

Ripple Effect

Sinking financial and residential sectors make waves in commercial real estate.

By Jon Peterson, *Commercial Investment Real Estate, CIRE Magazine*

For the first time in four years, capitalization rates on commercial properties are moving upward. This is due in part to tighter credit restrictions and the fallout in the single-family housing market. But the questions on everyone's mind are: How long will the downturn last? And, perhaps more importantly, what impact will it have on commercial real estate? National and local commercial real estate experts are observing numerous ripple effects in markets across the country.

New Era for Cap Rates

From 2003 to mid-2007, cap rates on the major commercial real estate sectors fell to historically low levels. Fueled by rapidly escalating prices, some properties in prime markets traded at cap rates between 4 percent and 5 percent.

This came to a halt in mid-2007, and the shakeout in the credit market wiped out a whole segment of commercial real estate buyers. As a result, "Highly leveraged buyers have been taken out of the marketplace," says Rob Kochis, principal with The Townsend Group in Cleveland. "These investors were using 80 percent to 90 percent debt to buy properties," he says.

The exodus of highly leveraged buyers has prompted investors to get back to basics. "The days of being able to buy real estate and turn a great profit in a couple of years are now over. It has returned to paying a good price for a building, managing it effectively, and then selling it for a decent profit based on the income that has been generated over a three- to seven-year period. These are basic real estate fundamentals," Kochis says.

In the current market, many all-cash or lower-leveraged buyers won't have to be as aggressive when bidding for new acquisitions. "The end result will be that cap rates will move up by 25 to 100 basis points over the next year on the purchase of existing assets," Kochis notes. "Some of the variables will be the quality of the asset and market location," he adds.

In tandem with the slowing market, prices for commercial real estate are dropping. Third-quarter 2007 marked the first negative quarterly price change in the Massachusetts Institute of Technology Center for Real Estate's Transaction Based Index since 3Q03. "This will not be the only time this will happen," says David Geltner, the center's director. "There could be a similar drop for at least the first two quarters of 2008 as buyers and sellers continue to try to work out deals in a tough market," he says.

Other industry experts predict that a market correction may take time. "We have seen several price reductions on listed apartment assets that we track and we anticipate that there will be more to come before sellers' expectations meet buyers' objectives," says John Gallagher, CCIM, vice president of TRI Commercial in Roseville, Calif.

Kenneth Bendalin, CCIM, vice president of Staubach Capital Markets in Dallas believes midrange deals may stand to lose the most. "I believe that the class B or lower, value-added or midlevel opportunity deals nationwide will be hit the hardest," he says.

Sectors within a few local markets, such as Southern California, are relatively insulated from the downturn's effects. "Industrial assets in our market have seen cap rates drop to as low as the high 4 percent to the low 5 percent range. Deals are still being discussed in this range now. There is still plenty of all-cash or lower-leveraged capital in this market to support low cap rates," says John Hurley, a principal with Penwood Real Estate Investment Management in Hartford, Conn.

Capital Crunch

The shrinking pool of available financing has sidelined many investors' acquisition plans. "Many lenders around the country have tightened up their lending requirements both in terms of pricing and the amount of leverage accepted," says Earl Webb, a chief executive officer of Jones Lang LaSalle's capital markets group in Chicago. Tight lending requirements "have made it harder for borrowers to find sources of capital for deals that could have been done a year ago," he says.

Buyers no longer can secure the aggressive financing that was offered as recently as mid-2007. "Interest-only amortization or very low spreads are not offered. This means that buyer returns are thinner than prior to the credit crunch and lenders will not reach for deals as eagerly as before," Bendalin says.

Projects with residential components are being heavily scrutinized by lenders, particularly in oversupplied markets such as South Florida. "Virtually no one in our market is looking at acquisition and development loans with a residential component. The days of run-and-gun equity for condo conversions are gone. Speculative deals are struggling. Even good projects have been picked apart before getting an approval," says Steven W. Moreira, CCIM, president of Magic Financial Services in Longwood, Fla.

"Many local banks I've worked with over the years are now on a tight leash with their board of directors on lending guidelines," says Peter J. Barnett, CCIM, a vice president of J.A. Barnett Realty Group in Tampa, Fla. "In years past they would bend on their debt coverage ratio to get deals done. Now additional policies are in place to make sure that the bank will have no problem if they end up owning the real estate after a failed loan," he says.

With less funding available for acquisitions, the deal flow in the second half of 2007 also slowed: Transaction volume dropped by 24 percent from 2Q07 to 4Q07, according to Real Capital Analytics. "I would expect that this will continue to be the case for a good portion of this year [as well]," says David Lynn, managing director of research and investment strategy for ING Clarion Partners in New York.

New-Development Woes

New-development financing also has dried up. There are fewer sources of funding for developers and tighter controls.

"It's now much more difficult to get new-construction financing for projects," Webb says. "Lenders on commercial developments are taking a much harder look at financing new buildings. There are more hoops to go through including setting up specific preleasing requirements and cost guarantees to make sure that if the project ends up going over the allowed budget, the terms the borrower agreed to will change," he says.

But even in the face of tighter restrictions, developments are breaking ground in solid markets. "We are still involved in some new projects in major markets like Washington, D.C., Chicago, Seattle, and northern California," Webb adds.

Also some new development is moving forward in Dallas. "The financing costs are significant, but I'm still seeing some new [office and retail] projects in the Dallas area," Bendalin says. "The economy here is doing pretty well and there is some demand for new space."

Effects on Property Sales

With less capital available for financing acquisitions in the marketplace, some sellers are rethinking whether to keep properties on the market or wait until the pricing for real estate settles.

The original purchase date of a piece of property has now become a deciding factor for some investors. "If the property was bought five years ago, it would still make sense to sell it now, because the owner acquired the property before values peaked and would still make a good profit by selling it now," Kochis says.

It could be a different scenario, however, if the asset was purchased two years ago. "In this case, the property was bought at the top of the market and now is not a good time to sell. The good news is that there aren't many owners of commercial real estate that are forced to sell because of financial reasons," Kochis adds.

On the other hand, some industry professionals will shelve deals that can't be completed quickly. For instance, Gary Schwandt, a principal with Great Point Investors in Boston, found a buyer for an office flex building in suburban Boston. The buyer, however, must secure 50 percent financing to complete the transaction. "If this buyer has problems arranging financing, there is a good chance that we will pull the property off the market," Schwandt says. We are not forced to sell, and we could wait for the price issues to be worked out."

The Krausz Cos. in Irvine, Calif., changed its buy-and-sell strategy for at least one property as a result of the shifting market conditions. While the company generally executes Section 1031 exchanges when selling assets, it couldn't find a suitable replacement property for a building sold last year. So Krausz cashed out and paid capital gains taxes on the sale.

"This is the first time that we decided to do this," says Jay Krigsman, CCIM, vice president of Krausz. "We were having a hard time trying to figure out the value of any asset we wanted to buy in the second half of 2007. We felt it was better to just pay the taxes on the property that we sold," he explains.

Hardest Hit Segments

Office, retail, and multifamily properties have suffered the most from the stricter financing requirements and the residential market woes.

Office. In many markets, office assets are feeling a leasing pinch due to the mortgage companies, financial services firms, and residential home builders that are downsizing and requiring less space for their respective businesses. For instance, a glut of existing office space is available for lease in Orange County, Calif., where suffering mortgage companies have downsized.

New York's office market also is being impacted by the credit squeeze. "There will be some financial service companies like Bear Stearns or Citibank that will have some layoffs in the region, which will lead to more office space on the market," Lynn says.

Similar trends are occurring in smaller office markets, such as Sacramento, Calif.'s suburban submarket. This area has seen a considerable rise in office vacancies over the past several months. "This is happening due to the consolidation or closing of title companies, mortgage brokerage houses, and home builders' offices. The direct or indirect effects have unfolded with subcontractors and suppliers of household flooring, furnishings, and appliances closing or reducing their work force," Gallagher says.

Retail. Many segments of the population have less disposable income as a result of rising gas prices, residential mortgage rate adjustments, and layoffs in the real estate and other job sectors. A drop in consumer confidence also has hurt some retail tenants' performance and thereby space needs.

Retail segments such as restaurants and furniture stores are particularly hard hit. "People will be more likely to spend more of their food dollars at home and not go out to eat as much with less capital to dispose of. Instead of buying new furniture when a family gets tired of the color, the existing couch will be kept longer until there is more cash in the family budget," Krigsman says.

Multifamily. Apartments have been deeply affected by the marketplace changes. More apartment properties are on the market, with failed condo conversions accounting for a good portion of these assets. This has certainly been the case in markets such as South Florida, Phoenix, Las Vegas, and San Diego.

But on the plus side, new construction is limited in many markets and home buyers who fell out of the single-family market in early 2007 are now in the rental market, helping to keep vacancy in check.

Strategies for the Market

There is at least one method for coping with the faltering market that several experts recommend. "Cash or equity will become king of the marketplace for real estate investing," Kochis says.

In addition, "The sources of capital will be able to take advantage of some good investment opportunities," he says. "This could be a joint venture with a local operating partner. Another possibility is a capital source talking directly with a property owner that needs a new equity source for its asset. The leading sources of this capital will be pension funds and foreign investors."

One of the new areas for potential investment will be in the financial arena. "It's our belief there will be a mix of structured finance possibilities," Lynn says. "Some of the areas that we would look at are commercial mortgage-backed securities and mezzanine debt. The pricing on these should be attractive, given that some sources of capital have been taken out of the marketplace," Lynn says.

There are some regional investment opportunities to consider while the market is low as well. For instance, Orlando, Fla., is piquing investor interest as the city continues to install new rail service in the area. The mass transit rail line is expected to become fully operational in 2009 or 2010.

While there is not a lot of capital available for land investment now, Moreira thinks this could change soon. "There will be development opportunities for capital sources to buy land near where the rail service will be coming to," he says. "This would be for mixed-use projects such as housing and retail and would allow a segment of the population to get out of their cars and use public transit to get to work. It will get people closer to shopping and entertainment."

Hotel development also could be an area where some capital could be placed. "There have been few hotels developed in the past several years with an increasing demand," says Guy Trusty, CCIM, president of Lodging & Hospitality Realty in Coral Gables, Fla.

Land and projects still in the planning stages are other potential deal sources in the current market. "We are seeing more deals come across our desk looking for a developer to step in and take over projects that are still in the planning stages. Larger plots of land once destined for housing are now back on the market. This is providing developers with more choices," Krigsman says.

Overall Capitalization Rates, 4Q07

SECTOR	AVERAGE %	ANNUAL CHANGE BASIS POINTS
Apartment	5.75	-22
Warehouse	6.48	-34
CBD office	6.64	-30
Regional mall	6.68	-18
Power center	7.13	-1
Suburban office	7.20	-43
Strip center	7.24	-3
Flex/R&D	7.60	-46

Source: *Korpacz Real Estate Investor Survey*