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The financial/economic house is still standing - by Bill Norton

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Bill Norton

We have made it halfway through 2023 and the financial/economic house is still standing! In fact, several pundits are starting to float the idea that there will be no recession this year. The democrats will go to extreme ends to achieve that because of the blow-back on the Biden Administration and their hopes for re-election. But we are not out of the woods as there are many indicators that suggest a recession or “correction” is overdue. Alas there are many pieces to this puzzle and not enough pieces have been put together to see what shape this will ultimately take, not to mention how long/when.

So much of today’s news is about single-family housing. Shortage of supply; extreme demand; dozens of buyers/bidders for every house; overbids on already inflated asking prices; waiver of inspections and appraisals.... The consensus was that rising interest rates would cool things off, but not so far. There are still lots of cash buyers in the market. I had suggested they would peter out by Labor Day, not so. At a recent CIBOR event several residential managing brokers do not see a let up in the current frenzy until well into next year! A key element beyond purchase prices (up 62% since 2018) and rising interest rates is occupancy costs: real estate taxes go up due to inflation and are compounded by rapidly rising assessed values. Utility costs go up and up and up. Insurance costs are skyrocketing with dramatic increases in replacement costs along with hurricane, tornado and storm losses in the billions. Auto insurers have lost billions too. Most homeowners bundle home and auto. Cable and Internet costs are rising. (I cut the cord with Comcast/Xfinity when I hit \$179 for basic internet and cable). In two years, basic cable will be at least \$100 per month, and for many households with cable and streaming much more.

Commercial real estate is facing rising costs as well. But certainly, for office, most retail and hospitality demand is flat or shrinking. I had the pleasure of telling one landlord last week that the tenant we put in his building(s) will not be renewing 125,000 s/f! Work from home, full or part-time is a real phenomenon. One of our clients, an engineering firm just consolidated two offices into one, shrinking from 33,000 s/f to 16,000 s/f. That leads to a lot of increasing vacancies in secondary and tertiary markets as well as downtown Boston.

Many office landlords are being forced to look at conversions to residential, but not all office buildings can be or should be converted. The current construction costs are prohibitive. In the commercial sector most mortgage financing is a “ten-year balloon”, with a 20- or 25-year amortization, but they must be refinanced or paid off in 10 years. Thus, roughly 10% of commercial properties come up for refinance every year. To quote fellow CRE, Dan Calano of Prospectus in Cambridge, MA:

“The confluence of lower revenues to building owners, worse loan-to-values, higher cap rates implying lower value, and higher debt service ratios eventually require equity and infusion, all of which have brought the situation to a dangerous brink.” (NEREJ May/June)

This squeeze on office is dynamic and ongoing as company boards are demanding fewer people and lower costs resulting in the need for less space. Because office leases are for multiple years it

will take several more years to see the ultimate effect. It may be quite some time before demand for office space re-emerges, longer than many landlords can wait.

New Hampshire has reported that at midyear “the numbers are pretty good, a strong improvement over a year ago. People are out, they are spending, taking vacations, buying cars.... It is the proverbial rising tide floating all boats. But for those of us who have been at this for a while (20, 30, 40, or 50 years) know that this hyper-inflated residential market must and will correct. And the commercial markets will as well. COVID coalescing with the global slowdown has impacted the office sector first and hardest, but industrial and warehouse may well have peaked. With a typical two-year permitting process some projects in the development pipeline will have to hit the “pause” button or risk poor timing, hitting the market when demand has pancaked. One sector here in the Northeast is the bio tech / lab space. Many startups in this sector were funded by Silicon Valley Bank which is now kaput! There are millions of s/f of lab space in the pipeline, now with little or no prospective tenants. What can these projects convert to? Especially given their astronomical construction costs.... Commercial portfolios are typically hedged by geography and product type. Thus, they may be somewhat resilient, vis a vis the residential mortgage REIT buying and consolidating mortgages in one area of the country.

So, while we have made it through (and even prospered) in the first half of 2023, there are many headwinds in front of us. There are macro market corrections due at some point. If the U.S. can keep firing on all eight cylinders, growing the economy (especially wages as 70% of the economy is consumer driven) then we may finagle our way out of this without too much pain. But if global geopolitical or macroeconomic events trip us up, then there is a period of pain and suffering in our future. Will it be a year or so, or prolonged to 3-5 years? Stay tuned.

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