nerej CELEBRATING 55 YEARS

Spring has sprung, but commercial real estate is still moving at a slow pace

April 04, 2013 - Northern New England

Spring has started and our office phones are ringing more, albeit some of these "rings" are e-mail inquiries on our site signs. We are 4+ years into a scheduled recovery from the market reversal in 2008. We are told the "Great Recession" is over, but for many folks on Main Street (v. Wall Street) this recovery is not readily apparent. But folks are tired of holding on, so most are trying to move forward. Those rascals in Washington D.C. are doing next to nothing to help. A pox on both their houses!

We have prognosticated that 2013 will be only slightly better than 2012, which was slightly better than 2011. The slightly better is preferred to worse, so we will need to work with the anemic recovery as we have it. For commercial real estate, this means focusing on historically low interest rates. Banks need to lend and while they want to be conservative, there is a surplus of capital and thus plenty of lenders for most deals. The volumes are not great because if a property is yielding 6%, 8% or 10% why would you sell it? Where would you put the money to earn anything close to that?

Thus, the properties for sale tend to be "value add" properties, those needing investment, improvements, new tenants etc. to increase their value. These can be dicey propositions. A continuing constraint is the short-terms of new leases. Few, if any, are committing to 10 years, most are 3 to 5. Some are longer, but often have early "outs," the right to terminate sooner by giving 6 to 12 months written notice. Thus a seven-year lease with a two-year early termination cause may in reality be only a five-year lease....5 years seems to come much sooner these days, especially when the commercial mortgage financing is a 5 or 10 year balloon note!

A further headwind is the length of this very slow recovery. Investors who put significant equity into a deal, prefer to refinance it on its rising value and take their equity out to be deployed to the next deal. When the real estate cycle is not rising quickly, refinancing is not an option. This is why we keep saying real estate is not a liquid asset. But in the current economic environment, not much else is liquid either.

We are told that this is not a typical or usual real estate cycle (of 5, 7, 10 or 13 years - take your pick) but a financial "reset" correcting for the extreme excesses of the century's first decade, and that the 2008 - 2018 period may be a "lost decade." We've seen those before, not exactly like this one, but with similar results.

There are key fundamentals in commercial real estate investing. #1 is location, location, location. Good sites will always have value. #2 is sector analysis. There are five property classes in commercial real estate - office, retail, warehouse/industrial, multifamily and commercial (everything else). In large urban "A" markets all sectors are performing, including hotels. But in the smaller "B" and "C" markets the performance is spotty. Office rents in midtown Manhattan are trending toward a

20% to 25% increase over 12 to 24 months. Apartments have been strong, but there are large numbers of new units under construction (over 5,000 in or around downtown Brooklyn), some of these will fill up but some may not.

The "B" and "C" markets have much less momentum and, of course, lower volume given their smaller size. In Concord, N.H. in 2011 only seven commercial properties sold as "arms length transactions." In these markets, many properties are not going to return to their former use. They will need to be repositioned through adaptive reuse. We have several we are marketing right now. Two large former medical/clinical sites. There are no independent users and those affiliated with large area hospitals are already housed in space close to the hospital. So, if they are not clinical, what are they? Most likely housing! We also have a 200,000 s/f manufacturing building. The owner is using less than half and could shrink more. Four other buildings in the same industrial park are empty as well. These will not be housing... may be boat storage, or indoor sports or...

So after 4+ years of anemic recovery, some property owners are having to face the music that what their property was is no longer needed, which equals no demand. They need to reposition that property to another use that is in demand. Sometimes that translates to equal or higher value. But oftentimes it means a lesser value.

Bill Norton, CRE, FMA, is president of Norton Asset Management, Manchester, N.H.