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National Outlook: Construction Industry

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Winter's gloom continues to settle in on the non-residential construction market nationally. Bank lending for commercial construction remains restricted, secondary financing vehicles, like REIT's or commercial mortgage backed securities, remain closed down markets. Compounding the financial issues, widespread downsizing has elevated unemployment to levels not seen since the early 1980's, further suppressing demand.

"We're in a matzo economy," said Stuart Hoffman of PNC, speaking at the March 10 Grubb & Ellis forecast breakfast. "The ingredients for a recovery – low energy prices, fiscal stimulus, more stable home prices, and improved credit arteries – are in the recipe. What's missing is the yeast, an improved consumer psyche."

Hoffman's presentation didn't overlook the fundamental weaknesses in the economy, nor did he ignore the difficult period of adjustment to come as businesses worked their way through the recession. But Hoffman also emphasized that one component needed for a real solution was consumer and business confidence, something that has been missing since what he termed the "financial anxiety attack" of late 2008.

The only real solution for the slowdown in commercial construction nationally is a rebalancing of supply and demand. That's a technical way of saying that there will have to be less construction this year. As the mid-year of 2009 approaches, the main hope for a contracting boost lies with the government spending that will come from the American Recovery and Reinvestment Act (ARRA). While non-residential rebalances, the tipping point of recovery remains the much-hoped-for rebound of housing prices that will trigger consumer confidence. And the news on that front is still mixed.

The delinquency rate for mortgage loans on one-to-four-unit residential properties rose to a seasonally adjusted rate of 7.88 percent of all loans outstanding as of the end of the fourth quarter of 2008, up 89 basis points from the third quarter of 2008, and up 206 basis points from one year ago, according to the Mortgage Bankers Association's (MBA) National Delinquency Survey.

Subprime ARM loans and prime ARM loans, which include Alt-A and pay option ARMs, continue to dominate the delinquency numbers. Nationwide, 48 percent of subprime ARMs were at least one payment past due and in Florida over 60 percent of subprime ARMs were at least one payment past due. The impact of these riskier mortgages is on the wane, however, as the resets for the last of these products will run out by mid-2009, noted Jay Brinkmann, MBA's Chief Economist and Senior Vice President for Research and Economics.

“The delinquency rates continue to climb across the board for prime fixed-rate and subprime fixed-rate loans, loans whose performance is driven by the loss of jobs or income rather than changes in payments,” said Brinkmann.

While the lingering effects of the recession while likely cause the delinquency rate to climb higher, there is the growing realization that the subprime resets were far less of a problem than was expected, with overall mortgage performance remaining higher than the valuation of most of the mortgage-backed securities (MBS).

This imbalance between the MBS books value and the actual performance of the underlying assets, the mortgages, is creating opportunities for entrepreneurial investors with cash. Private wealth manager BNY/Mellon reports increasing approaches by private equity firms looking for buyers of new products based on distressed assets. Former Wall Street workout executives are forming new funds aimed at buying marked-down assets from troubled financial institutions, and holding them long enough for the loan performance to significantly increase the value.

For the short term, however, not much movement has been made towards identifying what the market thinks will be a safe value at which to buy the MBS inventory that banks have been shelving for almost a year now. While most of the devaluation has been with residential properties, the uncertainty is freezing the commercial market as well, keeping what might be $150 to $200 billion in financing on the sidelines.

What will be required to see an eventual return of mortgage securitization is an end to the decline in housing prices. To that end the data from the first quarter is both good and bad (which is a constant refrain of this point in the recession).

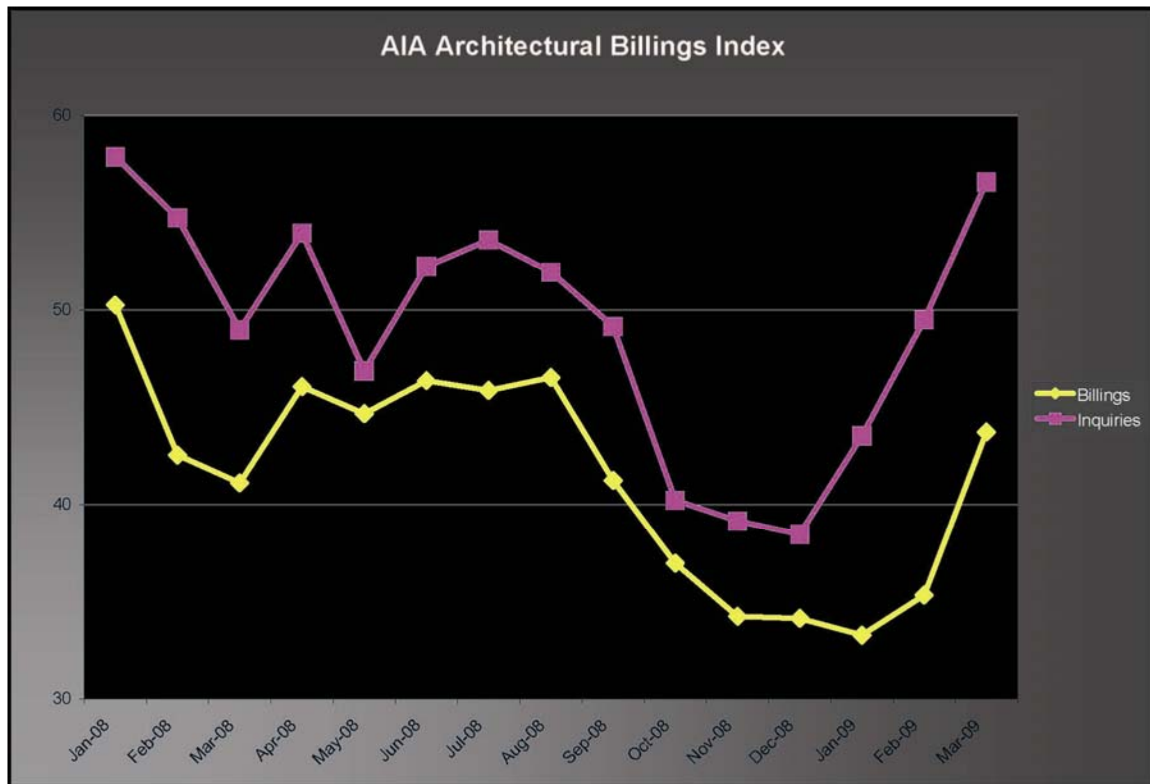
March housing start data showed a reversal from the surprisingly good February numbers, with starts dipping to a 50-year low 510,000 annual rate, and permits to 513,000 units, a decline of 11% and 9% respectively from the previous month. Median home prices fell to $165,400, a decline of 15.5% from the same time in 2008.

These are gloomy numbers but economists are seeing them as a precursor to the proper conditions for a housing recovery. The new housing starts are roughly one-third the annual household formation rate, and mean that the builders aren’t adding to the inventory. The falling median price, while adding to the adjustable mortgage problems, means that affordability is climbing to higher levels. The increased affordability is especially critical because it is reopening the housing market to more first-time buyers who were previously locked at record high price levels. For the short term, declining inventories and better affordability will be offset by rising unemployment, but the conditions will be set for a sustainable housing recovery in 2010.

Data for non-residential construction in the first quarter reflects the progression of the downturn into all sectors of development. Reed Construction Data reported an 18% decline in square footage of construction compared to 2008. On a contracting value basis, education construction was flat year-over-year, but retail construction decline 16%, hospitals fell 1% and offices dropped by 25%.

New York-based real estate researcher, Reis Inc. reported that vacancy rates climbed a full percentage point in the first quarter to 7.2%, while retail vacancy rose to 9.1% and office vacancies jumped from 14.5% to 15.2%.

McGraw Hill Construction released a Spring 2009 Outlook Update on April 2 that forecasts an increase in public works construction from the ARRA investment, but forecasted a steeper decline in institutional construction, down 6%, and commercial construction (which includes offices, retail, warehousing and hotels), which McGraw Hill is expecting to decline by 27% in 2009.



One bright spot for non-residential construction was an uptick in the AIA Architectural Billings Index (ABI). The survey, which asks AIA firms to report their billings for the month compared to the previous month (50 = no change), saw an increase to 35 in February, with a more pronounced increase in the number of inquiries, to 49. The ABI is limited statistically, but has a history of accuracy as a lead indicator. If the pattern of increased inquiries continues, there is a good chance that increased construction opportunities will show up in contractor’s offices at year-end.

Image
(march ABI) Source, AIArchitect