

Commercial Real Estate, Come On Down

By Steven Pearlstein
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Here's the next shoe to drop as a result of the bursting of the credit bubble: commercial real estate.

It won't be anywhere near as dramatic as the fallout in the residential real estate market. But, at the same time, it won't simply be a temporary disruption in financing followed by a modest correction in pricing that the industry is now predicting.

In markets like Washington, [New York](#), [Boston](#) and [San Francisco](#), the last four years have been among the best the industry has ever seen -- falling vacancy rates, rising rents, soaring values and a ton of new development. Now, that's all about to come to a grinding halt as financing becomes more expensive and more restrictive, the economy slows and a big slug of new inventory hits the market.

"It's over," one local developer told me this week. "It was a great ride, and now it's over."

You can date the beginning of the end of the commercial real estate bubble to February of this year, when the [Blackstone Group](#) closed on its \$39 billion purchase of Sam Zell's [Equity Office Properties](#), the largest single commercial real estate portfolio in the country.

Within weeks of the deal closing, Blackstone had managed to sell off a good chunk of the Equity Office portfolio for \$18.5 billion at prices even richer than it had paid.

In early June, [Tishman Speyer](#) and Lehman Holdings offered to buy another big real estate investment trust, [Archstone-Smith](#), for \$22 billion.

In the last few weeks, however, as lenders and investors have begun to come to their senses, the market for "commercial mortgage backed securities" has virtually shut down. Those are the packages of commercial real estate loans that are sold off in pieces to hedge funds, pension funds and other institutional investors. And without that cheap and easy financing, neither Macklowe nor Tishman/Lehman have been able to secure permanent financing for their deals, putting them in what you might call an awkward financial position.

They are not alone. Across the Washington region and the country, there are reports of sales falling through or held up by buyers seeking a lower price. And with financing costs uncertain, negotiations over new deals have been put on hold.

Meanwhile, developers who have just completed buildings and need to convert their construction loans into permanent financing are finding that the only lenders interested in talking are banks and insurance companies that traditionally hold their loans on their own books rather than selling them into the securities markets. These "portfolio lenders" still have plenty of money to put out, but unlike the "hot money" lenders who sell their loans, they charge higher rates and demand lower levels of debt.

All this is likely to sort itself out within a month or two. But when it does, it will have a significant impact on prices.

In recent years, commercial real estate prices have been driven up by buyers such as Blackstone and Tishman who were able to bid up prices as long as CMBS lenders were offering low-rate, interest-only financing for as much as 95 percent of the purchase price.

But in the future, if the only financing available is for interest and principal loans at 75 percent of the market value, with an interest rate a percentage point higher than before, the price that investors would be willing to pay for a building, given the same market conditions, could be 20 to 25 percent less.

Unfortunately, market conditions are not the same as six months ago.

As the [Federal Reserve](#) acknowledged last week, the turmoil in financial markets is likely to cause a slowdown in economic growth and raise the risk of recession.

And in markets like Washington, the pace at which buildings have been leasing has slowed even as a large number of new buildings are about to come on line.

According to the latest data from [CoStar Group](#), for example, office vacancy rates along the I-270 corridor have risen to 11.6 percent from a low of 9.7 percent a year ago. Buildings under construction will add another 5 percent to supply over the next two years, with roughly a third of it pre-leased.

The market in the [Dulles](#) corridor is also beginning to weaken. There, the vacancy rate is up to 14.2 percent from 13

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percent in the past year, with nearly 4 million square feet of space under construction, equal to about 8 percent of current supply. After four years of steady growth, rents are beginning to flatten out.

For the moment, the District's office market remains strong, even as developers struggle under a glut of unsold condos. But it's hard to imagine that the market will be able to absorb all the exciting development that is now slated to rise out of the ground over the next five years, from [Union Station](#) to the old convention center site and areas along the Potomac and Anacostia waterfronts.


Over the past year, local real estate types have tended to dismiss suggestions that the market was overheating. Their story was that the Washington economy is relatively immune to downturns, and a global savings glut would keep interest rates low. Moreover, with a large number of low-rent leases set to expire in the next couple of years, they were counting on big spikes in rental income.

However convincing that story was six months ago, it sounds a lot less convincing today.

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