



Commercial Real Estate Quarterly: First Quarter 2009

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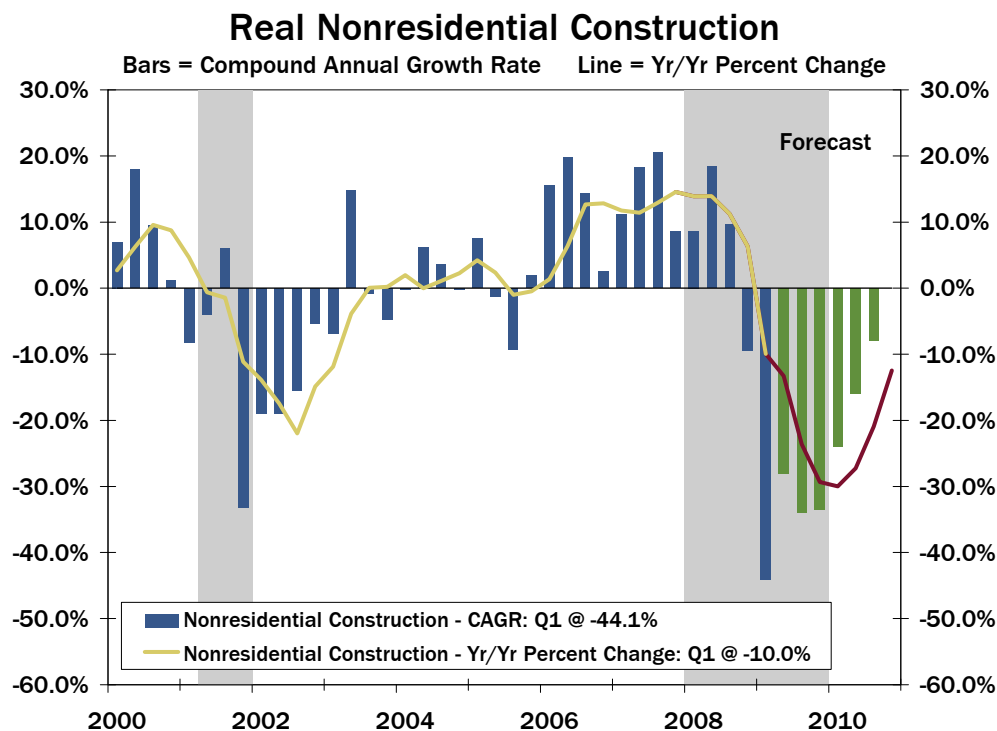
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Real nonresidential construction tumbled at a record 44 percent annual rate during the first quarter, subtracting over two percentage points from real GDP. A large portion of the drop was due to a pullback in oil & gas drilling and exploration. Building activity is also winding down, particularly in office and commercial construction which includes multi-tenant retail space. The economic downturn and tight credit conditions should continue to put downward pressure on nonresidential construction for the next couple of years. Moreover, lower prices for commercial real estate mean that it is much cheaper to buy properties than it is to develop them.

Lower prices for commercial real estate mean that it is much cheaper to buy properties than it is to develop them.

Figure 1



Source: U.S. Department of Commerce and Wachovia

Contents

I. Nonresidential Construction Spending.....	3
II. CRE Mortgages Outstanding.....	4
III. CMBS.....	5
IV. Lending Standards.....	6
V. Fundamentals....	7
VI. Office	8
VII. Industrial	9
VIII. Apartments.....	10
IX. Retail.....	11

The onset of the financial crisis marked the end of the era of cheap and abundant credit for commercial real estate.

Expectations have been steadily reduced for the commercial real estate sector ever since the financial markets seized up in August 2007. Commercial mortgage-backed securities (CMBS) spreads began to widen almost immediately and blew out to record levels after the crisis intensified. The onset of the financial crisis marked the end of the era of cheap and abundant credit for commercial real estate. Years of easy credit and low interest rates had fed a boom, which helped pull commercial property prices sharply higher. With billions of dollars of commercial real estate loans coming due and lenders more interested in preserving capital than putting it at risk, values have come under extreme pressure and construction activity is winding down.

Various measures of commercial property values show prices topping out in the second quarter of 2007 and are currently down a cumulative 25 percent. We expect further price declines over the next 18 months, as sales of distressed properties increase. Shopping centers are particularly vulnerable at this time because many retailers have shut stores and ramped down store openings. The largest drops will continue to be in areas where housing weakened the most, including Florida, California, Arizona, Nevada and Atlanta. Many of these markets had also seen considerable development in recent years and have some of the highest ratios of square feet of retail space per resident.

Office markets are also coming under pressure, particularly in markets with significant exposure to the financial sector.

Office markets are also coming under pressure, particularly in markets with significant exposure to the financial sector. Financial services employers have eliminated 433,000 jobs since the financial crisis began, with some of the largest cuts in New York, Southern California, Chicago, South Florida, Philadelphia and Charlotte. The loss of financial service jobs has helped pull office employment down 6.3 percent over the last 16 months, which has severely curtailed demand for office space in many key markets. Vacancy rates have increased and will almost certainly climb higher as leases expire and are not renewed.

Industrial markets also remain under pressure throughout the country. Inventories have now been declining for the past two years, with the largest declines occurring in building products and discretionary consumer goods. The massive restructuring of the motor vehicle sector will likely put additional strain on industrial markets, particularly in the Midwest.

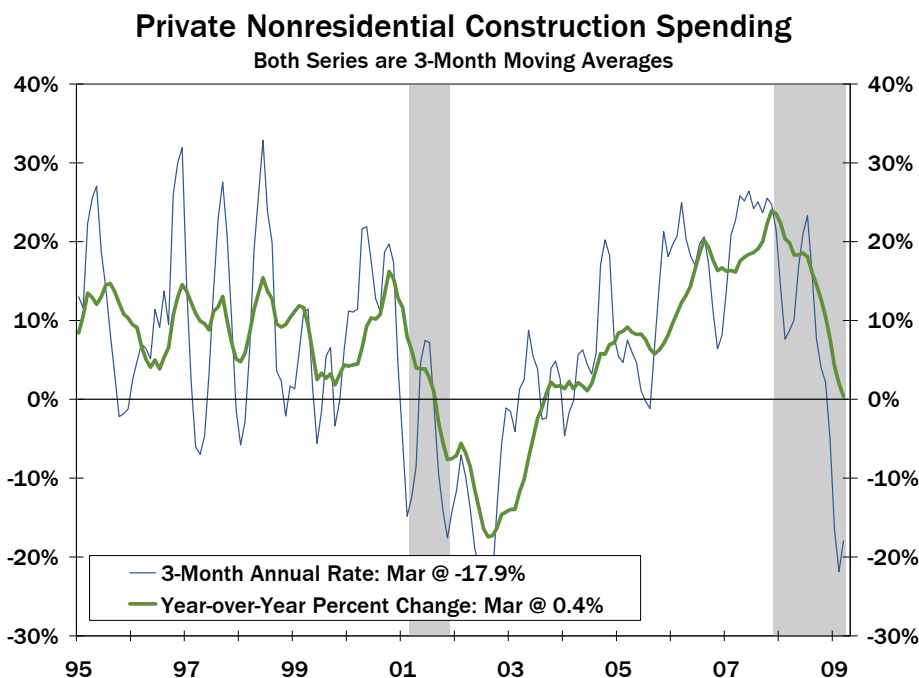
Apartment vacancy rates continue to trend higher. While demand for rental units has risen relative to for-sale housing, there is still a tremendous oversupply of housing in general. Moreover, household formations slow during recession periods and typically do not pick up until about a year after employment starts rising. We do not expect to see a significant improvement in the apartment market until early to mid 2011.

We expect construction outlays to fall 30 percent this year and an additional 10 percent in 2010.

Commercial construction has only recently turned negative but is set to decline substantially over the next 18 months. We expect construction outlays to fall 30 percent this year and an additional 10 percent in 2010. Some of the sharpest declines are now occurring in the energy exploration sector, where a boom in natural gas exploration fueled a surge in the rig count. In addition, several large refinery expansions started a few years ago are now beginning to wind down. The drop in these energy-related projects combined with the pullback in commercial building is why we are projecting such a large pull back in nonresidential construction.

I. Private Nonresidential Construction Spending

Figure 2



Nonresidential Construction Spending Staged for Weakness in Coming Months

Private nonresidential construction spending will likely show weakness in coming months. Sectors such as power, manufacturing, and lodging have remained surprisingly resilient amid the deteriorating economy, but should begin to come off their highs. Power projects are one of the strongest sectors with new gas-fired electric plants, oil refinery expansions, ethanol, and bio-fuel plants leading the way. Sharply lower crude oil prices have quelled demand in this sector and many projects are now being scaled back, extended, or canceled outright. Manufacturing construction spending also has shown considerable strength but contracts are clearly slowing. Upgrades of HVAC systems and co-generation facilities are also bolstering the numbers. The Architectural Billings Index, a leading indicator of commercial building, bounced off its all-time low but remains exceptionally weak. A meaningful recovery is still a long ways off.

Figure 3

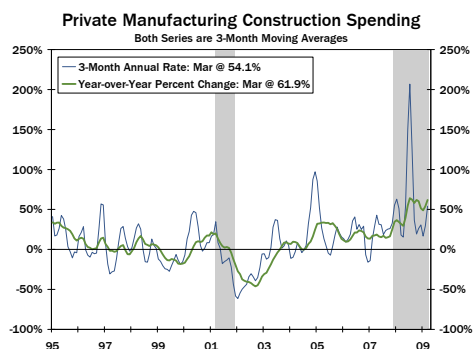
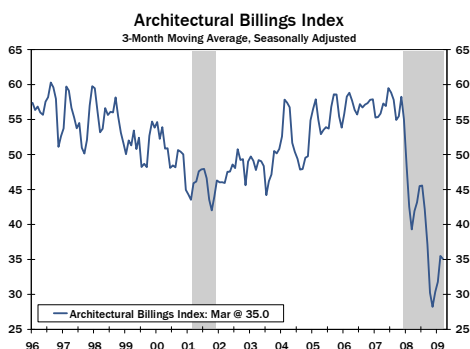


Figure 4

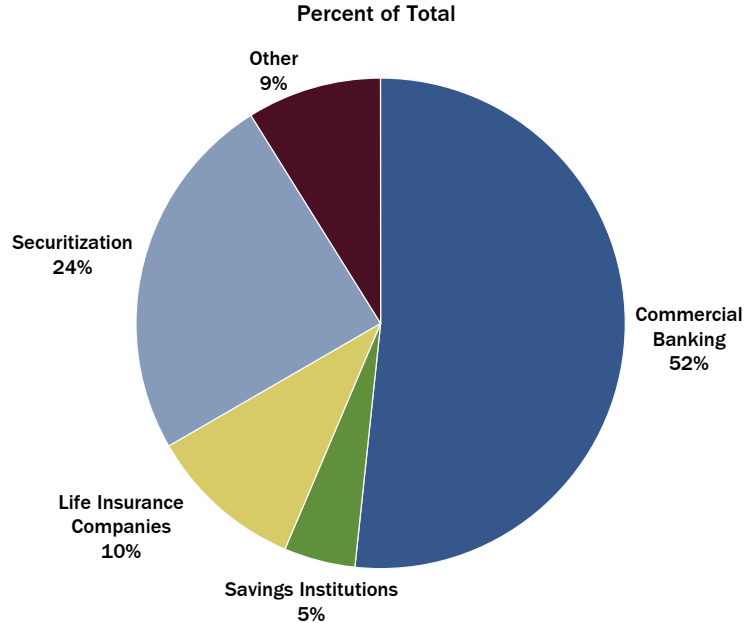


Source: The American Institute of Architects, U.S. Department of Commerce and Wachovia

II. Commercial Mortgages Outstanding

Figure 5

Commercial Mortgages Outstanding - Q4 2008



Commercial Mortgages Outstanding Contracted to Lowest Level in 14 Years

Commercial mortgages outstanding grew roughly four percent in the fourth quarter from a year ago, its slowest pace since 1997. The largest declines were in property casualty insurance, REITs and securitization. The securitization market was the fastest growing sector in commercial mortgage lending for a decade, but has virtually dried up leaving borrowers to seek alternative financing. Life insurance companies were well positioned to capture market share, but perceived risk and annual caps limited gains. A stronger stock market would help alleviate this hurdle. Commercial banks continue to hold the largest share of commercial mortgages. Commercial mortgages to total bank loans remain elevated suggesting banks with heavy concentrations will winnow their portfolios and keep underwriting criteria tight. The commercial real estate delinquency rate is now at its highest level since 1994.

Figure 6

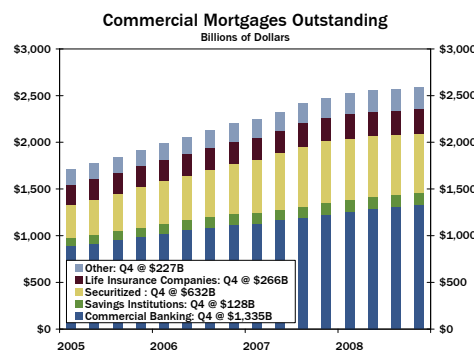
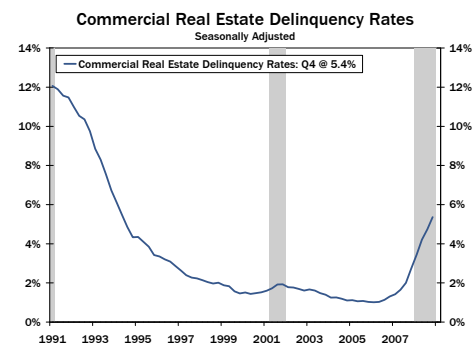


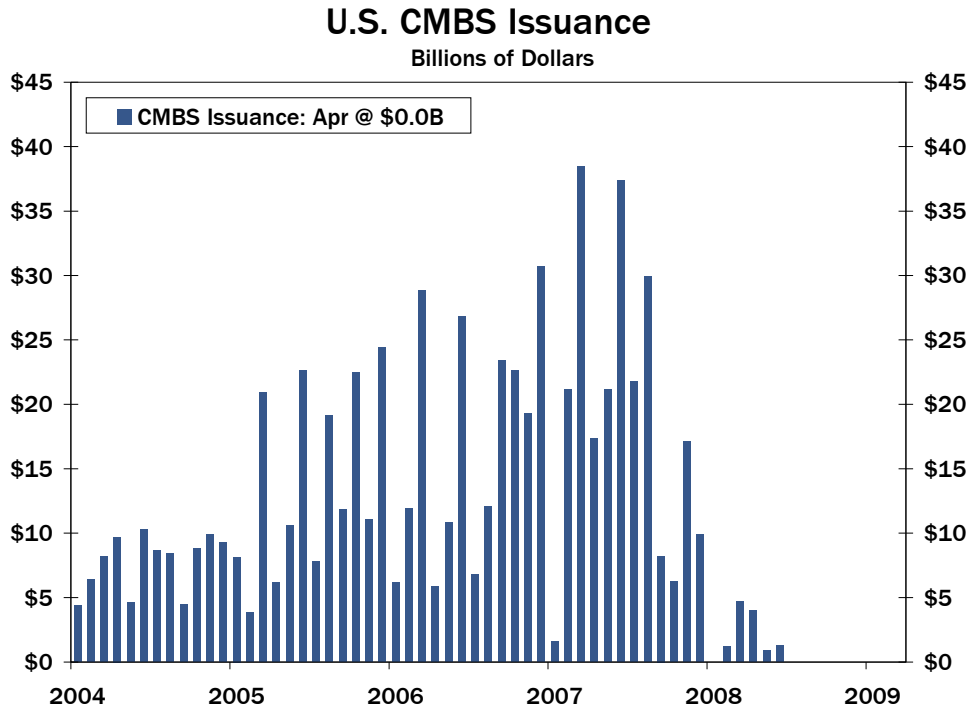
Figure 7



Source: Federal Reserve Board and Wachovia

III. Commercial Mortgage-Backed Securities (CMBS)

Figure 8



CMBS Issuance Remain at a Standstill

CMBS issuance essentially ground to a halt in 2008 with most of the issuance occurring in the first half of the year. CMBS issuance in 2008 was the lowest since 1991 and declined roughly 95 percent from the previous year. CMBS issuance has not resumed, but spreads have come off their peak, although they remain at historically wide levels. CMBS delinquencies and defaults also continue to tick up. The delinquency rate reached a record low in 2007 and has risen gradually. Tight lending standards will continue to squeeze the market as mortgages become due and refinancing remains complex. Numerous loan funds and boutique investment firms are lining up to work out distressed properties and to buy assets out of bank and insurance company portfolios. The sticking point remains at what price, however.

Figure 9

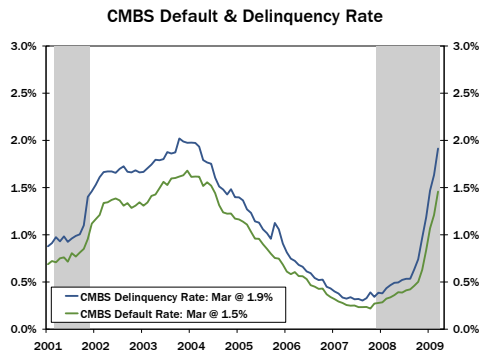
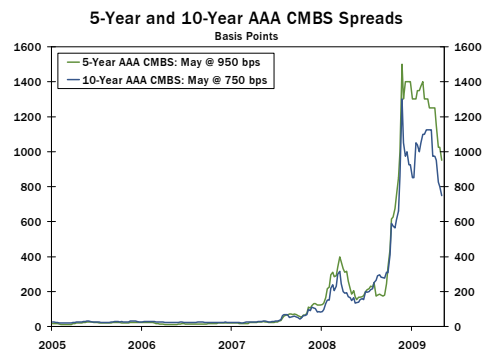


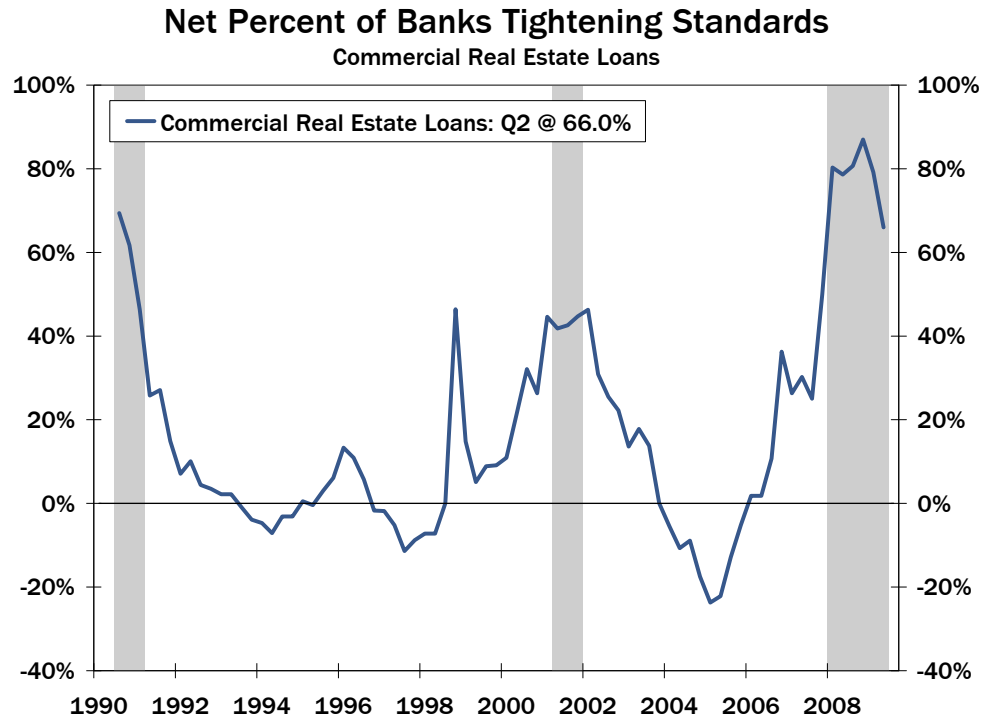
Figure 10



Source: Commercial Mortgage Alert, Wachovia Securities and Wachovia

IV. Commercial Real Estate Lending Standards

Figure 11



Lending Standards Decline, but Remain Tight

Commercial real estate lending standards have come off their record high reached in the fourth quarter, but are now at the highest level since 1990. Banks are trying to preserve capital by committing to fewer projects. Tightening standards are partly responsible for the slowdown in nonresidential construction. Domestic banks are not alone, other traditional providers of commercial real estate credit and securitized lenders are also pulling back and increasing underwriting standards because of the higher cost of capital, credit deterioration and weakening property fundamentals. Banks are essentially requiring stronger guarantees, better collateral, and are taking less risk in general.

Figure 12

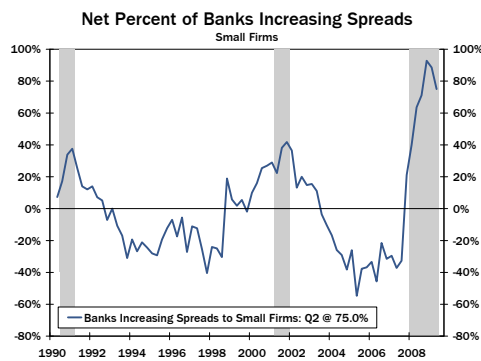
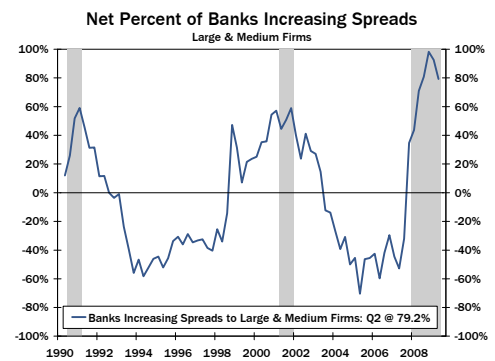


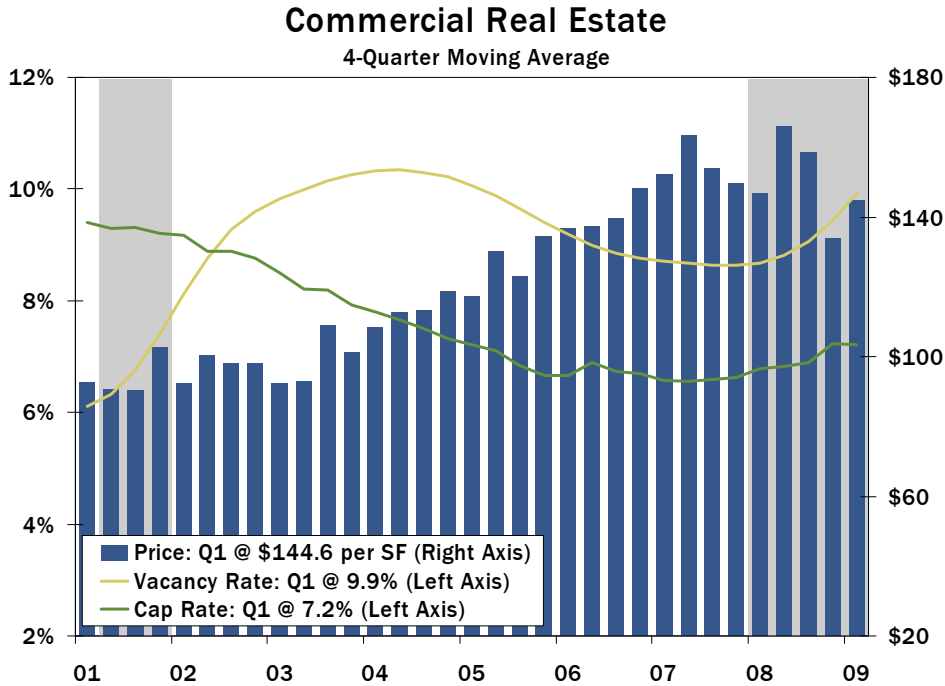
Figure 13



Source: Federal Reserve Board and Wachovia

V. CRE Property Fundamentals

Figure 14



Vacancy Rates Continue to Edge Up

Commercial real estate vacancy rates are at their highest level since 2005. Most of the rise in vacancy rates can be attributed to retail and office, where supply continued to come on line even as demand weakened late last year. Further, the economic downturn and weak labor market will likely put downward pressure on prices in coming months. Problems are most severe in markets where housing has collapsed, which has put added pressure on retailers and led to large cutbacks in supporting industries. Higher borrowing costs will likely lead to a modest increase in cap rates in coming quarters. Moreover, transaction volumes are falling as investors become more risk averse and lending becomes more restrictive. The spike in price per square foot was driven by a couple of transactions which skewed numbers to the upside. However, removing these transactions show the underlying trend remains downward.

Figure 15

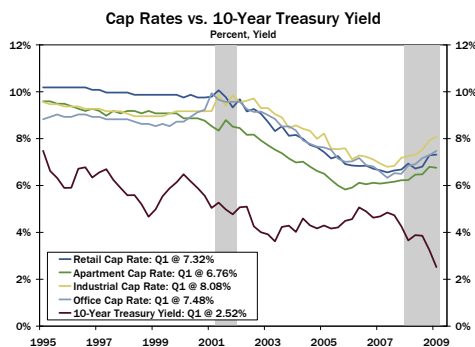
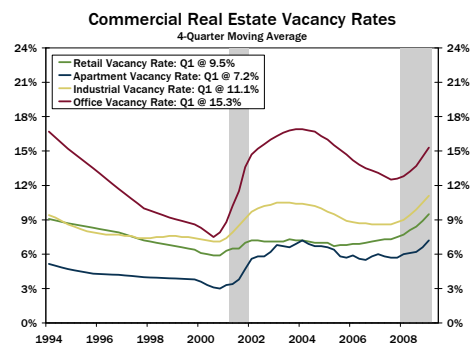


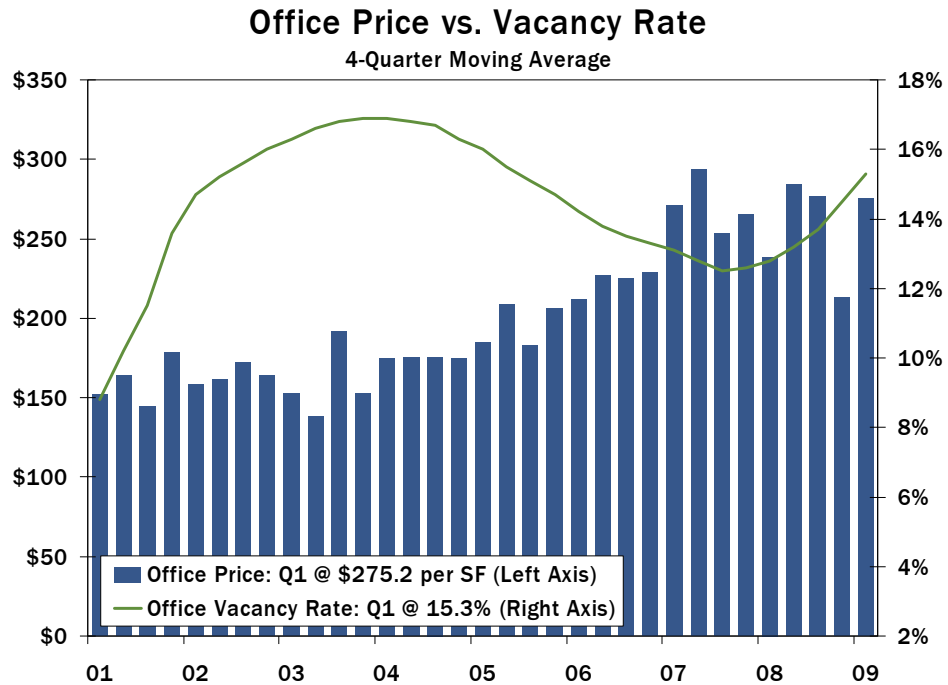
Figure 16



Source: Federal Reserve Board, PPR, Real Capital Analytics, Reis, Inc. and Wachovia

VI. Office

Figure 17



Office Space Demand Slows

Office fundamentals are weakening due to the broader economic slowdown. Net absorption of office space has fallen sharply as businesses have grown more cautious about committing to space. Reduced demand for office space has also put more sublet space on the market. The global financial crisis has led to substantial consolidation in the financial sector and has substantially reduced demand in major financial centers. Office employment is down more in this recession than it has fallen in any previous downturns. While slower economic growth is already priced into most office deals, the negative underlying fundamentals are keeping a lid on transactions. A few transactions in the central business district skewed office price per foot to the upside. Removing these transactions show the underlying trend remains downward.

Figure 18

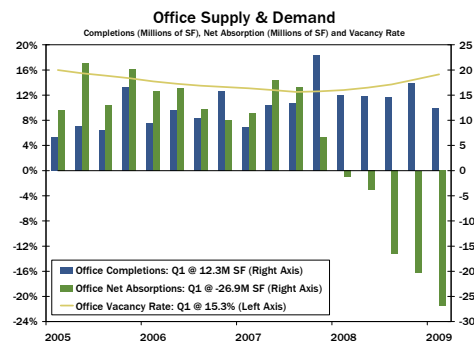
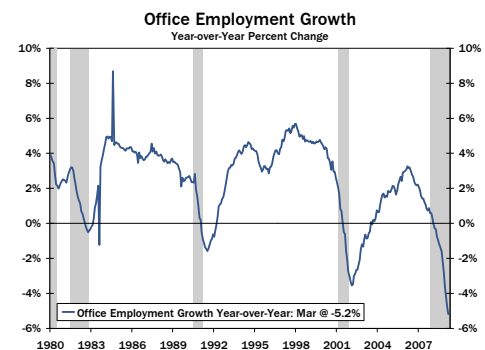


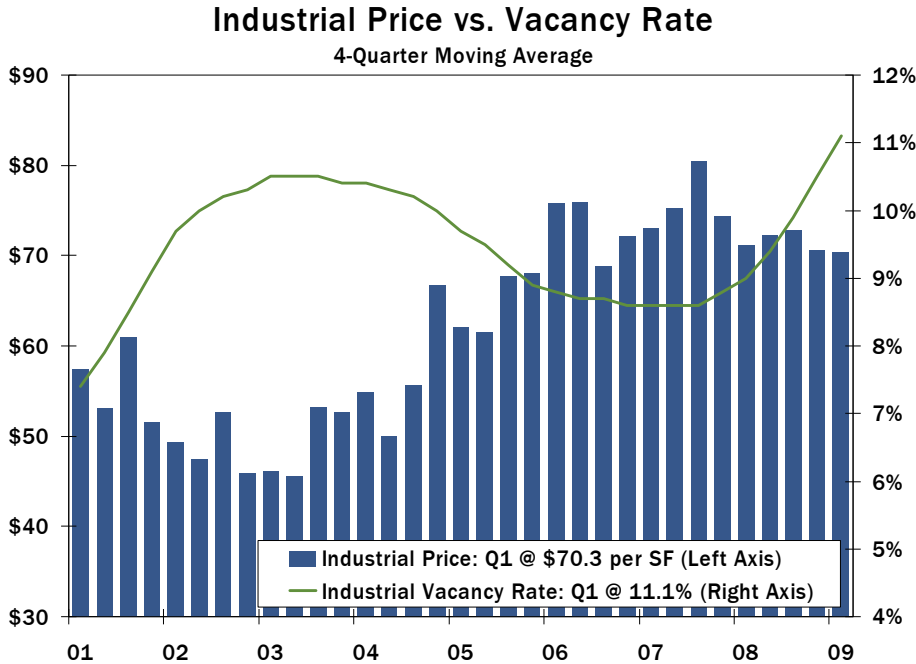
Figure 19



Source: Real Capital Analytics, Reis, Inc., U.S. Department of Labor and Wachovia

VII. Industrial

Figure 20



Industrial Demand Cooling Off

Demand for industrial space has cooled off considerably, particularly for firms in the building products and discretionary consumer goods sectors. In addition, vacancy rates have risen at many of the distribution facilities near major ports, reflecting declining imports. As a region, the Midwest is holding up the best, as are few high priced markets along the West Coast. These areas missed much of this decade's construction boom and are seeing only modest gains in vacancy rates as firms reduce their space needs. Prices for industrial space are declining slightly, although there is a dearth of transactions. Cap and vacancy rates are rising and are likely to climb further. Industrial space remains a popular investment vehicle. Demand is strongest in areas that enable firms to avoid congested highways and shorten delivery times.

Figure 21

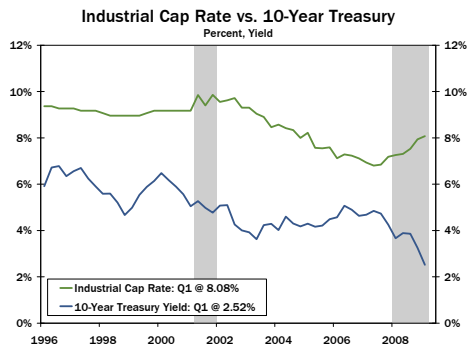
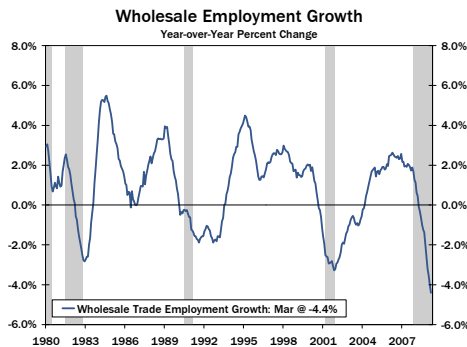


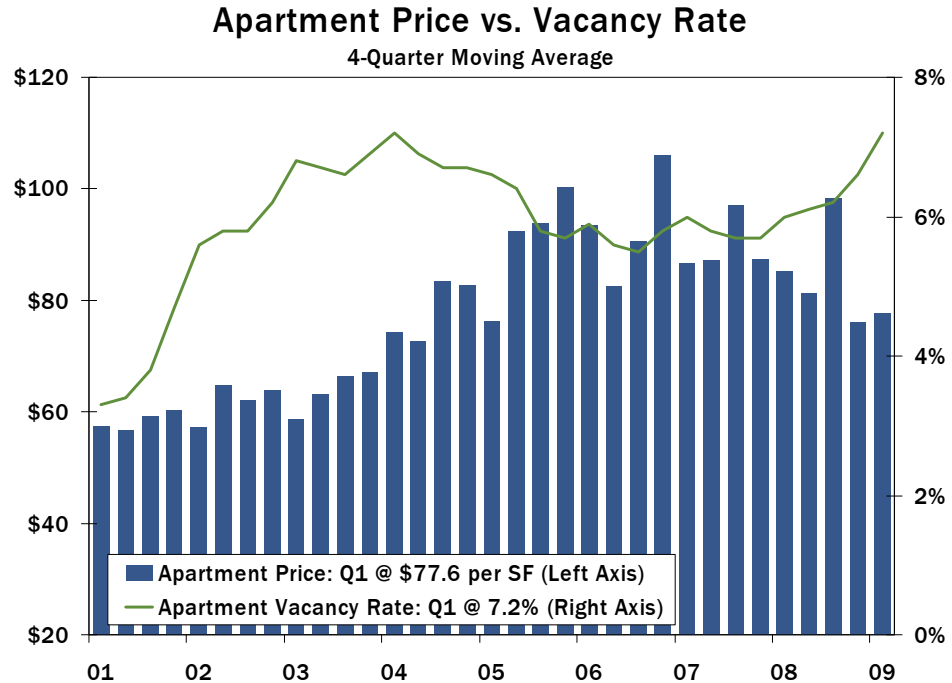
Figure 22



Source: Federal Reserve Board, PPR, Real Capital Analytics, Reis, Inc., U.S. Department of Labor and Wachovia

VIII. Apartments

Figure 23



Shadow Inventories Snag Would-Be Apartment Renters

Apartments were widely expected to benefit from the bust in for-sale housing. While demand for rental units has increased, so has supply. Shadow inventory from the glut of single-family homes and condominiums is now a major component of the rental market and is contributing to the rise in reported vacancy rates. Apartment construction has also increased as many condo developers and single-family homebuilders are converting projects to rental communities. Finally, apartment demand is closely correlated with employment, which has contracted substantially. We do not expect hiring to pick up in a significant way until mid to late 2010. Demand for apartments tends to improve about one year after employment turns up, which means a significant improvement in demand is still likely two years away.

Figure 24

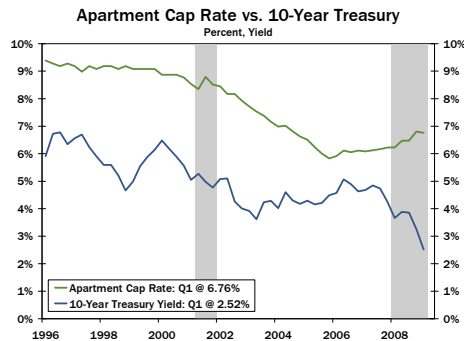
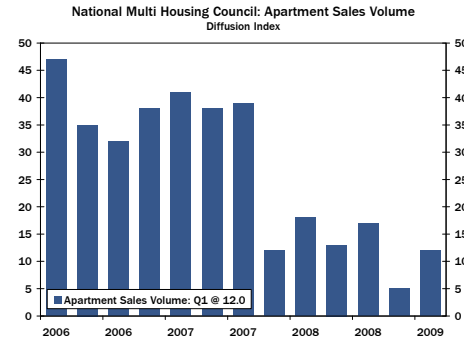


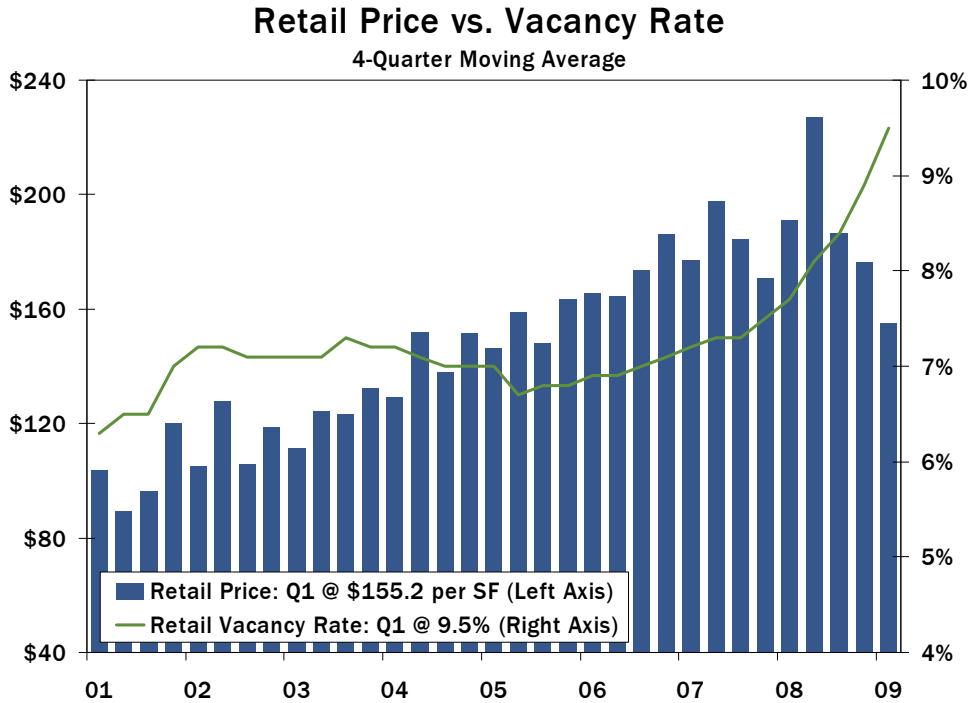
Figure 25



Source: Federal Reserve Board, National Multi Housing Council, Real Capital Analytics, Reis, Inc., and Wachovia

IX. Retail

Figure 26



Retail Slowing With Consumer Spending

Demand for retail space has weakened dramatically over the past two years, as falling home prices have triggered a massive pull back in discretionary purchases. Retailers were left with far too much inventory and had to slash prices and many ran into trouble meeting their debt obligations. There were a rash of store closings and several bankruptcies announced earlier this year, which continue to return space to the market putting upward pressure on vacancy and cap rates. Retail vacancy rates are now at record highs and will almost certainly move much higher. Occupancy levels of neighborhood and community shopping centers deteriorated sharply in the first quarter as demand weakened, pushing the national vacancy rate to 9.5 percent - the highest on record. Power centers and shopping malls have also run into trouble, as the number of credit worthy tenants has dwindled.

Figure 27

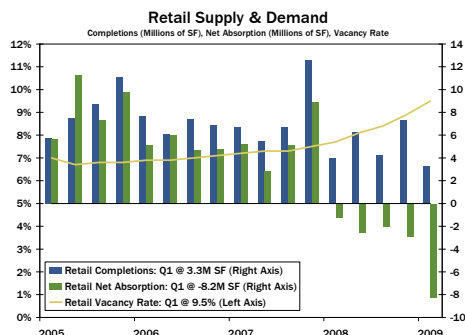
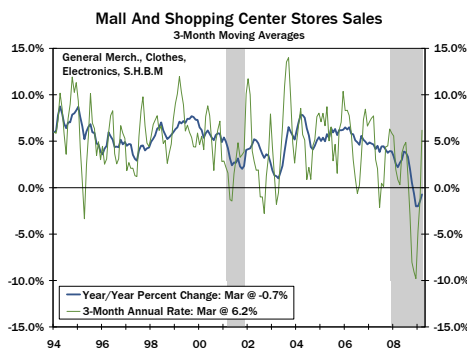


Figure 28



Source: Real Capital Analytics, Reis, Inc., U.S. Department of Commerce and Wachovia

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