting, with opportunistic capital ready to deploy, for a pullback in pricing and are unlikely to let pricing levels drop far.

All of this is good news independent from the recent disruption in the capital markets. Sellers understand capital is available and a brief period of buyer discretion will not encourage sales of buildings at fire sale prices. Local and national economic strength will continue to be the drivers of rent growth. That, along with creative and effective asset management, will be the key in realizing the returns investors seek. Ultimately, the revised underwriting standards will be accepted and capital markets will continue to expand to unprecedented levels with the help of more sophisticated derivative products. While this happens, the strength of local real estate fundamentals will continue to support institutional sales.

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