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After the real estate crash - Catching a cyclical opportunity or catching a falling knife

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The title of this article is the same as the real estate part of a private wealth symposium taking place in Rhode Island on July 22, 2010. There is a lot of smart money on the sideline trying to determine if this is a good time to jump into the market or if it is wise to stay on the sidelines.

In this article I will try to quantify economic factors, outline history from the 1990- 1992 recession and end with a two-part answer.

Economic Factors

Employment is the driver to which real estate is attached. Raymond Torto, CBRE's global chief economist predicts that all jobs lost in Massachusetts during the Great Recession will be recaptured by mid-2013Â± three years hence. NEEP predicts that it will take until 2015 to reach within 30,000 jobs of where we were prior to the 2001- 2003 "dot.com" recession.

As we look up today, for office space we have in the Greater Boston area an availability of 40.3 million s/f that is 20.2% of a 198.3 million s/f market. The largest availability is in the suburbs at 23.3%.

In terms of positive office absorption, the only areas of any size are Cambridge and Back Bay and potentially mid-Rte. 128.

Clearly, in the loose money period of the first eight years of the 21st Century, Boston overbuilt its market.

History from the 1990-1992 Recession

The fairy tale story of the 1990s was Wang Tower's February 15, 1994 auction for $525,000 or $0.25 per s/f for this 1.3 million s/f office complex at the bottom of the market.

Our spring 1993 Bottom Line report showed 16.08% availability at about time of sale and a 136 million s/f market. By the end of 1999, the office market had grown to 163.4 million s/f and availability was down to 8.7%. Wang Towers caught the curve and resold for over $100 million.

This time around, we will have to wait until 2015 just for the office market to reach 8.7% availability under the assumption that no new office space is built. Between spring 1993 and year-end 1999, we added 27.3 million s/f of space and absorbed 35 million s/f. We were in a growth, not recovery cycle.

Cyclical Opportunity

The cyclical opportunity rests with the properties strongly leased to major credit with leases in place to reach out to 2020. Three prominent sales have taken place. These are:

* One Brigham Circle - 6.36% capitalization rate
* 10 Brookline Place - 7.13% capitalization rate
* IBM - Littleton - 7.30% capitalization rate

With cash commanding a 0.1% return and treasury rates in the 3%'s, all cash returns at 6.36% to 7.30% are attractive.

My partner, Dave Pergola Sr., uses the term: "Is it a BMW or is it a beaten up old Taurus?" It is the BMWs with a 10-year lease warranty attached that is the cyclical opportunity. The concept is to reach out beyond the 2015-2017 hurdles that the balance of the real estate industry will face.

The Falling Knife

The problem is that so much of the industry contains "beaten up old Taurus". These are not prime high-rise towers like the Prudential complex in which I sit where there is a new long term Ropes & Gray lease. This is not the repositioned John Hancock Tower or its equivalencies. This is not the lab market in East Cambridge or mid-Rte. 128.

The falling knife represents property that requires carry of vacant space, repositioning, large tenant improvements and a substantial leasing and capital cost.

A lot of falling knife space exists. The private wealth market must be careful on its tap into this product on the turnaround. Private wealth money is mostly second or third generation money. The money is managed by a family office. They are not the true real estate developer who knows how to buy property at cents on the dollar, reposition and sell when the market recovers. There will be few if any Wang Tower with 500% profits on the turn.

Conclusion

The falling knife will continue to plague commercial real estate for another three to four years as markets recover. Foreclosures will continue.

For the very capable, there will be opportunities. The Davis Companies' purchase of One and Three Burlington Woods is a prime example. The acquisition price for this 267,829 s/f complex was $122 per s/f or 50% of what it sold for at the market peak.

For every transaction such as the Davis purchase, there are those on the other side in great pain. The problem is the clouds over all our heads.

The two hundred pound mushroom mooring is the Federal Government, rising taxation at all levels, and a penchant to not leave private enterprise alone.

It is private enterprise that can and will ride through the next five years to dull the falling knife and create opportunities, all be it at lower levels of economic return, than of that in the past.

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