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## Commercial Real Estate Rolls Along

By Dan Caterinicchia 10.21.07, 1:50 PM ET

WASHINGTON - The excesses that led to a bust in the housing boom haven't spread to the commercial real estate market, where the outlook is cautious but decidedly upbeat.

Led by strong growth in the office and retail segments, commercial property sales hit \$401 billion through Oct. 18, outpacing last year's \$359 billion total, according to Real Capital Analytics, a New York based real-estate research firm.

Construction spending on office buildings, shopping centers and other private, nonresidential projects jumped 15.2 percent in August, the Commerce Department said last month.

There are some signs of slowing growth, analysts say, but nothing compared to the residential real estate market, where foreclosures and mortgage defaults are still rising rapidly, mainly from subprime mortgages extended to risky borrowers. Most economists forecast further declines in home sales and prices, making it "the most significant current risk to our economy," Treasury Secretary Henry Paulson said last week.

The commercial market has not been dragged down by the residential mortgage mess because for the most part, buyers and sellers are more sophisticated, and they have more financial flexibility and resources to ride out credit-market turmoil, experts said.

"It's a different animal than the nonresidential construction business with the direct relationship between banks and business leaders, not banks and homeowners," said Bernard Baumohl, managing director of The Economic Outlook Group in Princeton, N.J.

That doesn't mean the market would be unaffected if economic growth stalls.

"As home prices continue to fall, people feel poor and spend less," and that puts pressure on the profits that fuel corporate spending, said William Wheaton, research director at the Massachusetts Institute of Technology's Center for Real Estate. He puts 50-50 odds on a mild recession in the U.S. within the next six months.

Economic data due out soon is likely to show that September was one of the slowest months in several years for all areas of commercial real estate - from apartment buildings to retail properties, according to Real Capital Analytics.

If the broader economy stumbles, the commercial real estate market would be vulnerable to "credit-risk contagion," Wheaton said. Already, the credit crunch that started in mortgages has spread to other markets, including the commercial market, with some sellers asking for more capital upfront when mortgage-backed assets are financing a transaction.

Projects in Midwestern cities dominated by individual investors have seen prices plateau and capitalization rates rise compared with developments in New York, Washington and San Francisco, where institutional and foreign investments remain stable, said Dan Fasulo, managing director of Real Capital Analytics.

Risk premiums also are up, which means commercial real estate investors can't get sellers to finance as much debt as before. And there has been an "above-normal flow" of lodging project cancellations and postponements, even though the increase is "not excessive or alarming," said Patrick Ford, president of Lodging Econometrics, a Portsmouth, N.H.-based real estate consulting firm. Speculative deals or developments with marginal profits are "dead," Wheaton said.

Yet only a handful of deals have been cut, analysts said, generally because the buyer or developer had terms that "pushed the envelope's edge" in a tight credit market. As an example, Wheaton cited recent media reports of struggles at Macklowe Properties, which in February financed the roughly \$7 billion purchase of eight Manhattan office buildings with little equity and heavy short-term debt.

Representatives from New York-based Macklowe Properties did not return calls for comment. But Fasulo said "anyone expecting defaults on those loans will be disappointed," especially since Citigroup Inc., Bank of America Corp. and JPMorgan Chase & Co. this week said they will pool money to buy distressed short-term debt in markets that were roiled this summer by a collapse in securities backed by subprime mortgages.

Homeowners who foreclosed or would-be home buyers who can no longer get financing are seeking to rent, a positive development for the apartment sector in the commercial property market.

Fundamentals in the commercial market remain strong with rising rents and occupancy levels expected to continue, especially in metropolitan areas. And while overbuilding in residential housing is worsening the magnitude of the downturn, commercial markets are not in oversupply mode.

"There's plenty of excess capital that wants into real estate, especially in metro areas," Fasulo said, adding that apartment building operator Archstone-Smith Trust's \$22.2 billion acquisition by a partnership led by Tishman Speyer earlier this month provided a "real shot of adrenaline to the marketplace."

Tishman Speyer, which owns New York's Rockefeller Center and Chrysler building, led the takeover with capital organized by Lehman Brothers Holdings Inc., Banc of America Strategic Ventures Inc. and Barclays Capital.

As the housing market struggles to regain its footing, the outlook for commercial real estate is mostly positive, and investors are reaping the benefits.

A recent example: Host Hotels & Resorts Inc., the nation's largest lodging real estate investment trust, this month reported third-quarter results that beat Wall Street estimates on improved occupancy and lodging rates.