Does sequestration really matter?

Effects on the U.S. economy and commercial real estate markets

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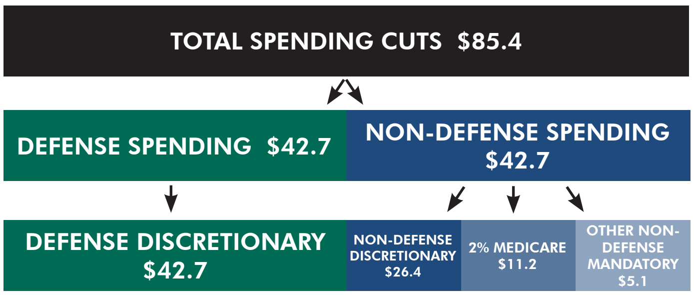
HIGHLIGHTS:

- The effects from sequestration will not be draconian. Total federal spending will continue to grow at a slower rate, but not decrease. Compared to a 7.2% average annual growth rate over the past 40 years, total federal spending should increase by 6.7% annually, on average, over the next decade.
- Sequestration will take some time to reach the market. Most of the automatic budget cuts will be borne by contractors over a period of time – not immediately. Federal government contracts that are subject to annual or periodic appropriations are most at risk of cutbacks.
- The largest impact from sequestration is added uncertainty surrounding which federal programs will be cut. This uncertainty is factoring into tenants' leasing decisions. Both public and private sector tenants are mitigating lease liabilities by renewing in place for shorter lease terms.
- Despite sequestration, the General Services Administration's (GSA's) leased real estate portfolio continues to grow at a national level.

On March 1, 2013, sequestration officially arrived, although fear of sequestration started well over a year ago. Concerns over federal government spending cuts started when the congressional "super committee" failed to reach consensus by December 31, 2011. The failure triggered automatic federal budget cuts, known as sequestration. Details on budget reductions have been unclear, driving uncertainty into the economy and commercial real estate markets. Adding to the uncertainty, the U.S. faced various political and fiscal events in 2012 such as the debt ceiling debate, the so-called fiscal cliff, national elections, a debt downgrade, the near shutdown of the Federal Government, the eurozone crisis and a slowdown in China.

To address a ballooning federal deficit, the U.S. Congress ratified the Budget Control Act (BCA) of 2011. The BCA included a sequestration provision to reduce the deficit by almost $1 trillion over the next decade. The first half of these automatic spending cuts is allocated to discretionary defense spending such as construction and aircraft manufacturing. The second half includes non-defense discretionary programs—such as disaster relief and special education programs—and some mandatory programs containing the unemployment trust fund and Medicare provider payments. It is important to note that large entitlement programs—such as Medicaid, Social Security, and food stamps (SNAP)—are excluded from the automatic cuts.

Figure 1: Estimates for 2013 Automatic Spending Cuts (in $ billions)



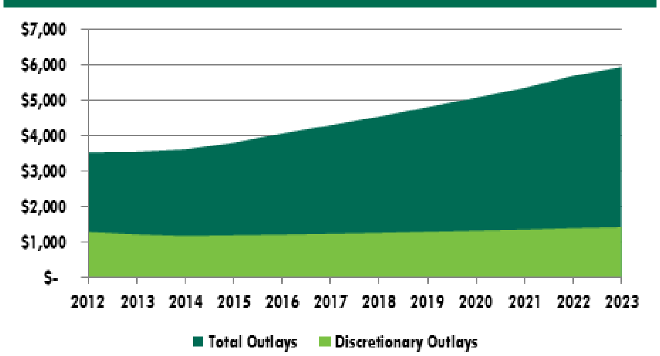
Source: CBO, Q1 2013.

In 2013, $85 billion in automatic cuts will occur in federal spending, while an estimated $109 billion in annual reductions are scheduled for each year from 2014 to 2023. The precise cuts to federal budget line items are difficult to determine. The BCA established the total dollar amounts for budget cuts, but the Office of Management and Budget (OMB) has the ultimate authority to implement the automatic cuts. The total impact of budget cuts will not be felt immediately, but over a period of time. Currently funded programs are expected to be carried out. However, programs that are subject to annual or periodic appropriations by the U.S. Congress, such as weapons programs, are at risk.

OVERALL, SEQUESTRATION WILL HAVE A LIMITED IMPACT ON TOTAL FEDERAL SPENDING.

The majority of federal spending occurs in mandatory programs, accounting for 57% of total outlays, which are generally exempt from sequestration. In fact, most of the automatic budget cuts are concentrated in discretionary programs, which account for a small portion of federal outlays. Consequently, total federal spending will continue to grow at a slower rate, but not decrease. Compared to a 7.2% average annual growth rate over the past 40 years, total federal spending should increase by 6.7% annually, on average, over the next decade.

Figure 2: Federal spending continues to increase: CBO Baseline Budget (in $ billions)



Source: CBO, Q1 2013.

REDUCTIONS IN FEDERAL SPENDING WILL SLOW ECONOMIC GROWTH IN 2013.

Federal spending accounts for 19% of the U.S. Gross Domestic Product (GDP). A decline in federal spending can severely impact economic growth. For example, a 22% drop in defense spending during Q4 2012 weakened GDP growth by 1.3 percentage points. Further federal spending cuts will create headwinds to economic expansion. The Congressional Budget Office (CBO) forecasts 2013 GDP growth at 1.4%.[i] If sequestration had not occurred, GDP would increase by an estimated 0.5 to 0.7 percentage points higher.[ii] The D.C. Metro will experience large federal budget cuts that will slow economic growth. Moody's forecasts Washington, D.C.'s Gross Metro Product to increase 1.8% in 2013, compared to the 2.4% average annual growth rate recorded over the past decade.

Cuts in federal spending will no doubt slow employment growth. Estimates show that the U.S. will employ 1% fewer workers in 2014 than it otherwise would without sequestration, and employment losses will disproportionately impact the construction, scientific research, and engineering fields.[iii] In 2014, the largest number of job losses are projected to occur in California (212,000 jobs), Texas (154,000), and Florida (102,000), although the largest percentage of the workforce affected will be in the District of Columbia (-3.0% total payrolls lost), Maryland (-1.8%) and Virginia (-1.7%). In 2013, Moody's estimates that the D.C. Metro will add only 16,700 non-farm payrolls, significantly down from its 20-year historical average of 34,000 jobs added annually. Slower job growth, government furloughs and reduced federal salaries could restrain consumer spending and impact businesses such as restaurants and local retailers.

DEFENSE CONTRACTORS ARE THE MOST SUSCEPTIBLE TO CUTS.

Due to the large proportion of automatic budget cuts planned for the Pentagon, defense contractors will be highly affected. Metropolitan areas with high levels of defense contracting—such as Washington, D.C., Los Angeles, Seattle, St. Louis and Norfolk—will feel the greatest impact from these cuts.

A CONTRACTOR'S SIZE AND ITS DIVERSITY OF BUSINESSES WILL DETERMINE HOW IT CAN BEST WEATHER THE STORM.

Contractors with a large portion of private sector business may be able to absorb the impact of budget cuts. Large contractors who support numerous federal programs are somewhat shielded, should a few of their contracts be cancelled. Small contractors who rely on a few contracts are at risk. To mitigate risk, both large and small contractors have consolidated real estate requirements or decreased space utilization rates in their real estate portfolios over the past year or so.

Despite numerous roadblocks, the General Services Administration (GSA) is still signing leases. Over the past year, the GSA has faced the threat of sequestration, a transition to new GSA leadership, the President's "no net new leasing" directive and battles with the U.S. Congress on utilization rates. As a result, the GSA is executing a limited number of new leases. Instead, the GSA is signing renewals and extensions for existing space. Leases with previously allocated funds are still being executed.

It is also interesting to note that the total square footage of the GSA's leased real estate portfolio across the U.S. has increased—not decreased—by 5 million sq. ft. since July 2011. However, some of this growth can be attributed to moves from government-owned buildings into leased space such as a 1.2 million-sq.-ft. lease executed in Kansas City.

Despite looming sequestration, the nation's capital has experienced a negligible reduction in leased space by the GSA over the past year. The GSA reduced its 57.4 million-sq.-ft. portfolio of leased space in the National Capital Region by only 200,000 sq. ft. from January 2012 to January 2013. Moving forward, the GSA will continue to feel pressure to right-size its portfolio and find ways to reduce costs.

Figure 3: Preliminary estimates of several sequesterable programs affected in FY'13 (in $billions)

Navy, Army, Air Force aircraft procurement	$5.1
DoD Operations & Maintenance	$3.9
Defense Health Program	$3.3
National Institutes of Health discretionary programs	$2.5
Navy shipbuilding	$2.1
Special education	$1.0
Children & Family Services programs	$0.8
Department of Energy weapons activities	$0.7
Customs & Border Protection	$0.7
FEMA Disaster Relief	$0.6
Supplemental Nutrition Program (WIC)	$0.5
Centers for Disease Control & Prevention	$0.5
National Science Foundation research	$0.5
Military construction, defense-wide	$0.4
Aviation security	$0.4

Note: estimates were made before the sequestration deadline was delayed from 1/2/13 to 3/1/13.

Source: OMB, Q3 2012.

SEQUESTRATION IS NOT ALL BAD FOR COMMERCIAL REAL ESTATE.

There are opportunities for both tenants and landlords. Federal budget cutbacks have slowed employment growth and commercial real estate absorption in markets such as downtown Washington, D.C., Northern Virginia, Suburban Maryland and certain Los Angeles submarkets. Tenants in these submarkets should carefully review their real estate portfolios to take advantage of favorable market conditions. In submarkets with high vacancy rates, tenants may negotiate advantageous rental rates and concessions. Tenants may also acquire newer, more efficient, or better-located space at competitive rental rates as they right-size and consolidate their real estate portfolios.

Uncertainty surrounding sequestration has resulted in short-term lease commitments and a higher probability of renewing by federal contractors and the GSA.

Both of these trends favor building owners. Owners can continue to keep their tenancy in place and rationalize short-term commitments based on the small capital costs of renewal transactions. Additionally, landlords should make strategic decisions about when to use their increased renewal leverage to their advantage. In many cases, rental rate increases and low concessions on renewals are possible when the threat of tenant relocation is minimal.

On the other hand, building owners faced with short-term leases may be poorly positioned if they are trying to refinance. Commercial lenders such as banks, life insurance companies and pension funds will not refinance loans on commercial properties with short-term leases in place.

Both tenants and landlords should plan ahead and pay close attention to lease expirations. It is important to know whether the tenant will be impacted by sequestration and if the lease could be in jeopardy as agencies and contractors downsize or consolidate. If a renewal lease is signed, it is paramount to document any administrative changes including planned rental rate and operating cost adjustments.

SEQUESTRATION IS NOT THE END OF THE STORY, JUST A PIECE OF THE PUZZLE.

Now that sequestration has arrived, there are other fiscal issues to consider that will also impact the economy and commercial real estate markets. At the end of March 2013, the federal government's continuing resolution (temporary budget) expires. If a budget agreement is not reached, the Federal Government could shut down. The last federal government shutdown in 1995 and 1996 resulted in federal workers being furloughed and a suspension of non-essential services. In April 2013, the U.S. Congress must pass a budget plan according to U.S. law. Debate surrounding tax and spending priorities may create further turmoil and uncertainty. In May 2013, the U.S. will once again hit the federal debt ceiling. All of these events will cause landlords, tenants and investors to remain cautious as the drama in Washington, D.C., continues to unfold.

i. CBO, The Budget & Economic Outlook: Fiscal Years 2013 to 2023, February 2013.

ii. CBO & Bipartisan Policy Center.

iii. Third Way & Regional Economic Models Inc., February 2013.

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