

## Tomorrow? The sun will come out for commercial real estate, but it's more than a day away

Excerpt from CIRE Magazine, July / August 2009 by Anthony M. Graziano, CRE, FRICS, MAI

This midyear commercial update comes at an inflection point in our economic cycle. Commercial real estate's economic strength is a byproduct of the country's general economic health. The reality - that this economic contagion has gone global - makes for even less reassurance that foreign capital might quickly offset the domestic pain of our massive deleveraging efforts. Accordingly, it is fairly difficult to uncover the silver linings in the storm clouds hovering over our collective uncertainty.

Last year's outlook (See "Making Sense of the Market," CIRE, July/August 2008) predicted commercial real estate value declines of 10 percent to 20 percent by the end of 2008 across all asset classes, primarily as a function of the rising cost of debt. Given the current trickle of debt capital and the rising cost of perceived economic risk, commercial real estate values are continuing along this arc of value decline as capitalization rates head for the double digits for the first time in more than a decade.

### Rays of Hope

So where are the silver linings? The first glimmer comes from the housing market. As a primary economic driver in nearly every market nationwide, the housing sector's performance signals three fundamental underpinnings of economic health: job creation/stability of construction trades, general employment stability, and consumer confidence. In an Integra Realty Resources survey of nearly 100 commercial real estate analysts in 58 markets nationwide, 93 percent of respondents indicated their local housing markets are nearing the probable bottom. Philadelphia, Dallas-Fort Worth, and Tulsa, Okla., were noted as just beginning to see residential price declines. Those continuing in decline without a bottom include Portland, Ore., Atlanta, Boise, Idaho, and Los Angeles. Nashville, Tenn., and Pittsburgh have bottomed out and price stability is evident there.

The National Association of Realtors and the National Association of

Homebuilders both issued moderately upbeat reports in 1Q09, indicating an upswing in overall transaction volume. Assuming another 12 to 18 months of sub-6 percent home mortgage interest rates, with or without federal first-time home buyer stimulus, the housing market appears on track to reach equilibrium by early 2010 in most markets. Almost every market is reporting improved volume and even some price pressure in the segment below the local median. Continued price corrections are most evident in the move-up and custom high-end segments.

The second flicker of positive news is that the commercial real estate ask versus bid price disconnect is fairly over in most markets. Sellers have conceded that the current investment environment is more than just challenged; it is capital impaired on both the equity and debt sides. In many markets, sellers' asking prices and investment rates are being quoted on in-place income instead of pro forma assumptions. Analysts also noted stabilized cap rates higher than 10 percent for the first time in well over a decade, signaling sellers' intent to recognize lease-up and income risk.

Lastly, sellers are aware they are racing against time before they are forced to compete with liquidation prices from bank portfolios as the delinquency rate on commercial mortgages doubled by 1Q09. The counterpoint to sellers finally coming to their senses on asking prices is that buyers are quickly transforming into vultures looking to feast upon only the weakest sellers.

### Best Bets for This Year

What asset classes and markets will fare well through year-end? Setting aside the basic commercial real estate food groups for a moment, Integra analysts ranked 10 specific property types. Consistently ranked highest nationwide were **student housing, medical office, and assisted living/seniors housing**. Naturally, investors must consider local conditions, but each of these subsectors rests on some fundamentally solid trends.

**Student Housing.** With a weakened job market, students will be extending their stay for post-graduate education. Universities and colleges historically have been underbuilt to accommodate existing school populations in dormitory housing, and continued government emphasis to save construction jobs probably supports funding to keep these projects moving in a slowing construction environment.

**Medical Office.** Hospital systems are struggling, consolidating services, and limiting new major facility construction. More importantly, significant changes in technology are allowing medical professionals to establish remote or secondary outpatient facilities for many major conditions that, until the last 20 years, were the exclusive domain of medical centers. And, of course, the baby-boom demographic is aging into its sixties, which will drive the demand curve for medical facilities in the coming two decades.

**Assisted Living/Seniors Housing.** This industry rocketed to prominence 20 years too early and has evolved into a very specialized niche that already has suffered an oversupply and contraction phase. However, every subsequent generation is less likely to have children living locally to assist in their elderly care. Combining significant increases in personal longevity, long-term health insurance contracts, and improved program planning and pricing, this asset class is here to grow.

Other classes that received mixed responses include self storage, mobile home parks, marinas, small commercial, mixed-use, and net-leased properties. Notably, lifestyle retail was rated a poor investment by the majority of respondents given the current economic outlook for retailers in this environment. The asset class also has been overbuilt in some markets, or saturated by collateral competition such as outlet stores.

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### Asset Class Overview

A look at commercial real estate's major asset classes and the markets to explore follows. The markets indicated for investigation are those that are classified as active - markets where deals are happening, although many at discounts to replacement cost because of uncertainty about the future. The geographic market rankings are reflective of market commentary with respect to fundamentals impacting the stability or future outlook for the specific market.

**Industrial.** Direct investors should concentrate on markets with core manufacturing industries that will lead the U.S. out of recession. Government incentives will favor these industries first instead of warehousing locations. Job growth is the government's No. 1 call to action, and warehousing does not contribute to job growth. Corporate sale-leasebacks on industrial assets to shore up company balance sheets most likely will be this year's best-received investment opportunity. Otherwise, buy well-managed, transparent industrial real estate investment trust shares and hang in there. *Markets to investigate: Memphis, Tenn., South Florida, Dallas-Fort Worth, Pittsburgh, Chicago, Tulsa, Okla., Washington, D.C., Indianapolis, Tampa, Fla., and Los Angeles.*

**Retail.** It's easy to say retail is doomed for the rest of the year. But consumer spending's dramatic free fall since 2007 doesn't take into account the massive price reductions of necessary disposables such as gasoline and food in the past 18 months. Shopping centers will be cheap in 2009 and 2010, and investments will be based on trailing actual income, not pro forma projections. But a shopping center's location cannot be replicated, so if the asset is a good core location locally, it's time to buy. Consumers may not return immediately to past levels of spending, but U.S. consumers can't go four years without something new. Major durable purchases will return by 2010-2011, including automobiles. The only question is what tenants are in a position to survive the unknown for that long. *Markets to investigate: Houston, South Florida, Kansas City, Mo., Boise, Idaho, southern Indiana-Kentucky, and Tampa.*

**Office.** Many analysts look at the current rising unemployment rates and ponder the death of the office market entirely. This is a savvy investor's advantage. First, the primary driver of this recession has been in banking and loss of retail sales. So by extension, the largest employment losses have been

in banking (and collateral sectors) and retail sales staff (including restaurants). The general office market has been level for a long time and rents have traded far below replacement cost, so it is hard to envision this asset type being punished much further on price/value. Sure, branch banks are doomed in the short term, as are large urban office buildings that lease to financial services companies. But the same economic issues that have held office back for the past decade (employment growth in home and remote businesses, entrepreneurship, and sales forces not requiring offices) are the same factors that lead to the conclusion that most office buildings don't have much further to slide. In 2009 and 2010, investors should seek class A buildings with high vacancy and poach tenants from class B space, or purchase class B buildings with undermarket rents. Investors will shy away from office condos being sold at replacement cost, and C buildings larger than 20,000 square feet should be balanced against land value. *Markets to investigate: Chicago, Miami, Pittsburgh, Washington, D.C., Tampa, Indianapolis, Sacramento, Calif., and Phoenix.*

### All That Glitters...

Overall, one major trend is worth noting. Lifestyle locations such as Miami, Las Vegas, and Southern California are all struggling to find the bottom. Smaller, less visible cities didn't see the run-up in prices because investors never flooded those markets with excess speculation. These are the markets likely to experience a slow and steady investment arc in the short term. Indianapolis, Pittsburgh, Nashville, and Kansas City don't top the list of destination cities, but the stability of their economic base makes them safer investments in a volatile environment.

Some investors have a high tolerance for volatility. In such cases, those who also have a high percentage of cash might find good, even great deals in struggling lifestyle cities. Other investors tend to stay local or regional, with a lesser appetite for carrying costs and leasing risk. These investors should investigate the nearest "steady" secondary or tertiary market with strong economic fundamentals.

### Outlook Through Year-End

The paralysis that stymied the commercial markets midyear 2008 continues into the 2009. The biggest impact on current investor inertia is the inability to price assets on a cash basis because cash buyers either tap their investment

portfolios to raise cash, raise cash in equity markets through REITs or private investment funds, or refinance existing assets to monetize realty. Selling stocks to raise cash today is foolhardy, issuing stocks to raise cash today is difficult, and refinancing existing assets is daunting.

Many of the cash buyers in today's pipeline refinanced or sold their stocks prior to 3Q08. They know they have a fixed amount of cash to work with, and the future well of cash will be dry for the balance of 2009. The depth of the investor pool is unknown, but informal data suggests there is significant equity on the sidelines waiting for the banks to bring the non-performing assets to market.

The commercial markets will remain unsteady into 2010, but there will be no universal bottom. There will be good investments, great investments, and no investments. But stability should return by 3Q10 favoring the investors with a low basis who made a safe bet on future inflation.

Above all, investors should remain confident that real estate will deliver the three inherent benefits that make it part of any diversification strategy. One, unless you are over-leveraged, real estate never goes to zero. Two, the current ballooning deficit and debt will require a return to much greater inflation than we've experienced in the past 15 years. And finally, fixed real estate assets purchased during an economic downturn with higher-than-stabilized vacancy almost always outperform stock and bond gains on a tax-adjusted basis.

### Investment Market Prospects National markets with positive demand (Texas)

**Austin, Texas** - Retail, leisure, and hospitality are all up in 2009; Texas still strong

**Dallas-Fort Worth** - Energy, healthcare, and infrastructure expansion holding steady

**Houston** - Energy and high-tech expected to benefit from inflation; strong U.S. healthcare industry

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