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When does commercial real estate not perform like real estate?

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When does commercial real estate not perform like real estate?

Answer:

When traded like a commodity and laced with collateralized debt obligations.

We can now look back and realize that the principle of balance, an appraisal term, was forgotten in the flood of capital that flowed to real estate as a safe haven from the securities market following the 2000 stock market decline.

The purpose of this article is to answer one question posed by brokers at our leasing meeting of February 4th and present commentary on when the deck will likely clear.

A Case Study

We had just had two major lease negotiations falter. The market was for landlord paid tenant improvement allowances but the landlord could not raise the capital. The question asked of me was "when will the market turn?" I did what people do in my business; I reached out into the market to try to find out the status of capital markets to learn how long the deals might be on the shelf.

So that readers understand tenant improvement allowances, this is one of the major costs of owning office property. They are not small dollars.

The property under study happened to be a grade B office building in downtown. Average asking rents in grade "B" buildings in downtown are $39.46 per s/f.

I looked up a recent deal done on Congress St. close to Post Office Sq.. The average rent was $37.50 per s/ft gross. After free rent and $60.00 in tenant improvements, the effective gross rent "as is" was $24.77. The difference represents amortization of improvements over the lease term and is a huge cost.

The Capital Market

The Commercial Mortgage Backed Securities part of the capital markets is in paralysis. The securitization of debt is only as good as the ability to price the various tranches. With no one knowing how to price risk pieces, the market remains in "seriously bad shape".

The problem is that with the property at issue recently re-financed, there was no ability to again refinance. LTV ratios, at one time 75% and with mezz debt 90% or more are today 65% with mezz debt 80% at best. While banks and insurance companies are lending at their 2007 pace, $230 billion in CMBS debt of 2007 has slipped to a trickle. You do not take $230 billion out of the real estate market without a serious impact. Where that impact is showing up is in capitalization rates, and thus values.

Capitalization Rates

Our CB Richard Ellis Q2 2001 survey for Class "B" urban office similar to our case study indicated an average going in cap rate of 9.78%. At the end of March 2001 10 year treasuries were at 4.89% and borrowing rates were at the upper 6% level. There was positive leverage in real estate.

As of the beginning of 2008, borrowing rates are at the 5.75% to 6.00% level yet Q4 2007's CB Richard Ellis urban office Class "B" cap rates were 6.56% or close to the borrowing rate.

There was no positive leverage.

What has happened is that the flood of capital that flowed into the market over the past 7 years knocked the market out of balance.

Debt rates and capitalization rates for real estate can not remain at similar levels. What happened in the market is that with strong real estate fundamentals, certain investors believed that they could increase property cash flows and drove cap rates down to levels not seen in 100 years.

Conclusion

2006 and 2007 will go down in history as great arbitrage years. The buy and flip era however is over. Real estate can not be thought of in the same venue as hedge funds.

A study of good grade, reasonable credit urban Class "B" office buildings is showing capitalization rates moving upward toward the 7% level. This makes far more sense than the levels reported in surveys.

To the question asked of me, my response is that property owners are going to face more and more calls for equity. As shown in the example reported, if you wish to keep your buildings full, owners must be prepared to reinvest back into property. This can mean times where no cash flow can be distributed.

The answer as to when the deck will clear is far from defined. One year from now the real estate market will be far more settled. In the mean time, limits on capital for real estate will place many transactions on hold and cause a general overall slowing in what had become an over heated commercial real estate market. Those properties that are laced with leverage and acquired for short term profit will find that the lender more than the borrower will be in control.

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