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PPR Releases 3Q 2006 Forecasts

Vacancy Declines Are Easing

Real estate investors have rosy, wind-whipped cheeks from riding the recent recovery. Enjoy this healthy glow, because the occupancy ride is coming to an end in many markets. In fact, vacancies in all property types save office will be above current levels in 2011. The good news is that there is still plenty of room for rent growth, and in many markets fundamentals are strong enough to support new development. Let's slice and dice the data further to reveal these opportunities.

Vacancy rates continued to decline during the third quarter, but at a slower pace than in recent quarters. Since June, vacancy rates in the office market fell 0.2 percentage points to 16%, which was the steepest decline of any property type. The apartment and retail markets both witnessed a 0.1-percentage-point drop, while warehouse vacancies remained flat. Along with the slowing national economy, in many markets, the real estate recovery has peaked. Job growth has moderated to 1.3% year-over-year as of September, GDP growth dropped to 1.6% in the third quarter, retail sales growth is slowing, and all of these factors are contributing to weakening absorption across the board in real estate. Beyond the more macro trends, the apartment market in particular is seeing vacancies stabilize, as condo converters are no longer pulling supply off the market.

So what does this all mean for the future? Over the next 12 months, apartment vacancies are expected to fall only 0.2 percentage points, to 5.5%, versus a 0.7-percentage-point decline over the previous 12 months; office vacancies are only expected to fall another 0.1 percentage points over the next year, compared to a 0.9-percentage-point drop over the past 12 months. Also, after falling by 0.7 percentage points since the third quarter of 2005, retail economic vacancies will remain flat at 9.3%; and warehouse vacancies are expected to rise by 0.5 percentage points, to 9.3%, compared to a 0.4-percentage-point drop over the past year. The long-term view is that the office market recovery will resume after 2007 and vacancies will ultimately drop 1.3 percentage points, by the end of 2011. However, in the other property types, vacancies will continue to increase, most notably in the retail market, where economic vacancies will rise by 1.4 percentage points by the end of the forecast. The apartment market will see vacancies 0.5 percentage points higher than their current level, and warehouse vacancies will rise 0.4 percentage points by the end of 2011.

Certainly, some markets have more life left in their recovery than others. Sixteen markets will see a vacancy decline of at least one percentage point over the next 12 months. The top three will be New Orleans office, Raleigh retail, and San Jose office. Of course, some of these markets are in dire straits right now. New Orleans is still suffering from the effects of last year's hurricanes and is contending with a vacancy rate of 26.5%, and San Jose is still climbing out of the tech wreck, with a vacancy rate of 20%. Raleigh retail has seen record levels of construction, which is finally slowing and will allow vacancies to decline. Denver office and apartment both make the winners list, as do East Bay retail and warehouse. Denver, late to the game in terms of the economic recovery, is outperforming currently and is expected to continue to do so. Raleigh apartment, San Jose warehouse, Boston office, Phoenix apartment, and Portland retail also have some spark left in their recovery and are each expected to see a vacancy decline of at least one percentage point over the next year.

Slowing Vacancy Declines Don't Mean Rent Growth Is Over!

Apartments, with strong demand and supply curtailed by condo conversions, have seen the strongest rent growth over the past year, 4.6%. This was followed by warehouse with 4.1%, retail with 3.9%, and office bringing up the rear with a still healthy 3.8% growth in asking rental rates. However, the tables will turn over the next year, and office will move to the forefront. The office market has seen the strongest vacancy recovery recently, which will flow through to rental rates. Over the next 12 months, office rents are expected to rise from $23.86/SF to $25.05/SF, a growth rate of 5%. Apartment rent growth will remain strong at 4.8%, but rent growth will slow considerably in retail and warehouse properties, where vacancy declines are over. In fact, since warehouse vacancies are expected to rise 50 basis points over the next year, rent growth will fall to 3%, the lowest in the four property types.

The 20 markets with the strongest rent growth over the next 12 months are shown in the chart below. The majority are office and apartment markets. The tech-heavy markets in the West (San Jose, San Francisco, and Seattle) are expected to see the strongest rent growth over the next year. Apartment markets in Florida have extremely low vacancy rates resulting from condo conversions and are still seeing some conversions, and as a result, will have very strong rent growth over the next year. Los Angeles warehouse, San Diego retail, and Fort Lauderdale retail also appear on the list.

Metro	Property Type	Rent Growth 06Q3-07Q3
New Orleans	Apartment	16.3%
San Jose	Office	12.1%
San Francisco	Office	9.5%
Seattle	Office	9.2%
New York	Office	8.7%
Miami	Apartment	8.0%
Austin	Office	8.0%
Los Angeles	Office	7.9%
Portland	Office	7.8%
Fort Lauderdale	Apartment	7.6%
Orlando	Apartment	7.4%
Dallas - Fort Worth	Office	7.3%
Tampa	Apartment	7.3%
Phoenix	Apartment	7.2%
Palm Beach County	Apartment	7.0%
East Bay	Office	7.0%
Los Angeles	Warehouse	6.9%
San Diego	Retail	6.9%
Orange County	Office	6.8%
Fort Lauderdale	Retail	6.6%

While the occupancy recovery is largely over in many markets, rent growth projections are still healthy. Upcoming rent growth in the apartment and office markets will outpace that of the past year. The picture is not so rosy for retail and warehouse markets, where rent growth is slowing, but still-decent growth is projected in the near term. With cap rate compression ending, the ability to grow income will be more important than it has been in years. Markets will matter, and PPR is here to help you invest in the right ones.

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