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The diverging fates of different sectors in the commercial real estate market

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Despite grindingly slow economic growth, multifamily fundamentals have vastly improved while office occupancies and rents have barely recovered. What explains the disparity?

National multifamily vacancy levels hit 4.7% in the second quarter of 2012, a 330 basis point decline from 30-year highs of 8% in late 2009. The apartment market has grown exceedingly tight. For perspective, there has been only two other times in three decades of Reis history that vacancies fell below 5%, and landlords are charging rent levels well above peaks achieved before the downturn.

By contrast, office vacancies remain stuck at 17.2%, a level last observed in the early 1990s. The vacancy rate barely dropped, descending only by 40 basis points from its peak of 17.6% in end-2010. Asking and effective rents have grown slightly, but are still about 10% off peak levels achieved in mid-2008, before the implosion of Lehman Brothers drove the recession into high gear.

What are the biggest drivers that explain these differences? First, office sector rents and occupancies are more intimately linked to employment growth than apartment fundamentals. Though national employment levels have increased every month since October 2010, we have hired back less than half of the 8.4 million jobs that were destroyed in the last recession. Office fundamentals have therefore remained weak-the pace of hiring has been too slow to stimulate robust demand for more office space.

Demand for apartment rentals, on the other hand, received a boost from the moribund state of the for-sale housing market. Jobs might not be as plentiful, but as U.S. households continue to grow, they are choosing to rent rather than buy. Credit is still tight except for the most cash-rich of home buyers, despite record low mortgage rates. With home prices not expected to rise significantly, there is no sense of urgency to buy a home. And with job security still at risk, many households prefer the short-term commitment of a one-year lease versus having to commit to owning a home with a 30-year mortgage.

The Capital Markets

Conundrum

Despite how well apartments are doing, relative to office properties, cap rates for both sectors have come down at equally swift rates. Consider the graph below, which provides an index of vacancies and cap rates for the apartment and office sectors, pegged to 2006 levels. As discussed in the previous section, office vacancies remain well above 2006 levels while apartment vacancies have come down well below that. However, check out the cap rate graph: both apartment and office cap rates now hover at 2006 levels. Bidding for properties on the market are frenzied affairs, with 20 to 30 participants pushing cap rates for the best buildings below 4% in some primary markets. How can cap rates fall so low-and property values rise so quickly-for both property types when rent and occupancy performance is so radically divergent?

Selection bias explains this conundrum. Vacancy rate trends are calculated for every property in the market, while cap rates can only be measured for properties that transact. Since national transaction volumes are still about 70-80% down from peaks attained in 2007, buildings that have transacted since 2009 tend to be class A properties in prime locations. With investors still risk-averse, marquee properties in the most liquid markets are driving cap rates down to pre-recession levels, with scant activity transpiring in secondary markets.

Outlook for 2012 and 2013

Short of a double-dip recession these trends are likely to continue for the remainder of the year and 2013. Apartment fundamentals will remain healthy, though vacancy declines may be more muted as developers bring more rentals online in 2013. Office vacancies will deflate slowly, unless job growth picks up. U.S. commercial property markets are benefiting from both foreign and domestic demand, as investors seeking higher yield flee to the relative safety of U.S. assets. But expect overall transaction activity to still remain relatively muted, and largely confined to the bigger primary markets.

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