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From Boom to Bust

S&P Economics does not expect a near-term rebound in commercial construction.

In 2008, after three years of solid construction spending, the U.S. commercial building sector began to show bruises from brutal economic conditions and tough credit markets. While new construction starts rose 4% to their most recent peak in 2007, they began to slow toward the end of the year, with an overall drop of 26% in 2008.

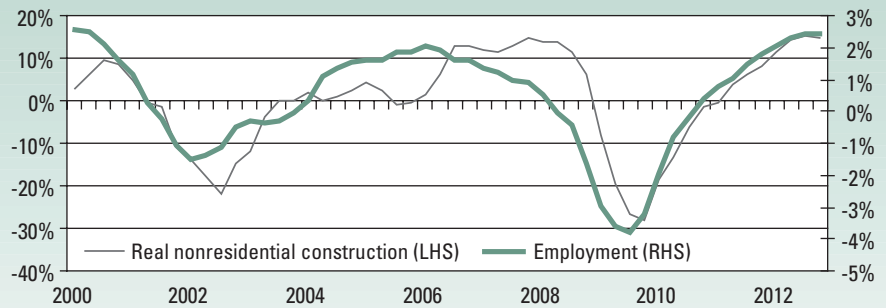
The financial markets are still constraining development this year — loans are more expensive and harder to get, and securitization activity remains very weak, although there are some signs of life after the total freeze late last year. It's always hard to tell how much of the decline in activity is from a lower willingness to borrow versus a lower willingness to lend, but this time around, the latter seems to be the dominating factor.

Delinquencies of commercial mortgage-backed securities are also rising, and a large volume of commercial mortgages that were issued mid-decade are coming due between this year and 2012. With property values flattening out or declining in numerous markets, many of these mortgages won't qualify for refinancing.

The economic stimulus bill that Congress passed on February 13 offers no direct help to commercial

NONRESIDENTIAL CONSTRUCTION FOLLOWS EMPLOYMENT

(Percent change year ago)



Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, S&P.

building, but, indirectly, it should moderate the decline in employment and offer some help in setting the stage for a faster economic recovery. Nevertheless, we expect spending on nonresidential construction to drop 29% by the end of 2009 (fourth quarter to fourth quarter) and another 2.3% by the end of 2010. (See the May 20 issue of *The Outlook* for a take on the companies that could be affected.)

Another Slow Year

New construction activity slowed sharply in 2008, and we're expecting it to do the same in 2009. This was a big change from 2007, when

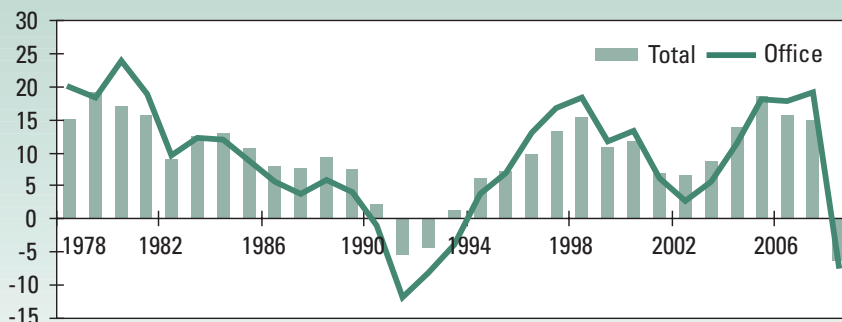
new construction starts rose 4%, peaking at 1.055 billion square feet in response to high occupancy rates and easy financing conditions. However, starting in the fourth quarter, new activity dropped significantly because financing became more difficult and employment growth slowed. New construction starts dropped a further 26% to 777 million square feet in 2008, although the drop was smaller in dollar terms, at 16% to \$84.6 billion. For 2009, we expect new construction starts to be down 33% to 520 million square feet, and in dollars terms, down 29% to \$60.3 billion.

While new nonresidential starts remained weak in 2008, the carry-through from buildings that began in 2007 boosted overall nonresidential construction spending 11.2% over 2007. However, the boost was only temporary: After falling 9.4% in the fourth quarter of 2008, spending plunged 44.2% in the first quarter of 2009. We expect 2009's overall decline for commercial building to be 21.3%.

Nonresidential construction helped to counter the effects of the residential slowdown, but this will likely stop in 2009. Residential construc-

PROPERTY RETURNS PLUNGE

(Percent)



Sources: NCREIF Property Total Returns Index, Global Insight, S&P.

tion subtracted about one percentage point from growth over the past two years, but nonresidential construction added back 0.4 percentage points in both years. Together with the 1.4 percentage points the improved real trade deficit added in 2008 (which added 0.6 percentage points in 2007), the sectors were a near wash for real growth. In 2009, residential construction will continue to subtract from the real economy (likely down 24.3%), and while residential investment may improve next year, nonresidential construction will likely continue to decline in 2010 (down 12.4%).

Commercial property returns have also started to buckle. After four years of double-digit returns, the NCREIF (National Council of Real Estate Investment Fiduciaries) commercial property total return index plunged 6.3% in 2008. Most property types are down sharply (only farmland and timberland properties reported positive returns). However, the scarcity of new deals makes the pricing a bit more uncertain than usual. Total returns remained lower in first-quarter 2009.

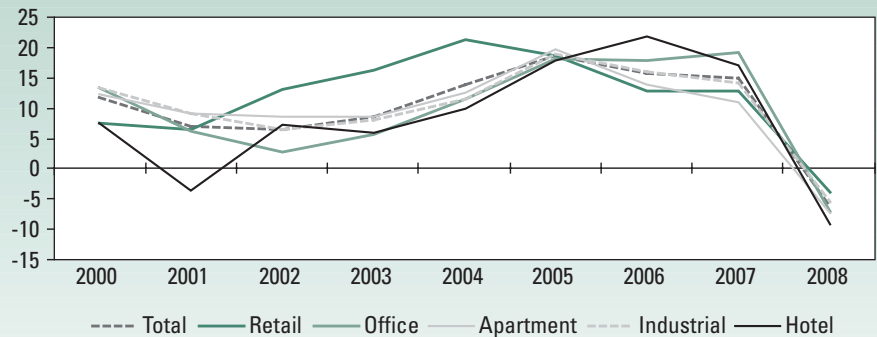
It Could Have Been Worse

Offices are the largest component of nonresidential construction, and, historically, often the most cyclical. This time, however, offices seem less vulnerable than usual. The peak apparently came before developers managed to overbuild as much as they had in the past. In 2007, office construction hit 219 million square feet, well below the activity of the peaks in 2000 (298 million square feet) or 1985 (350 million). In 2008, it dropped to only 164 million square feet, with Standard & Poor's expecting further declines this year.

That's not the only discouraging news: Office vacancy rates are rising. CB Richard Ellis reports that the suburban office vacancy rate reached 16.3% in fourth quarter 2008, while the downtown vacancy rate moved up to 11.7%. And with employment

PROPERTY RETURNS BY SECTOR

(Percent)



Sources: NCREIF Property Total Returns Index, Global Insight, S&P.

declining, vacancy rates will continue to climb. However, the vacancy rate data could be misleading. As in 2001, high levels of sublease activity could be concealing vacancies. According to Grubb & Ellis, sub-space leases rose to 81.9 million square feet in the first quarter, up almost 6 million square feet in nine months. Much of the problem is concentrated in a few major centers, particularly in Orange County, where many subprime mortgage companies have closed down.

Employment is proving to be a huge problem. It's now dropped for 16 consecutive months, with the U.S. losing 5.7 million jobs so far, and likely more than 2 million to go. Fewer employees imply less office space. However, the largest employment declines are among construction and manufacturing workers, not office workers. Still, a weak employment market should translate into lower demand for office space.

For office construction contracts, 2008 was especially bad, with a 25% drop to 164 million square feet. Accordingly, we're forecasting office contract awards to decline 27% to 120 million square feet in 2009, and be down 7% to 112 million square feet in 2010. However, opportunities for government office buildings may help the office sector this year. The stimulus bill provides \$4.5 billion for energy upgrades to federal buildings, and some of this

work will show up as office renovations over the next two years.

Stricter bank lending standards among the financial market turmoil caused many office projects to stall last year, but we don't expect them to worsen this year, with some improvement likely. By 2011, an improving employment market and declining vacancies should allow construction to recover, albeit slowly. The decline will not be as long as the downturns after the 1991 and 2001 recessions, but it'll still be painful.

How Bad Could it Get?

All categories of commercial construction are likely to weaken further this year, with retail, hospitality, and offices in the greatest danger. On the positive side, the degree of overbuilding in commercial properties was far less than in the late 1980s, when downtown office vacancy rates were 20% even before the start of the recession. At the end of 2007, vacancies were averaging about half that amount. But a recession reduces demand for office and retail space, and this is the deepest recession since World War II.

In any event, the commercial construction boom is long over. What remains to be seen is how severe the bust will be. What seems clear for now is that most areas of commercial construction are likely to continue their swoon well into next year. ■