

Private-sector needs to create jobs; we need to get people earning a paycheck and paying taxes

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We are asked every day "are you busy?" The answer is yes, but currently it is mostly advisory/consulting work. The transactional side is quiet. That is not to say no one is leasing or buying, but activity is way down from 2007/early 2008 levels. And it should be! Deals done in those years were way over the top. Here are some examples.

Pity those who bought dirt (sites) in 2006, did their design and permitting in 2007 and built in 2008. Pre-manufactured steel frame buildings were being built for \$100-\$125 per s/f. Today, you can build that building for \$58 per s/f. Investment capital was awash, lenders wanted to lend, appraisers extrapolated five years of recent/escalating sales, interest rates were historically low, business was good, what could go wrong?

Well, for starters there is this long-lived thing called the real estate cycle. At the risk of being overly concise, it goes like this. The economy is growing, people are hiring, more jobs mean more space. Existing buildings begin to fill up. Vacancy rates drop so it is time to build. Alas, this engine gets fueled up and before you know it we have overbuilt for many reasons, but the lag between demand and actually completing a building after design, approvals, permits, and construction can be 2-4 years. Regardless, when we experience a strong and extended up cycle the overbuild can be significant. This manifests itself in two ways. First, more square footage is built than there are consumers, buyers or tenants to occupy it. But secondly, people tend to build above their means, especially when the capital spigot is wide open. Result? Buildings built for \$125 per s/f in 2006 are worth \$70-\$80 per s/f in 2010. A small amount of this is manageable, but like housing, the hundred home builders in southern New Hampshire don't always talk to one another and before you know it now we have 50 homes under construction in one town and there are no buyers.

I spent time in the past couple weeks with some home builders. Their lenders now have their 2009 tax returns. Sales in 2008 = \$6 million. Sales in 2009 = \$3 million, whoa we better trim their line of credit, we better appraise their inventory, we need to protect ourselves. But when the up cycle suddenly stops, the down cycle begins and as Newton told us, what goes up will come down.

So for those of us who have worked in the commercial real estate sector for more than a decade, this current downturn is no surprise. But the depth, severity and duration is not yet known. I recently met with three home builders, each of whom had 10 to 15 house lots approved and ready to go in one town. In the hay days of 2006, 2007 and early 2008 they were each selling a dozen homes per year. But sitting here in 2010, how many new homes will sell in this town in 2011? 2012? 2013? So what are those lots really worth? Well, if my 15 lots will be the first to sell, say in the next three years, they are worth X. But if Jim and Joe's lots sell first, my lots may be only salable 9 to 10 years from now, they will be worth less than X. How much less? $\frac{3}{4} X$? $\frac{1}{2} X$? $\frac{1}{4} X$? Now if you estimate these particular lots are worth $\frac{1}{2} X$, but you owe $\frac{3}{4} X$, what do you do? Well, if you are thinking we

will rebound soon, you may choose to hold on and wait it out. But if you are overleveraged, are being squeezed by your lender, and think the rebound may be four, five or six years out, your calculus may lead you to cut your losses. If one, two or three home builders are facing this situation, it is painful for them, but not impacting the rest of us. If 10, 15, or 20 home builders are feeling this, then the impact ripples throughout the local economy.

Like it or not, ultimately it comes back to job creation and when that is not happening, then it is hard to stay positive. The Feds are running out of bullets. With interest rates still essentially at zero, there is no fiscal stimulus left. The spending side stimulus has sputtered and the deficits are scaring the daylights out of people. What to do? Well, John Maynard Keynes may roll over in his grave, but government does not create jobs. It takes private-sector businesses and individuals paying taxes to support government employees. To incentivize the private sector we typically turn to tax cuts, but holy smokes, we spent an extra trillion dollars we didn't have last year, so how can we possibly cut taxes? This isn't working. The bottom-line is we really need to cut public spending because we don't have the money. With unemployment added to under employment and adding back in the "discouraged workers" today's real unemployment is 16-18%. Why don't we get those folks back to work, earning a paycheck and paying taxes. A little known fact: regardless of where tax rates have been set in the past, tax revenues have never strayed far from 20% of GDP. To get a bigger numerator, we need to build a bigger denominator. Selfishly, from the commercial real estate sector, jobs fill buildings.

Keep in mind if income taxes to pay for government services are 20% of GDP, if healthcare is approaching another 20% of GDP, if retirement, Medicare and Social Security are 15% of GDP, wow there is not much GDP left to go around. Plenty of food for thought as we enjoy the waning days of August and get ready to "go back to work" after Labor Day. Oh, is there a mid-term election this fall?

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