# Cloud Over Commercial Real Estate Is Slowly Lifting in Texas

***By D'Ann Petersen***

The year 2009 was a terrible one for Texas commercial real estate. With the U.S. and Texas economies mired in recession and credit markets still reeling from the global financial freeze-up, every segment of the state's commercial property sector suffered. Demand withered for space in offices, warehouses and retail centers, pushing up vacancy rates and lowering rental rates. Private nonresidential construction dropped sharply, reaching near-record lows.

Texas' commercial real estate (CRE) sector has been through booms and busts before—most notably, leading up to and following the state's deep recession in the mid- to late 1980s.[1] What differed in the current down cycle was a global financial crisis that temporarily brought lending to a halt.

Problems began on the residential side but soon spread to CRE financing. Commercial-mortgage-backed securities (CMBS) lending dried up in Texas and the U.S. as it became clear that repackaging suspect loans didn't lower risk. Banks also became wary of adding CRE loans to their books, especially in Texas, where the share of these assets exceeded the national average. By 2009, no one wanted to touch CRE.

Commercial real estate impacts the region's economy through several channels. For example, construction activity contributes to state output and employment growth, and CRE lending is important to the state's banking sector.

While the recession appears to be over, commercial activity is a trailing indicator and, given still-tight credit conditions, remains a potential drag on economic recovery.

Significant declines in property values and rents have raised concerns about impending defaults and foreclosures as loans come due, posing risks to the banking sector and the economy as a whole. Indeed, the share of nonperforming CRE loans at Texas banks is rising.

In a positive sign, the lower rents and prices are beginning to stir demand for space as well as investor interest. In addition, sectors of the economy that drive real estate demand have turned the corner, suggesting the bottom is near.

## Construction Hits a Wall

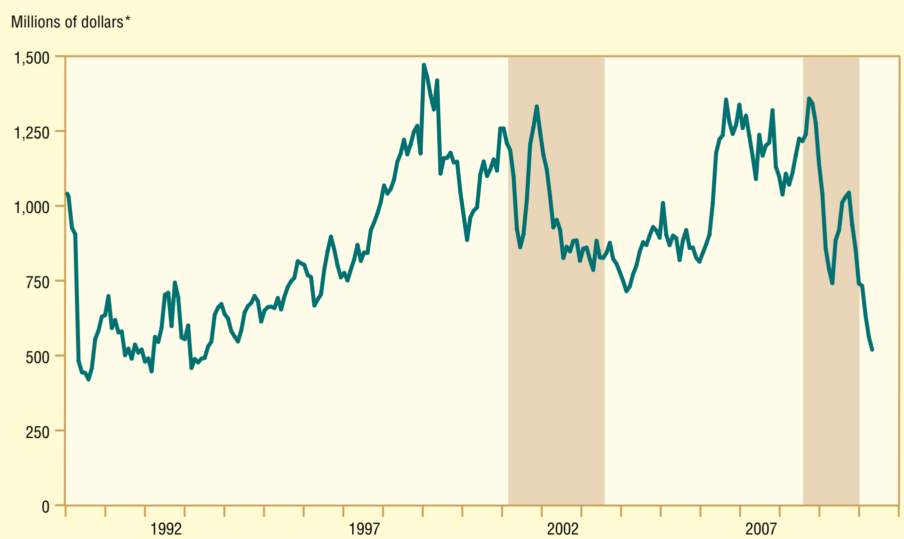
Texas private commercial construction surged during the state's expansion, picking up steam as the economy shook off the jobless recovery that followed the 2001 tech bust. Growing demand for Texas-produced goods boosted construction of industrial space, and more office space was built as service-sector firms expanded. Construction of retail space was also strong. By 2006, the inflation-adjusted value of CRE construction had almost reached the high of the previous economic boom.

Just as the construction cycle was gaining steam in Texas, the global financial collapse put an abrupt halt to activity. Construction faltered in 2007 and plunged in 2008 and 2009 (*Chart 1*). Currently, private CRE construction levels are near lows last seen after the Texas oil and real estate bust of the mid- to late 1980s.

The Dallas Beige Book, the Dallas Fed's anecdotal survey of economic conditions, regularly includes comments from executives at construction and building-related product companies. In late 2008 and early 2009, contacts said private construction activity came to a virtual standstill as credit dried up. Since then, reports on building activity have remained grim.

With construction of warehouses, office and bank buildings, and stores and restaurants in the doldrums, public construction accounted for a larger share of the pie. The little nonresidential construction that occurred in 2009 was partly the result of the federal government's economic stimulus programs.

**Chart 1**
**Texas Private Nonresidential Construction Plunges**



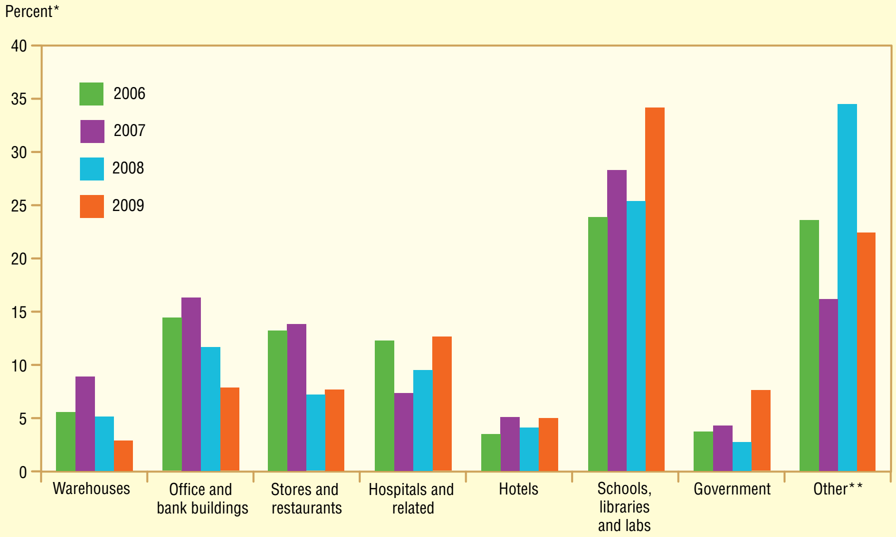

*Real dollars; five-month moving average.

NOTES: Shaded areas represent Texas recessions as defined by the Texas Business-Cycle Index. Private nonresidential construction is nonresidential contract values minus government buildings and schools.

SOURCES: F.W. Dodge; calculations and adjustments by the Federal Reserve Bank of Dallas.

Chart 2

**Public Projects Account for Most Construction Activity in 2009**




*Real dollars

**Includes churches, dormitories, parking garages and recreational facilities.

SOURCES: F.W. Dodge; calculations and adjustments by the Federal Reserve Bank of Dallas.

Compared with previous years, public projects like schools and government buildings made up a larger chunk of Texas building activity in 2009 (*Chart 2*). Hospital construction was boosted by strong population growth and a thriving health care sector. While hotel construction is largely private, building activity picked up in 2009 with the start of the Dallas Convention Center hotel, mostly funded by public dollars.

## Leasing Markets Suffer

The recession and the financial fallout took a toll on rental markets in Texas. As demand for space dropped off, vacancy rates climbed in the major property markets—retail, industrial and office.

**Retail.** Demand for retail space was strong from 2002 through 2004, thanks to the state's housing boom and retail sales growth. Even with new retail construction at high levels, vacancy rates edged downward in Texas metros. Texas' housing and retail boom lasted longer than the nation's. However, consumer confidence began to wane in 2006 as the U.S. housing problems spread to the state, and demand for retail space began to slow.

Already weakened by the housing drop-off, retail markets took another hit from the national recession in 2008. Store and restaurant closings—including Circuit City and some Starbucks locations, as well as Texas' own Bombay Company—were commonplace. In real estate circles, demand is usually measured by net absorption, or the net change in square feet for competitively leased space, including new construction. The widespread business closings and slack demand for retail space led to weak absorption from mid-2008 to early 2009, pushing up vacancy rates in Texas' major metros (*Chart 3A*).[2]

Overall, Texas had positive absorption of 873,000 square feet in 2009, an improvement over 2008 but still well below the 3.2 million in 2004. Conditions worsened in first quarter 2010, and the Texas population-adjusted retail vacancy rate edged up. In a spot of good news, recent industry reports suggest grocers, discount clothiers, wholesale clubs and electronics stores are expanding in Texas markets.[3]

**Industrial.** Before the recession, rising exports and imports and strong growth in industrial production played large roles in Texas' expansion, leading to robust demand for warehouse and industrial space.

However, the state's industrial real estate market deteriorated sharply as global demand for goods dropped off and Texas exports and production fell precipitously. The Port of Houston, for example, reported value declines of 15.9 percent for exports and 39.6 percent for imports during 2009.

Throughout the recession, Dallas Fed contacts reported almost no industrial leasing activity. Not surprisingly, the major metros had six consecutive quarters of negative net absorption totaling just over 26 million square feet as of first quarter 2010—more than half of which occurred in Dallas–Fort Worth, which houses the state's largest share of industrial space (*Chart 3B*).

Texas' population-adjusted industrial vacancy rate increased from 8.5 percent in third quarter 2007 to 13.5 percent in first quarter 2010, exceeding the highs of past recessions.

More recently, the Dallas Beige Book notes that some deals are being made after landlords took a realistic look at market conditions and drastically reduced rents. Contacts report a pickup in leasing transactions and firms scouting sites for distribution hubs. Still, the large amount of available space suggests it will be a slow recovery, and construction probably won't resume soon.

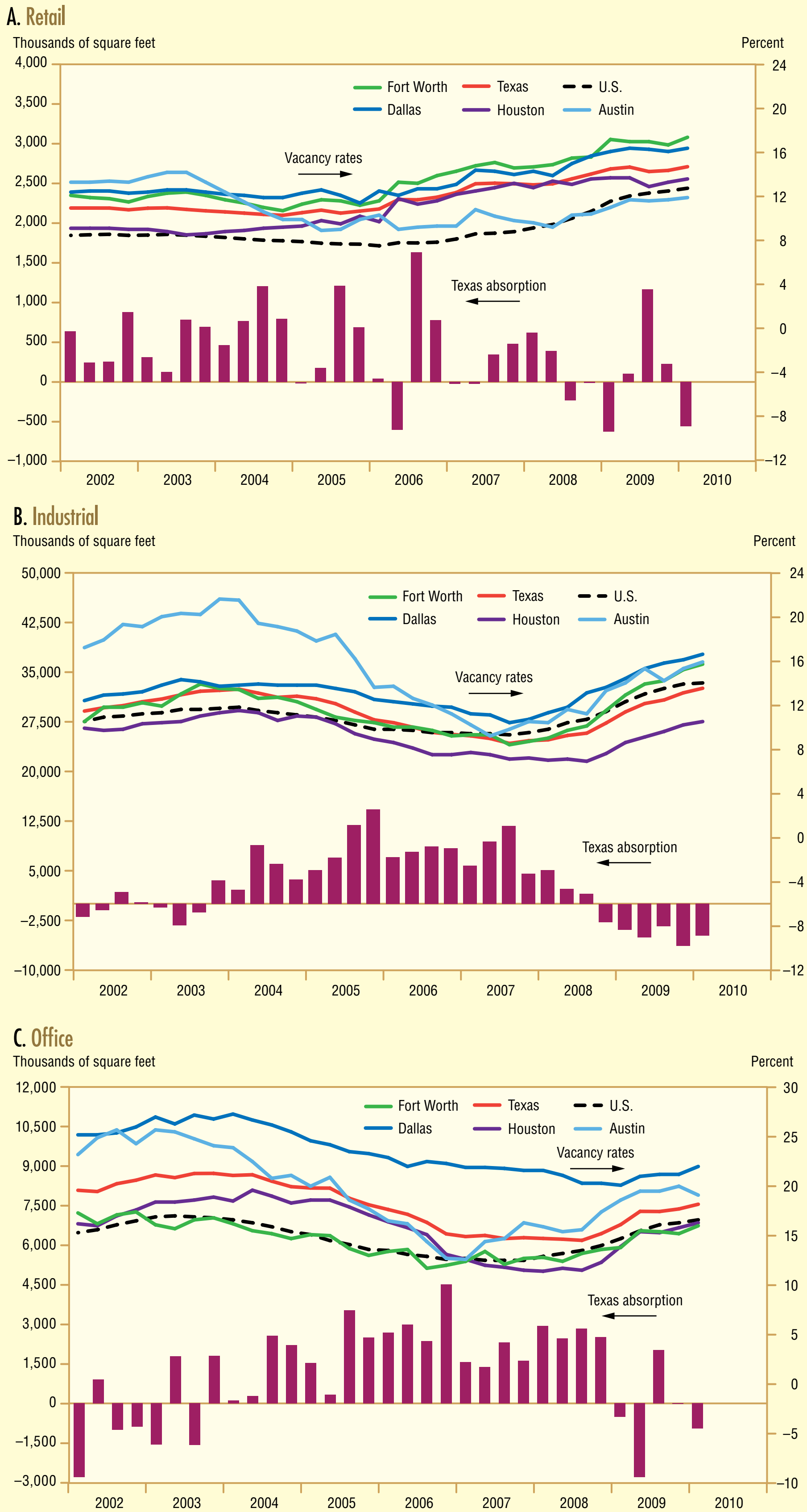
**Office.** Texas office markets weakened during the recession as firms in finance, energy, real estate and other sectors put leasing and expansion decisions on hold amid credit uncertainty, cost cutting and downsizing.

As a result, the Texas population-adjusted office vacancy rate began to rise in 2008 and stood at 18.2 percent as of first quarter 2010 (*Chart 3C*). Despite the increase, the rate remains below the levels seen in the previous two Texas recessions. However, absorption was negative in the first quarter of this year, suggesting vacancy rates may continue to edge up.

Dallas and Austin have the highest metro vacancy rates, although several downtown lease deals led Austin to a marked improvement in the first quarter. Because of the popularity of Austin's downtown location, several developers plan to build commercial properties with an office component once credit restrictions ease, according to C.B. Richard Ellis (CBRE).[4] Houston's vacancy rate is below the national average, but it may move up as construction wraps up on several large projects started before the recession took hold.

Dallas Fed business contacts report building owners are aggressively reducing office rental rates and making concessions. For instance, first quarter office rents are down $1.87 per square foot in Austin and $1.48 per square foot in Dallas from the highs reached in 2008, according to CBRE. The lower rental rates are encouraging some recent leasing activity, according to the Dallas Beige Book.

## Chart 3
### Commercial Real Estate Vacancy Rates Edge Up in Texas




NOTES: The Texas vacancy rate is population-adjusted by the Dallas Fed. Texas absorption is the sum of the major Texas metros.

SOURCES: CB Richard Ellis Econometric Advisors; calculations and adjustments by the Federal Reserve Bank of Dallas.

**Prospects for recovery.** A rebound in the retail, industrial and office leasing markets depends on broad economic improvement. Recent data give reason for optimism.

Renewed growth in Texas and U.S. retail sales bodes well for the retail property sector (*Chart 4*). Moreover, Texas exports have recovered from record lows, following improving trends in U.S. industrial production—an encouraging sign for the Texas industrial market. Finally, data point to a brewing recovery in Texas employment in service industries that typically drive office demand—notably, professional and business services and finance.

## Signs of Life

The analysis of conditions in Texas' retail, industrial and office property markets finds a common theme—a sharp decline during the recession that gives way in the most recent reports to a few glimmers of hope. A similar scenario emerges from data and reports on investment property sales.

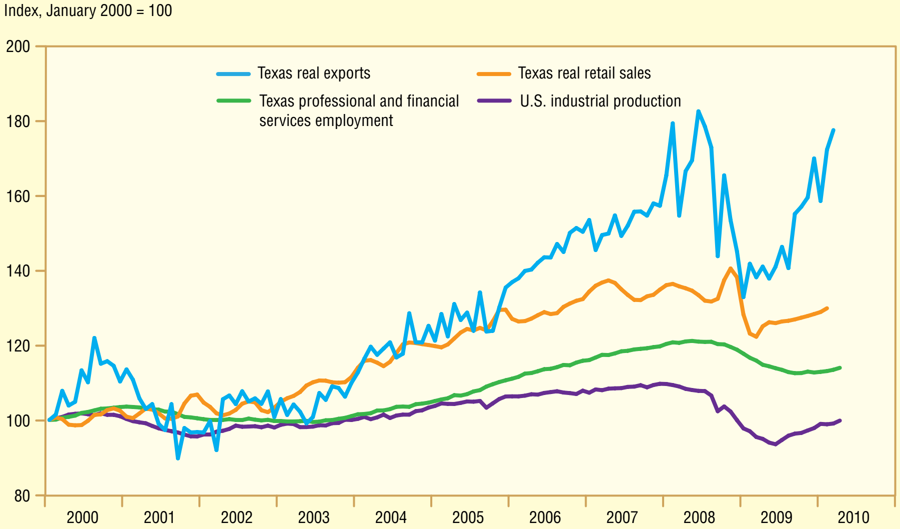
**Credit crisis halts investment.** In the years leading up to the credit crunch, financial innovations that repackaged risk—most notably, securitized lending—surged not only in the residential mortgage market but also in CRE and other investments. This led to large increases in the share of mortgages held by investors. CMBS issuers that held commercial and multifamily mortgages spiked from about 4 percent in 1990 to just over 25 percent by 2009 (*Chart 5*).

Commercial banks still hold the largest amount of CRE debt, with their share rising to 45 percent over the past two decades. Life insurance companies, savings institutions and other investors saw their shares decline. Researchers suggest that CMBS issuers' rising share made the overall commercial market more vulnerable to financial market disturbances.[5]

Texas' commercial investment market was jolted when financial markets panicked in 2007. CMBS lending was virtually shut down, and banks halted most CRE lending, too, putting stringent standards on new loans. The Dallas Beige Book noted that virtually no loans were being made for large commercial deals as banks tried to reduce their exposure to CRE.

**Sales low but starting to stir.** When credit dried up in 2008, Texas commercial property sales plummeted. Early 2009 was even worse, with Texas transactions falling to almost zero. Later in the year, business picked up, but the full-year sales volume

Chart 4
**Drivers of Rental Demand Show Improvement**




NOTE: Retail sales are estimated and based on quarterly data; exports and retail sales are in real dollars.

SOURCES: WISERTrade; Census Bureau; Bureau of Labor Statistics; Texas Workforce Commission; Federal Reserve Board; calculations and adjustments by the Federal Reserve Bank of Dallas.

of office, industrial, retail and apartment properties totaled just $3.8 billion, down 68 percent from 2008 (*Chart 6*).[6]

Sales activity for all property types was hampered not only by a lack of available credit but by sellers unwilling to sell at very low prices. Nationally, commercial property prices plunged 44 percent from their peak in late 2007 before bottoming out in October 2009, according to Moody's/REAL commercial property price index. Texas price statistics are difficult to obtain, but anecdotal reports and rough figures reflect the U.S. trend.

More recently, competition for good deals has spurred some property sales. Data from Real Capital Analytics show first-quarter property sales volumes inched up from year-ago levels in the U.S. and Texas. The largest transaction nationally in February was Anadarko's $215 million purchase of its headquarters in The Woodlands, near Houston. Anecdotal reports from Dallas Fed contacts concur that investor interest is growing, with scattered instances of bidding wars bumping up sales prices.

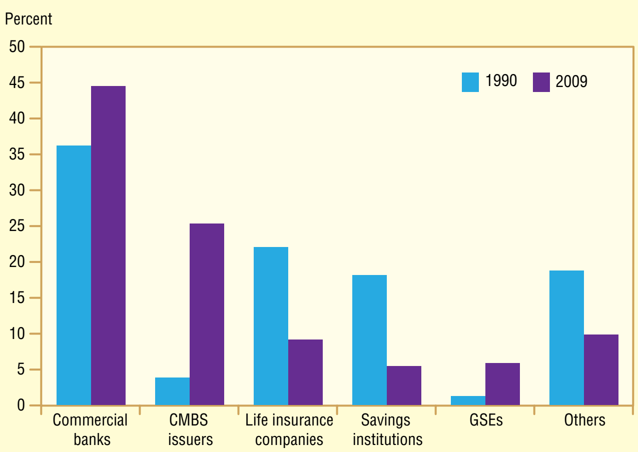
**Financial hurdles lie ahead.** Texas has its fair share of the nation's growing volume of distressed assets—defaults, foreclosures or bankruptcies. While rising distress may mean bargains for investors, it's a concern for the banking industry.

The large number of CRE loans maturing over the next several years is another worry for banks, given today's tighter lending standards and lower property values. This can leave borrowers who are current on their payments with a refinancing gap that may be hard to fund with new loans. This is why banks have preferred to extend maturing loans in hopes that conditions will improve.

Most Texas CRE loans are concentrated at smaller regional and community banks, which depend on CRE lending as a major source of business. Texas banks have almost double the commercial real estate exposure as the national average, although the Texas share has come down considerably from almost 30 percent in third quarter 2008 to 26 percent as of first quarter 2010. The good news is that Texas' share of nonperforming—or troubled—CRE loans has remained well below the national average throughout the downturn.

*(Continued on back page)*

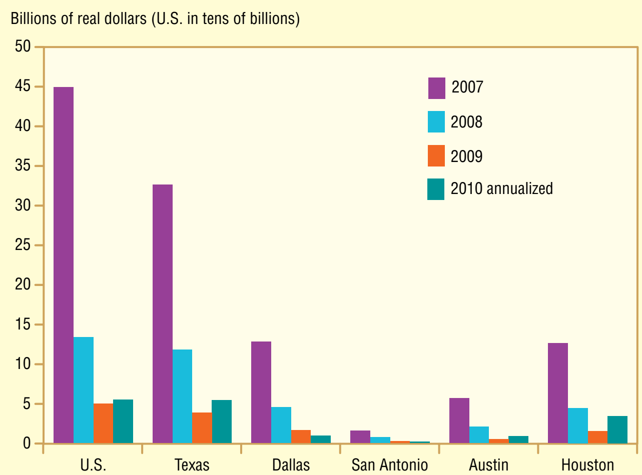
Chart 5
**Composition of Commercial Mortgage Holders Shifts**




NOTE: CMBS stands for commercial-mortgage-backed securities, and GSEs are government-sponsored enterprises.

SOURCES: Flow of funds data; Federal Reserve Board; Compendium of Statistics; Commercial Mortgage Securities Association.

Chart 6
**Commercial Real Estate Sales Volumes Inch Up**




SOURCES: Real Capital Analytics; calculations and adjustments by the Federal Reserve Bank of Dallas.

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## What the Future Holds

The outlook for CRE may not yet be optimistic, but it is less gloomy. With the national and Texas economies turning a corner and demand in the rental and investment markets stirring, a bottom may be within sight.

It will take time for the Texas CRE sector as a whole to heal, and it will likely be quite a while before private commercial construction activity picks up. Asset devaluations and weakness in rental markets remain challenges for CRE loans on banks' books. CRE lending will likely remain subdued while banks address these concerns.

Demand for new space will depend on sustained employment growth and business expansion, and the Texas economy remains fragile, having just entered recovery. Nevertheless, the state's business activity does appear to be moving in the right direction.

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## Notes

[1] See "Office Real Estate Cycles in Texas: Some History," by D'Ann Petersen, Federal Reserve Bank of Dallas *Southwest Economy*, March/April 2005, www.dallasfed.org/research/swe/2005/swe0502a.pdf.

[2] Data for all metro property markets provided by CBRE Econometric Advisors.

[3] Grubb and Ellis 2010 Forecast Reports.

[4] From first-quarter Austin office MarketView research report, CB Richard Ellis.

[5] See "Is Commercial Real Estate Reliving the 1980s and Early 1990s?" by C. Alan Garner, Federal Reserve Bank of Kansas City *Economic Review*, Third Quarter 2008.

[6] Apartments are included as commercial real estate properties in sales data because they are income-generating. For the same reason, apartment properties are included in banking statistics for commercial real estate.