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Recent trends should continue, but some level of correction is inevitable - by Bill Norton

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Bill Norton,
Norton Asset Management

I have been working in Vermont this week. Tough duty – late Indian summer. Some rain, but mostly sunny days with cooler nights. It is my favorite season here in New England. Alas, after Labor Day everyone wants to get back to work and get deals closed! This year seems a little bit more urgent. There is a hint of anxiety behind the curtain. Interest rates are rising. Appraisals are tightening up. Residential rents are flat and landlords are offering concessions and inducements. Retail and office space is flat, high-bay and warehouse space is still in tight supply and, thus, rents are still inching up.

Overall, volumes are still steady. There is concern for when (not if) the correction comes. This is not going to be 2008/2009, a major, deep and prolonged correction. This is, according to the pundits, going to be more of a flattening, a loss of momentum and a softening of prices. A big unknown is the manufacturing and distribution sectors. All the talk about tariffs (and so far it has been 90% talk) will have an impact once the tariffs take effect. Why are we picking on Canada, the biggest trading nation with the Northeast? I do see unfair dealings from China and some other nations, but our trade policies and treaties are convoluted, complex and very difficult to amend or partially adjust. We are likely to throw out the baby with the bathwater.

So, left to our own devices, the economy will likely plug along. But a big policy change from Washington (specifically 1600 Pennsylvania Ave.) or a significant geopolitical event can knock the U.S. economy off its tracks for quite some time. I was reviewing a residential multi-family portfolio with a client today. About 300 units from subsidized Section 8 (long-term with fairly fixed rents) to medium-price at-market units. The at-market units have had increasing rents for several years. But as newer, competing units have come on the market, renewals are getting tougher. Younger folks want to try the newest product. Older folks are less keen to move too often. Residential rents most often are a one year lease and then month to month. This works well when rates are rising, but creates volatility when rents flatten or fall. Landlords hate to go to existing tenants and offer to reduce rents, thus, they usually cross their fingers and offer to not raise rents further. In some markets this works, in others it does not. We have seen lots of units built in the last 4 - 5 years, both apartments and condos. Some areas are likely overbuilt. A slow down or correction will expose

these areas.

But overall, if a landlord has not aggressively refinanced, they can move up or down with rental demand. Even with most units essentially renewing annually, most tenants are not inclined to move. There is a strong correlation with age. Baby Boomers have lots of stuff and old tired backs. They do not move unless they have to. Millennials and Gen-Xers do not have a lot of stuff and have lots of friends with strong backs. They will move frequently. Unless there is a massive local economy downturn (plant closings, etc.) most residential landlords can adjust. The two exceptions are those who have over-leveraged or over-financed and those bringing newly constructed units online in a suddenly stalled or falling market.

Commercial spaces (office, retail, warehouse and manufacturing) typically have longer-term leases. Historically, these were often 10 years, but today they are shorter - mostly 3, 5 or sometimes 7 years (with an early termination clause). The good news for landlords is they know when the leases are scheduled to renew (or not) well in advance. Ideally, their leases are staggered so that lots of tenants do not all come up at once, which most often happens only with a newer building where all the initial tenants occupy in the first year or so.

So recent trends should continue except for major cataclysms, but some level of correction is inevitable. If mild, it will last 2-4 quarters, up to a year. If moderate, 1-2 two years. If severe, 3 years or more. Next month, I will be going to the fall CRE meeting. I will then share their collective wisdom with you. In the meantime, get out and enjoy this fabulous Indian summer and early fall weather because you know what is coming.

Bill Norton, CRE, FMA, Hon. AIA NH, is a principal of Norton Asset Management, Manchester, N.H.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540