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A case study in market change: portfolio and industrial props.

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Over time, people in my business develop sub specialties. In my case, one of these specialties is portfolio valuation. In terms of portfolios, historically industrial properties have become one of the most highly sought classes of real estate. They are NNN leased and are less management intensive than gross leased property. This article will address the history of portfolio sales, the new age of portfolios - 2002 to mid 2007, and events post August 2007.

Historical Perspective

In the United States, real estate was long looked at as the poor second cousin to the stock market. Real estate traditionally sold on a one off basis with bank or insurance company financing.

Multi-property portfolios were at a disadvantage. Over the years portfolio assemblages were created, typically by individual entrepreneurs. Because of age or income tax consequences, a need to sell could develop.

When a sales event occurred there were few options and portfolios typically sold at discounts. In the late 1960's to early 1980's I was involved in managing a REIT. We acquired 3 portfolios, typically at discounts of 15% to 20%.

The rationale was that the quality of the portfolio typically varied and the buyer was acquiring the good with the bad. Capital was going to have to be invested. Real estate was a very long term investment.

The New Age of Portfolios

With the stock market collapse of 2000 to 2001, and the Fed policy of low interest rates to pump the economy, real estate changed. Huge capital flowed to the industry. Real estate became a short term speculator's game. The easiest product to acquire and then sell at a profit was industrial real estate.

The market shifted from one of discounts to expectations of premiums. Further, the market benefited from capitalization rate compression. Premiums I found varied from a low of 7% to a high of 19%.

The only way to instantly invest billions was portfolio acquisition. G.E did so with a $2.3 billion mixed use portfolio. Cap rates were typically 6.85% to 7.29%. Average lease terms were 7 years.

Ever since August 2007

In real estate, defining moments take place: July 1990: Market crash; October 1998: Russian ruble collapse; and August 2007: Credit crisis USA.

In August 2007 the premiums paid for portfolios evaporated. The market stopped.

Large portfolios just could not be marketed. They had to be broken up to be sold. There were just no balance sheet lenders left to place blanket loans on portfolios. The number of offers dropped by 60% to 70% or more.

A new mind set developed in those buying property. They went back to one off pricing and in their bids for industrial property were searching comparable market data for one off, high cap rate deals to drive down price.

Assemblers of portfolios who used short term or mezz financing were finding no one willing to step into their shoes at premium pricing. One assembler we know sold but this time around at a 5% discount.

Summary

I recently attended a talk given by the publisher of Forbes Magazine to paraphrase, what is clear is that we are in a "credit reallocation" in this country. The Fed's stimulus of lower interest rates is falling on deaf ears. Further, the Fed's are failing in their second purpose; that of supporting of the dollar.

In the real estate business, cycles have typically been 10 to 13 years for Boston. This time around we have been hit by a two humped camel.

* 2001-2003 - Dot com collapse
* 2007 - ? Credit/sub prime collapse

How long it will take to work our way out of this is hard to tell. We know it will be multiple months and could be a year or more.

In the meantime, case studies like industrial portfolios will materialize from time to time. One thing clear to me is that real estate is shifting gears, moving back to its traditional mold and is being driven by underlying basis that many of us grew up with in the industry.

Webster Collins, MAI, CRE, FRICS is executive vice president and partner of CB Richard Ellis Valuation and Advisory Group, Boston, Mass.