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## **New England preview for commercial real estate: The economy is slowing, but not (yet) stalled**

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The Counselors of Real Estate met in San Francisco October 27-31. The theme was Taking the Long View. More than 20% of the membership attended. The venue of San Francisco had something to do with that! There are a few themes and topics that are presented at every CRE convention (twice a year). Specifically a look at the national and global economies with special attention to the real estate segments. The current consensus is that the economy is slowing, but not (yet) stalled. One presenter stated that a GDP growth of 1.5% is essentially the same as zero! We are currently somewhere between 2% and 3%. The numbers come out and often are restated/adjusted either up or down over the following months and quarters. The real estate sector moves in cycles. Presenters at this CRE meeting felt the slow down is coming perhaps in 2012. The caveats were many. Energy costs (oil at \$90-\$100/barrel); the weakening dollar; the sub-prime melt down (and just how deep those impacts might be).

So while there are numerous clouds overhead, there is also sufficient momentum in the economy. Most importantly there is far more capital looking to be deployed than there are good opportunities to invest.

In real estate, especially large scale investment properties, there are core deals and value added deals. The former are icon properties, fully leased with strong credit tenants and medium to long lease terms. These investments are essentially "bond" deals or annuities. You invest "X" and you get a reasonably reliable return of "Y." Currently cap rates are quite lean on these types of properties.

The value added deals are the classic "buy low, sell high" opportunities. Here you are buying a property that is not providing an optimum yield. The opportunity here may be leasing up the property; or conversion to another use; conversion to a condo (and subsequent sale); or building additional space on excess land, etc. In a strong real estate market these investments seem to be easier to find, to afford and do. In fact, these deals and rapidly rising values of core assets such as Equity Office Property sale to Blackstone and Blackstone's later sales have yielded values not even thought of 2-3 years ago. The prime argument is that even at these new strong prices, these properties are still significantly below replacement costs.

One session was very instructive. The presenter went back over 70 years comparing long term real estate returns vs. stock and bonds. This analysis showed that over long term periods, both stocks and equities, yielded approximately 10% over a 70 year period! The distinction is that equities are more liquid. So real estate brings liquidity risk while equities bring volatility risk. Of course, in these look back analysis the starting point matters. If one looks at commercial real estate returns from 1993-2003, then the returns are impressive. However, another 10 year look from 1985-1995 with several years of negative returns shows a much lower yield.

So once again the consensus is that commercial real estate is still a stable investment class. Capital

will flow to these investments. Will cap rates rise to the 7%-8% range we think of as the historical average? We really do not know. For the foreseeable future, investors will take lower returns if they feel they are stable. While there is definite level of dissonance in the markets and the general economy, overall these folks feel we will ease into a soft landing 3-5 years out. So for New Hampshire and New England, look for similar activity levels and pricing.

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