Owners with round holes and tenants with square pegs - by Bill Norton

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Bill Norton

Spring is finally here. No crocuses, but the snowbanks have receded to the shady corners of the yard. What portends for commercial real estate? There are still lots of headwinds, primarily rising interest rates. Given how low rates got (and stayed) the current rates are a shocker. Well, not so much for those of us who remember the early 1980s. My first mortgage was 9% which was a deal! One client has a 2.6% mortgage on an office building that rolls in two years. Sitting with them yesterday, we modeled 6, 6.5, and 7% with 20-year amortization and a 10-year balloon. Because the principal has been paid down it is not an enormous bump. But if a new tenant (s) requires significant renovations and fit up, it gets “thin” given current office rents.

This property is not convertible to multi-family housing. It was built as a corporate headquarters for a regional engineering firm. The firm has grown substantially and is moving to consolidate their New Hampshire and Massachusetts offices (shrinking by 30% overall). They have finally decided on a post-COVID office strategy, which is desks/chairs for 60% of the staff with common/ flex space sufficient to hold a full office meeting one time per quarter. They currently are on a three days per week in the office schedule. Although they now have a handful of employees who are really remote (100 miles +).

For my client, the landlord, finding a 20,000 s/f single tenant has not materialized. The building (two-floors) subdivides reasonably into two tenants, but more than that becomes very expensive and suboptimal, especially as smaller tenants most often look for shorter lease terms (three to five years). The highest and best use would be for a buyer/user as the building can be bought for far less than replacement cost. But to date, no users have expressed interest. There are reserves to fund re-tenanting but if the ultimate solution exceeds the reserves, then there is a cash call or a re-financing. Alas, this will be the norm for many office properties. Owners with round holes and tenants with square pegs.

Beyond interest rates, there are further headwinds. The bank takeovers in the past weeks affect interest rates but also lending fundamentals and appetites to lend. Appraisals are under scrutiny (loan to value). Next there is inflation, especially for utility costs (+30, 40, 50%). And recent town meetings found voters willing to spend mostly for schools) and thus raising real estate taxes.

When all these factors are taken into account, a traditional legacy office property is a less valuable asset. The new prototype is a “flex” building with R&D, lab, or assembly space in addition to office space. Some existing buildings can be adapted but the key constraint is clear height. Office buildings are typically 10 ft., 12 ft., 13 ft. floor to floor. Flex, lab, and assembly need 16 ft. to 20 ft.

We see ongoing stress for traditional office properties. In Boston, since the Great Recession, has seen dozens of primarily office buildings converted to multifamily (mostly on the upper floors). At one point that exceeded four million s/f. We also have seen “scrapes” – demolition to create a buildable lot for multifamily. But rising interest rates with historically high construction costs are making new construction very challenging to pencil. Residential rents have been going up and up, but they feel like they may be peaking. With the tech sector leading with significant layoffs, it gives one pause.

I don’t enjoy being the bearer of bad news but global geopolitics is very dicey right now – the war in Ukraine, U.S. tensions escalating with China, and the serious turmoil in Israel. My daughter and I just got back from a pilgrimage to Israel and the Holy Land. It was a phenomenal experience but we could clearly feel the tension in the air. The owner of the Christmas Hotel in Jerusalem speculated that Israel could be in civil war in three to six months. That would be a massive spanner in the global economic works!

Here in New Hampshire, we have to simply focus on what we can influence and affect. These larger forces will eventually play themselves out.

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