

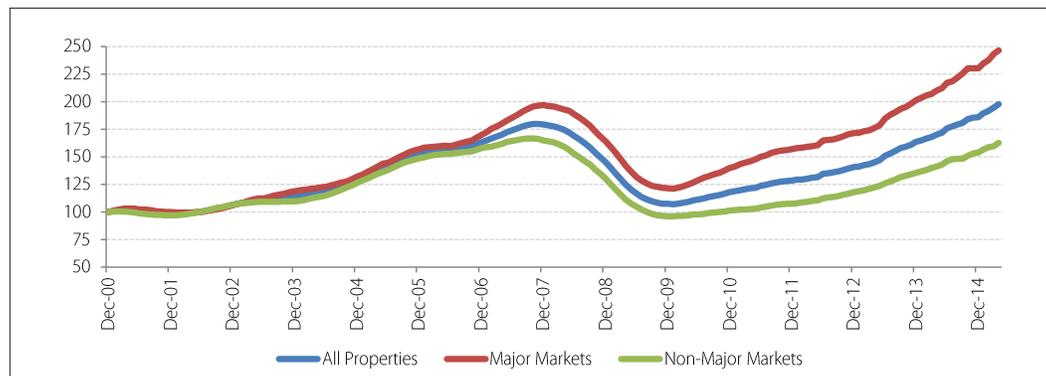
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Is Commercial Real Estate in Another Bubble?

Commercial real estate prices are hitting record highs in primary markets and eager investors are moving in droves to secondary markets to snap up assets. Lenders of all sorts are looking to make deals, and the volume of mortgages outstanding has reached record highs in each of the last few quarters. In most markets and property types vacancies are dropping, rents are rising and absorption is improving.

Commercial Property Price Index (CPPI) January 2000 to April 2015



Source: Moody's & Real Capital Analytics

All the good news is similar to the lead-up to the last downturn, which gives rise to the question: are we in another bubble period for real estate like 2007?

My answer is possibly, but not likely. While nothing is certain, there are significant differences between today's market and the way things developed back then. During the last cycle, lending became increasingly aggressive, particularly among CMBS programs, which kept refinancing buildings with higher proceeds. Most of these deals were underwritten using "pro-forma" underwriting, which means the in-place cash flow wasn't enough to pay the mortgage debt service, but the assumption was that income would rise enough in future years to make the payments.

Of course, the economy tanked and many of those loans defaulted. Lending has increased over the past couple of years, but there are important differences, for example:

- ❑ Property fundamentals are moving in a positive rather than negative direction. In 2007, the economy was on the verge of an unexpected jolt in the form of the global financial crisis. Today, however, the job market is expected to stay strong for another couple of years.
- ❑ Vacancy rates and rents have been slow to improve in most commercial real estate segments and are likely to improve moderately for another 2-3 years. In 2007, rents had climbed sharply in recent years and were vulnerable to the recession and overdevelopment.
- ❑ Although there have been extreme swings, property prices on average have increased by about 3-4% over the last decade, not out of line with the returns of the S&P 500.

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