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SUDDEN CLARITY

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I am sure you have all heard and read enough news and opinion on the terrorist attack that you certainly don't need some real estate guy trying to pontificate on the subject. But I would like to attempt, however unlikely, to say something intelligent about the future of the commercial real estate markets in the aftermath of this tragedy.

On September 10, 2001, the economic outlook was fraught with questions- the "crystal ball" was foggy, at best. Are we in a recession? Will we be in one soon? Can we avoid recession altogether? Will consumer-spending falter? Has the stock market bottomed? Is the S&P 500 oversold? In real estate, owners/sellers of commercial properties wondered: will decent fundamentals in the real property markets prop up values until the economy has a chance to bounce back? Buyers, on the other hand, asked: would the downturn last long enough to cause distressed property sales? This created quite a gulf between the prices sellers wanted and those buyers were willing to pay, with good arguments supporting both sides. As of September 10, everyone, it seemed, was a bit uncertain and just picked an outlook that felt good.

Shortly after the sun rose on the following day, the fate of the overall economy in the near future suddenly became shockingly clear.

It is now clear that there will be declining GDP in the third and fourth quarter of '01, and possibly first quarter '02. In the days immediately following the 11th, I remember hearing a report that the freeze in consumer spending that occurred on that Tuesday and Wednesday alone may be enough to ensure negative numbers for Q3. Layoffs will continue, exacerbating the slide in consumer confidence and spending. Sometime soon, there will be stock market advances, which is what happens once economic clarity is found, in anticipation of an economic recovery next year. However, most of the experts on that subject believe the indexes have just now reached reasonable value; so much of the progress will be slow as stock prices track real improvements in business profits. Finally, activity on all fronts will be sluggish, because people just aren't excited about business when we're at war.

To turn things around, corporate America must adjust its inventories, expenses, and expectations, protect or return to profit growth, then eventually begin hiring again to restore consumer spending. Many in the media are saying that the length of time it takes to return to a truly healthy growth rate depends entirely upon the progress of Operation Enduring Freedom. But it seems clear to me that this war is more accurately thought of as an ongoing new reality we will need to adjust to, rather than something where we can just hunker-down waiting for resolution and victory. It has been said that the world after September 11, 2001 is a new world, and there's no going back.

It's difficult to predict the long-term effects of this new world on commercial real estate, although I do not see any reason to believe there will be an impact on the fundamental use or value of it. Meanwhile, current conditions readily lend themselves to a vision for the short term. Outlined below are our thoughts on various sectors of the market.

OFFICE

It is now clear that the current high vacancy levels will not go away soon. Companies are contracting, and even when business adjusts to economic conditions it takes a while before hiring and expansion resume, so the demand for office space will be negative for at least a year. There will be downward pressure on rental rates as landlords compete for survival, which will cause pain for some owners, particularly those who underwrote recent acquisitions or new developments at top-of-the-market rental rates. In addition, lenders were getting fairly aggressive with office loans late in the up-cycle, despite all the talk of their "discipline" this time around. So, yes, there will be distressed property sales. And it's a good time to be a tenant. Sooner rather than later, sellers or would-be sellers will have to take a hard look at their prices and realize that no one is "buying on proforma" anymore, that assets will have to trade on in-place value again. In addition, in-place value will erode with the rising vacancy.

INDUSTRIAL

As the office market began its descent this year, many investors flocked to industrial assets as a safe-haven because of the low vacancy rates there at the time. In terms of property values, this statistical stability propped up the segment for a while, but as we have progressed through the year vacancy rates have risen significantly. The heart of the industrial market is manufacturing, and manufacturing has been and will continue to be hurting in this economy. It is now clear that despite the apparent resolution of inventory issues, as long as spending is down, so will be manufacturing. Slow recovery will mean continued downsizing, shutting plants, some bankruptcies, etc, so the facilities market will continue to soften. Further, if manufacturing is the heart, warehousing and distribution are the soul of the industrial market, and slower manufacturing of goods will obviously impact their storage and distribution. There will be pockets of growth around the country due to defense spending, but overall we expect higher vacancy rates in this sector in the next several quarters, which will cause downward pressure on rents and prices. The bright spot? Single tenant, long-term net-leased industrial facilities will see the bulk of demand from investors in the short run, due to their stability and simplicity.

RETAIL

The retail real estate market had been humming along this year, because prior to September 11, you may recall, consumer spending was "single-handedly holding up the economy". As evidenced by the weeks since the attacks, that is no longer the case. Retailers were opening new stores at a dizzying pace for most of the year, and rental rates were hitting levels that would normally cripple local stores ("mom-and-pop's"), but the spending levels supported the trend. Now, suffocating rent and slower spending will force many out of business, and along with national chain cutbacks, rising vacancy will squeeze the retail property market over the next year. There is a safe haven within this sector though- grocery and discount-goods retailers will stay solid through the downturn, and REIT's with charters oriented toward these users are a good bet.

ON A PERSONAL NOTE

At first I was hesitant to write this, since we have had more than our share of negative news lately. Funny thing is, doing it was actually somewhat inspiring because it reminded me that the swings of the US economy are part of our special culture of freedom. The business cycle is a uniquely capitalistic phenomenon, and in adversity is found opportunity. As I see the patriotic response in this country to the terrorist attacks, I am struck by how strong our will is to be Americans, able to seize new opportunities. We all know the economy will recover, and we will be better for it as a country. I am proud to know that our collective vision, focus, and passion to live as free people will pull us out of this slump just as certainly as the sun still rose on September 12.

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