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For Those with Money: "You Won't Find a Better Time to Be a Buyer"

Cash Will (Again) Be King as Slower Than Expected Recovery Will Create its Own Set of Opportunities, According to Commercial Real Estate Professionals

Although the future of commercial real estate remains murky, current operating conditions are crystal clear: There is very limited capital, extremely tighter underwriting, shrinking net operating incomes, shrinking space demand and declining property values. For companies today, that means leaner and more efficient operations and more focus on tenant retention rather than tenant attraction.

The bigger question may be how long will these current conditions remain in effect. And while they are far different than what conditions were just three years ago, the smart money is starting to act as if it expects the current operating environment will be in effect for some time and is starting to look for opportunities that match the times.

This is the assessment of a wide variety of CoStar Group customers and readers we contacted about what they expect the flip side of the current recession will look like. Last week in Part I of this news story, readers said that, despite some signs of overall economic stability, commercial real estate is still reeling from the effects of the credit crunch while trying to avoid the recession's knockout punches. At the same time, they know the cycle will eventually turn will eventually come to an end.

"We probably have already experienced the worst, but our economy is still falling, albeit at a slower pace. Several leading indicators suggest that we will likely bottom out before the end of this year," said Tim Wang, Ph.D. and senior investment strategist for ING Clarion in New York. "Nonetheless, investors should keep in mind that the economy declining at a slower rate is a lot different from actually beginning to expand. The recovery process could be less robust and take longer than expected."

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"We believe that there will be more distressed assets coming to the market over the next 12 to 18 months," Wang said. "Investors with cash can cherry pick the best assets in the most desirable markets. Preferred equity, mezz debt, super senior CMBS and 'loan-to-own' are also attractive investments during this period."

Paul J. Ruff, president of Triumph Real Estate Corp. in Englewood, CO, agreed that there are very early indications that an end of the recession may be in sight -- somewhere in the next several months.

"That doesn't mean the end is next month, but it might mean a continuation of reductions in job losses through the next two or three quarters, which will offer some hope but won't put a lot of money back in consumer's hands," Ruff said. "A return to growth is another story, because inflation and rising interest rates resulting from the stimulus is a real threat, and that will hold down spending and hiring. So the economy could very well flat-line or grow anemically for quite some time after the 'end' of the recession."

"That all being said, we will be seeking and making worthwhile real estate investments, with an emphasis on low cost basis, low or no leverage, and a lot of patience," Ruff said. "It would not be prudent to expect any quick turnarounds in value in the commercial markets, so conservative underwriting and forecasting will drive deals. We will buy office, industrial, retail or multifamily properties or whole loans backed by those types, and are anticipating the need to close quickly with cash."

"What does all of this mean going forward?" asked Joe Farr, Asset Manager for BGK Group in Santa Fe, NM; a question he then answered. "In my opinion, there will be a continuation of what everyone in the business now recognizes as the norm. First, lenders want more equity in the deals (whether it's a new loan or a refi). Second, prices have already dropped in most markets to the point where a lot of properties are under water or close to it, which will continue that downward pressure on prices because lenders will be taking back more properties and selling them at a discount to get them off their books and owners will be selling them at a discount to avoid going back to investors to raise additional capital for a ref,"

"We'll get through it, but it's going to take some time," Farr added. "I personally think it's too early to start any buying on a large scale, and you're going to need a lot of cash to make anything happen. The disconnect between what sellers want and what buyers are willing to pay is clearly pointed out by looking at sales volumes around the country-anemic compared to any "normal" year. I don't see anything that's likely to change that any time soon."

Because of the pricing disconnect between buyers and sellers, many in the industry are mining the books of lenders looking for nonperforming loans, foreclosed properties and pending loan maturities as a place to extract current opportunities.

All Eyes on Loans

Of course, the next big event on the horizon that all of us in the commercial real estate industry are holding our collective breath in anticipation of is the pending maturity of billions of dollars in commercial debt obligations. With falling NOIs and corresponding lower asset values, owners will be hard pressed to refinance and retain ownership of their leveraged assets over the next 12 to 24 months. As banks begin or continue to foreclose on commercial buildings, many of these institutions will be forced to make hard decisions about their move-forward strategy for these assets. As the economy begins to recover, well capitalized buyers will have many assets to choose from, both distressed and non-distressed, since, as we've heard so many times recently, if you have money, you won't find a better time to be a buyer.
Steve Hussey, Managing Director of Hyperion Asset Services in Chicago, IL

Based on conversations and business meetings, banks are getting into the commercial real estate business. If a workout cannot be accomplished on a default, banks will foreclose. However, once the property is taken back, I am finding very little opposition to a bank driven turnaround, or a sale offered at, or near the previous deed amount.
Trent Siskron, Associate Investment Brokerage Services at NAI Houston in Houston, TX

REO (real estate owned) opportunities are rising. It will be similar to the RTC days. People chasing notes are the first wave of investors stepping in. Purchasing notes have advantages but some serious disadvantages. What needs to happen is the foreclosures to happen expediently with the understanding that lenders are going to off load the properties just as fast.
Nicholas L. Miner, CCIM, Associate Broker at Eagle Commercial Realty Services in Phoenix, AZ

No investor is going to accept the prices that banks are trying to dispose of their assets because equity is expensive and the rules of the game are still changing. Immediate opportunities will continue to be those where investors are buying the notes at less than par (if the banks get rid of them at that price) with the expectation that these troubled loans are really REO opportunities.
John J. Tilley, Director of Real Estate at Jacmar Builders in Alhambra, CA

What is evident is that the looming commercial loan maturity crisis and the eventual solution for the disposal of commercial loan securities may create very attractive acquisition opportunities at potentially large discounts. Since the solution has not been finally scripted, investors should have multiple strategies in mind and be ready to act when it has become abundantly clear how the resolution will take place.
John T. Fenoglio, Senior Vice President of Grandbridge Real Estate Capital in Houston

The other aspect of the future of most immediate concern to CoStar readers was the transformation in thinking and operations that companies must consider going forward.

Industry Restructuring

CMBS/Commercial lenders and their servicing agents are going to be drinking from a fire hose shortly as we are seeing an increasingly large waive of troubled assets enter foreclosure. We feel that for the next 18 to 24 months, we are in for a rough ride downward as lenders continue to foreclose these troubled assets and more importantly sell them off at very low price-per-square-foot prices. Owners need to position themselves as best they can to compete with the REO product in terms of rental rates and concessions; which if they are underwater is going to be tough to do. The flip side is that if you have ready cash you will be able to pick up some incredible real estate at unheard of prices.
Thomas D. Kuffler, President of Civic Asset Management Inc. in Phoenix

I think the commercial real estate industry as a whole will shift from transaction oriented to management oriented. Returns from commercial real estate are made up of income from cash flows (NOI) and appreciation; traditionally 70% from cash flows and 30% from appreciation. The past five years or so have seen the majority of returns stem from appreciation due to cap rate compression not NOI growth. Now that cap rates are headed back up and probably will not return to historic lows in the next five years, returns have shifted back to cash flows as the main source. Real estate companies that have a core management focus will be well poised to assist property owners as they seek ways to increase their NOI by filling vacancies, increasing rents and reducing operating costs. Traditional transaction brokerage companies will survive, but on much less volume. Further, companies that can show a strong track record of management, leasing and disposition work will be well suited to partner with lenders who are forced to hire "work-out" firms to help delinquent sponsors that lack these basic skills.
Marty Busekrus, CCIM, NAI - Rauch Weaver Norfleet Kurtz & Co. in Fort Lauderdale, FL

The real estate industry is not in transition from one cycle to the next, it is undergoing a major transformation that requires new strategies, new business models, new business practices and new systems. There are many positive long-term trends and opportunities, however, getting there requires vision, leadership, capital and a knowledge- and customer-centric focus. Some of the areas of opportunity include, but are not limited to: energy; waste management; healthcare; data storage; government; R&D; trade; pharmaceuticals; corporate campuses; defense and security; high tech; green industries; FIRE; back office services; and infrastructure.
Chris Lee, President of CEL & Associates Inc. in Los Angeles, CA

I think that companies will have to become leaner and more efficient. It's a well known fact that many large brokerages have not only let go their lower performing sales people, but more importantly a lot of the staff that supported those people. There had already been some mergers in the business and I'd bet there will likely be some more. The opportunities coming out of the recession will in part be related to the accumulated market knowledge and more and stronger relationships that the survivors gained in the downtime, which only full-time immersion in the business can provide. Bad times can be a great opportunity to sharpen skills, take courses, clear your desk and your mind, refine marketing tools and techniques, and allow time to plan new strategies and tactics, some longer range planning than we are usually able to do during the busy times.
Mark Beaudry, President of Beaudry Commercial Real Estate in Stamford, CT

In terms of positioning for recovery, I know a lot of us are still counting our fingers and toes and hoping we can get some deals done in 2009. In terms of what is looking up, the big issue I see today is people making hard decisions to cut muscle (the fat has long since been cut), and not knowing when/where that muscle will be necessary in the future. I also think the emergence of boutiques from all of those who have gone out to start their own firms will be interesting. Some will be very creative/successful doing interesting things.
Nick Barquin, Senior Director of GVA Advantis in New York

I'm most optimistic in office leasing. There is always a need, and the number of businesses in New York City far outweigh retail operators and landlords. During the next two to three years, I do believe that companies that are faring well, comparatively, are going to be able to take advantage of the drastic cuts in office rents, and increases in landlord incentives. Over the next 12 months, I believe landlords are going to realize that anything resembling the $200/PSF era of the 2006/2007 leasing bubble will not be able to compete in the new economy. The supply and demand rules are in complete effect, and with

supply at its current levels landlords are going to have to adjust. If they aren't able to adjust (because of their break-even point) they are probably going to be in distress. Which then brings us back to bank foreclosures, and the need for everyone to face reality.
Christopher Okada, President of Okada & Co. in New York

There will certainly be pain to endure on the part of landlords, as many markets have seen rental rates start to soften and concessions have increased significantly. As loans mature and landlords look to restructure or renew their debt, many will face difficulties with higher vacancy rates and stagnant (if not decreased) base rental rates on their rent rolls. It seems that those companies with financial strength and long term perspectives would be wise to negotiate (or renegotiate) long term leases right now for those corporate locations that are deemed to be stable in the coming years. The company with long range strategic planning and the ability to make decisions will create tremendous value in the coming years as a result of transactions with excellent economics right now. With that being said, for branches or offices with uncertain futures, it makes sense to negotiate short-term renewals while ensuring for maximum protection and flexibility in the lease document.
Bradley D. Larson, Senior Account Executive at Partners National Real Estate Group in Dallas, TX

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