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## Moody's says commercial real estate prices are stabilizing at 2000-2002 levels

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Monthly a copy of Commercial Property Executive arrives in the mail. The January issue's Economist's View column was titled "Economic Ambivalence". Consider these two thoughts: "On one hand, economic activity as measured by the gross domestic product is growing. In addition, international trade has been rising, productivity has been advancing and corporate profits have been reaching new heights."

So far so good, but then George Ratiu, the writer continues "On the other hand, the level of first time unemployment insurance claims has remained stubbornly high, pegging the unemployment rate above 9% for the entire year. Moreover, with the housing market still looking for its way to recovery, consumer confidence has been low." Ratiu goes on, "The same degree of ambivalence has also marked the commercial real estate markets. On the fundamentals side, demand for space has been in negative territory for the third consecutive year, supply has been very limited and rents have declined. Meanwhile, on the investment side, the pace of sales increased throughout the year, accompanied by lower cap rates and higher prices, signaling renewed investor interest. However, [here he goes again!] with credit availability still extremely tight, the markets experienced a bifurcation, whereby larger properties in stronger markets are attracting investor interest. At the same time, smaller properties in slower markets continue to display signs of distress."

Alas, as I sit here listening to the wind whip around our fourth snow storm of the month, I look out at one of those "slower markets" with "smaller properties." But this market area has been good to me over the past 30+ years. And hopefully it will be again. We at Norton Asset Management, saw an 18% drop in brokerage revenues in 2010, thankfully offset by a 24% increase in advisory and consulting revenues. We much prefer to be on the tenant rep side than the landlord side these days. But given the small size and thinness of the local market, we have to serve both masters, as there simply is not enough tenant activity to support all of the qualified brokers and brokerages seeking to service them.

One good sign is that CMBS (Commercial Mortgage Backed Securities) seem not to have dried up and blown away. In fact, while one presenter at last fall's CRE conference in Philadelphia stated that only \$10 billion in deals were re-financed through CMBS in 2010 and likely only \$34 billion would likely be refinanced in 2011, globest.com reported today that 2010 had \$11.6 billion and that 2011 would likely top \$50 billion. That is good because traditional commercial bank financing is available but at much more "normal" terms (such as 70% LTV, conservative appraisals, 1.25 or higher debt coverage ratios etc.). Again Paul Bubny in globest.com stated, "In the current environment, we're seeing much more thoroughly underwritten deals and much more caution in terms of what loans are being made. Sure, there's competition to make loans, because you're still competing with insurance companies and banks. But it's nowhere near as frothy as it was at the peak."

Office lags in the eyes of lenders because it is tied to employment (which is still soft). Multi-family is the strongest of the commercial real estate sectors, while retail and hotels are spotty. So as Ratiu stated stronger markets are doing (selling and/or financing) bigger properties, while slower markets are not attracting CMBS or other sources of national capital, thus they are dependent on the commercial banks.

Forbes Magazine had a section on commercial/investment real estate in its Feb. 14th issue. Sam Zell alluded to his next play in international markets, particularly Brazil. Not having multiple billions and a private jet to get us in the field for research, that is not an option for most of us! But there is activity right here at home in the good old USA. A subsequent article by editor William Baldwin sees people buying buildings for cash ("there's good money to be made in commercial real estate, if you keep leverage modest and shop for unsexy properties").

Consider the following: First, leverage increases the risk of a capital call (such as when your tenant moves out.....). Second, debt costs money. Does it make sense to be part of a property syndicate that's paying 6% to borrow capital when elsewhere you are lending it out to a bank that's paying you 1% on a certificate of deposit? Third, debt can neutralize one of real estate ownership's biggest advantages - depreciation write-offs. Thus, Baldwin concludes, "low leverage solves a lot of problems".

There are deals out there; Moody's says commercial real estate prices are stabilizing at 2000 -2002 levels. But you need to focus on fundamentals.

Buy low! Have a long-term credit worth tenant. Do not over-leverage. Have cash reserves for repairs and replacements or re-tenanting the property if you suddenly find yourself with a vacancy. Pick good markets that you know. In this regard, look at city and state government finances. If either or both file Chapter 9, it leads to a downward death spiral (to wit - Detroit). So is it a good time to buy commercial real estate? Yes, if you do your homework, bring sufficient cash, and are satisfied with an 8-10% return.

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