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CELEBRATING 55 YEARS

By Bill Norton: Slow economic cycle for commercial real estate allowing communities time to evaluate their futures and look at redevelopment options

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This is my last column for the year. I can honestly say - we will not miss 2011. While we have scratched out a decent year (both revenues and profits were up), it wasn't a lot of fun. Long-time clients wrestled with tough decisions, some just rent concessions but others, deep discounts in sales prices and many had to see further reductions in the value of their commercial properties. For some, that was disappointing but manageable. While for others, it triggered "technical defaults", cash calls and in one case, filing for bankruptcy protection.

All of our clients ask us "What do you see for 2012?" The answer is "more of the same". While we have seen some stability of prices in some sectors, overall vacancies have not improved, tenants of all types are hesitant and concessions abound. However, we have seen, and are seeing, several not-for-profit entities positioning themselves well via the "Buy Low" principle.

One of the benefits of this slow economic cycle for commercial real estate is that it is allowing communities time to evaluate their futures and to look at redevelopment options. The lack of immediate pressure is key to rethinking things. The offset to this is that currently there are few active players and no one willing to take risks in development or redevelopment largely because lenders have turned to traditional (usual and customary) lending standards. Every week or so I am called to a property or project for a consult and my first reactions are: How did this ever get built in the first place? And who loaned money to do this project? We just completed a review of a small commercial project (partially built) with subdivision of two large residential lots. The location was "rural" at best. Regardless, there was a recent appraisal at $700,000+. We were asked to assist the out-of-state owners to identify and select good, active real estate brokers to market the property. After visiting the property, we e-mailed the first bad news -- not going to sell this for $700,000 (or even $600,000). We did solicit broker price opinions and marketing plans. Ugh, they ranged from $420,000 to $549,000 asking prices, but no one has paid asking prices in 3+ years. Next question is what is the debt? Oops - $485,000. Best scenario, sale(s) at $400,000 a year from now, less carrying costs and sales transaction costs......

The above is just one example of mathematical exercises we do every week, albeit this one is on the lower end. When the numbers get bigger, the decisions either become easier or much harder.

The hope has been that things would be getting better by now. The latest job numbers suggest some movement (unemployment officially down to 8.6%), but are subject to interpretations, adjustments, revisions and acknowledgment that most of the "improvement" was due to fewer workers looking for work and/or eligible for continued unemployment benefits more so than more workers returning back to work. More importantly, only one-third of the 8 million jobs lost since 2008 have been created despite massive government deficit spending, massive Fed action ("quantitative easing" and stimuli).

The longer this "Great Recession" goes on the more "structural" it is likely to become. The structural shift applies to commercial real estate as well. If after nearly 3 years I cannot lease my office space (or warehouse, retail space, etc.) should I reposition it as something else? These inquiries can be fun. But alas, even in a slow economy, construction costs for major renovations, which typically trigger full code compliance, are very expensive and current rents, even for alternative uses and tenants, often do not pencil out. There are exceptions, especially where not-for-profits can garner grant monies to "buy down" the project and get the cost basis and operating numbers more aligned with current (and future) market conditions.

Despite all of these ongoing challenges managing and leasing commercial properties, all is not lost. Commercial real estate is a "hard asset" and has intrinsic value in any market. That value may be far less than the hyper-inflated, over-leveraged real estate values of 5 to 10 years ago but only very rarely does a property's value go to zero. Returning for a moment to the commercial/residential property mentioned above, even in a distressed situation the underlying land value will be $200,000 to $250,000, what a cash buyer/speculator would pay. That may be only one-third of the recent appraised price but it is not zero or just pennies on the dollar.

In my next column, we will look at some of the long-term strengths of commercial real estate, such as with 70% of our economy being driven by the consumer, there will always be need for some retail space, and neither is medical space going to go away, or apartments.

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