nerej
EST 1963 | CELEBRATING 55 YEARS

Consensus views on economic crisis: How to navigate conditions impacting commercial R.E.

January 28, 2009 - Spotlights

The underpinnings of commercial real estate have become, in part an anchor to windward in Boston as economic distress buffets all sides of our industry.

The purpose of this article is to summarize consensus views on the crisis we face and outline how to navigate through conditions that exist with as little value loss and as much profit as possible.

There is no question that the severity of the recession we are in rivals anything we have ever seen. It is difficult to forecast duration. What we face is summarized as follows:

Summary of Consensus Views

Implications will last a long time:

1. The banking system is broken with no plan in place to revitalize.
2. Demand for credit exceeds the size of our entire banking system.
3. Unless we can unlock credit, we will remain in recession.
4. It is necessary to have a secondary market system like CMBS.
5. There must be a new central banking system with the key - control on rating agencies.
6. The problem is with the junk being mixed in with "good stuff."
7. A lot more federal regulation will result.
8. It is the same on both sides of the Atlantic.
9. We are at an all time high - total U.S. debt to GDP - exceeding that of the 1930s depression.
10. Numerous market failures all occurring at the same time are "muddling up everything."
11. Owners cannot trade assets at their true value.
12. Any private player of any size may not want to take a position because the asset could be worth less tomorrow.
13. Any federal stimulus that does not assist in the creation of a 21st Century Industrial Revolution is good money after bad.

In 2009, the commercial component will no longer be an anchor to windward. Impacts will involve the hotel sector and continuation in the retail industry with draw backs in consumer spending. This will also involve leasing as market uncertainty clouds tenant moves. I have learned over time that lessons from the past can provide solid guidelines for moving forward.

How to navigate through downturns with as little value lost and as much profit as possible

First, use lessons from prior recessions. In 1974-1976 banks/ lenders were allowed to cut interest rates with owners carrying property until the market returned. The problem with the 1989-1991 recession was that with mark-to-market requirements of the Fed, and the RTC debacle, a forced loss of $500 billion was the result.

With the current federal funds rate at .25%, there is support for lenders to cut rates on troubled loans to 2%-2.5% or a level that should be able to cover debt service. Auditors should be able to accept workouts as there is basis for low rates.

Second, rely on basics of real estate. Real estate is all about jobs. But for the financial sector impacts with a loss of 14,700 jobs projected by NEEP, 18,000 in new office jobs for Boston are projected by 2012. NEEP's number as of May 2008 was 54,100. The difference is brought about by the implications listed here in under consensus views. 18,000 office jobs converts into 4.5 million s/f of office space. Office vacancies are projected to decline from their current 15.7% to 13.4% with the change occurring mostly in the suburbs.

Finally, conserve capital. Great opportunities will develop in the secondary market brought about by the collapse of mezz debt. Rising cap rates and thus falling prices will wipe out equity in assets leveraged at 80%-85% of original value.

Conclusion

If you are a believer in cycles as I am, the next 24 to 36 months should produce opportunity. It is all about how you can capitalize on the failures of the secondary market. This market resulted from investors forgetting that you "Never borrow short to invest long."

Consideration must be given to investor's ownership within the various components of a property's capital stack. Investors with cash will not allow sales at a significant discount to their belief of stabilized market value. While mezz positions may be under water, to protect their long term investment, they will never sell below the combined level of the first mortgage and their position even if they have to overpay in terms of perceived values.

Timing is everything. On March 24th, 2007, Tom Flatley predicted "blood on the street" and was structuring himself to take advantage of the next opportunity. History has a way of repeating itself. One only has to remember JF Robert's buys in Boston and their profits to recognize.

Webster Collins, MAI, CRE, FRICS, is executive vice president/partner of CB Richard Ellis/New England in their Valuation and Advisory Services Group, Boston, Mass.