

# COMMENTARY

**Gary London** >> COMMENTARY

## Big Changes Ahead in Commercial Real Estate



The real estate market has entered a cataclysmic transition point:

- The residential market is near, at or just above the bottom. While we will not know until a couple of years after the fact

what this means in terms of values, clearly transactions are up. When the “shadow” inventory of bank-controlled properties hits the market, both value and activity will be impacted. The extent that activity will influence the recovery is presently unknown. It will depend on how fast this inventory re-emerges, coupled with consumers’ perception of where we are in the cycle, which will affect value.

- The commercial markets are now in retreat, with values of inventory, big or small, office, retail or industrial, severely impacted.

While this is a very deep and prolonged global event without precedent in modern society, the market will survive. The more difficult question is, for whom?

The commercial markets are about to be subject to an enormous change of wealth. Despite the fact that only a few distressed sales have occurred in the commercial market, we now know that many — if not most — commercial properties will see a very significant loss in value. Some believe it could be over 75 percent.

We are now reaching the point in the cycle when hard choices need to be made.

Commercial properties will be sold, and at price points far below their peak of just a few years ago. Vacancies, eroding lease revenues and the freefall of comparable sales, which will severely impact capitalization rates, combine to make this forecast inevitable. The process is likely to play out over the next few years.

### Bid-Ask Gap

Yet, there is presently a “bid-ask gap” in commercial markets. Simply stated, sellers want to achieve higher sales prices than buyers are willing to pay. Sellers will hope against hope that the recession has really ended, and that may contribute to a market valuation resurgence.

That is a very unlikely scenario, however. It is more likely that there will be a rather slow rollout of commercial inventory to the transaction markets. This, in and of itself, will act as a stabilizing influence and may temper the steepness of the commercial property pricing decline.

But it will not prevent the decline.

Moreover, it is highly probable that the bid-ask gap will not be cured by both sides coming to the middle. The “ask side,” that is, the sellers, are certain to come down. The buyers mostly will hold their “bids.” Why? Because they can, with the knowledge that there will be no shortage of acquirable properties. There is more money than there are deals — at the moment. But eventually distressed assets will overwhelm the markets.

Importantly, buyers — and these are mostly sophisticated real estate investors, including institutional investors and their advisers, wealthy individuals and foreign sources — will simply stay on the sidelines until the asking price matches their expectation of returns.

As in all market transitions, there are winners and losers. The losers now hold the real estate. Just as in the residential world, many have mortgages and partnership commitments based on the old numbers.

The winners have the cash to purchase the assets at the inevitable discount.

### Revise The Economic Model

What is the likely impact of this very large real estate transition? And what strategies and observations can be gleaned?

For all commercial real estate, the new valuation paradigm translates into lower lease rates. The means that expanding businesses and new businesses will have lower starting costs in a recovering market. This applies to service businesses that lease office buildings as well as retail businesses in shopping centers. Currently, commercial vacancies are high, so there is a lot to choose from. As lease contracts expire, new lease terms will involve lower rates.

Even in a retail revival, it is inevitable that consumers will be slow to spend. There is less voluntary money to spend. Savings rates have started to creep up. Until the unemployment picture improves, and this is going to take some time, consumers are in no mood to spend in excess.

But if costs are down for businesses, they will be presented with a wonderful opportunity. New, relocating or expanding businesses can now revise their economic model.

For instance, if you are a retailer selling goods, the reduction of the cost of doing business should translate into lower price points on your goods.

As a thought experiment, combine the new commercial valuation paradigm with the imprint of new technology. Pretend that you are, say, a distributor of plastic media that you display on shelves in mid-size stores dotted throughout many communities.

Now suppose that a new technology emerges that allows the distribution of the media from its source to your home, cutting out the need for the real estate.

What does this describe? The answer is Blockbuster, which just announced the massive closing of retail stores across the U.S. Netflix and other forms of direct delivery content have presented a huge challenge to the old business model.

Businesses must carefully rethink their strategic plans in light of this shift in technology, which impact business and consumer culture.

The trend is ubiquitous, cutting across all forms of retailing. No retail is safe from technologies’ challenge. And therefore, no commercial real estate is safe.

Businesses that lease office space will not only pay less, but they will probably require less space. This is not only consistent with the long-term trend of smaller office space requirements (which started when PCs replaced file cabinets) but in the more contemporary trend of personnel being able to flexibly “office” most anywhere, whether at home or on the road, always connected to the network.

So, there is a real estate conclusion to all of this. Owners of existing shopping centers, office buildings, industrial buildings and strip commercial space are all going to have to figure out the new paradigm of value, the uses of their real estate, or the “reuses.” This “figuring out” process will involve paint up and fix up of the properties in an effort to compete.

But it will also entail experimentation with uses. This is where real estate meets land use. Communities and their policy makers will have to become engaged in change. They will have to become more “elastic” in their thinking of what can be allowed in the space — because much will have to be converted to other uses — and this means changes in land use policy. In this period of transition, that involves a very high level of creativity and cooperation.

*Gary H. London is president of The London Group Realty Advisors, which provides real estate consulting and economic analysis. Check him out on the Web at londongroup.com.*

## LETTER

### Are We Experiencing a Technological Dust Bowl?

**Editor:**

Here’s a quote from John Steinbeck’s “The Grapes of Wrath”:

“The bank is something more than men. It’s the monster. Men made it, but they can’t control it.”

So, is it over yet? Can we stick our heads out of the sand and see the sunlight?

This economy really stinks — I don’t mean 1990 S&L kind of stink — I mean people in bread lines and jumping out of windows, 1929 Grapes of Wrath, kind of stink.

In the United States, recovery from the Great Depression didn’t start until the spring of 1933 ... almost four years!

To make matters worse, there was a great drought called the Dust Bowl that sent hundreds of thousands of lost souls from farm

jobs. The lifeblood of the economy at the time.

President Franklin Roosevelt gave the country the New Deal, which built roads and infrastructure that put people back to work, but the question remains ... where is the New Deal for our high-tech generation?

It is a fact that the American culture eats technology like food. We live and breathe it.

Many of us work at high-tech firms, whether it’s a traditional publishing company like the San Diego Business Journal or a break-through startup in someone’s garage in Silicon Valley.

Is there a technology drought going on? If there is no venture capital or advertising money to drive new technology, then what happens to it? Does it just go away quietly?

Do all the engineers thinking up great new technological solutions to better our daily lives pick up a shovel and build a new road?

Everyone’s lives are touched by technology in some way. The most common technology for businesses is e-commerce and that which drives e-commerce ... a Google keyword search.

Everyone has a Web site or a Facebook page — what would have happened to those common technologies if this recession had occurred say five years ago?

I guess the thinking is who cares about cool apps when you can’t pay your mortgage?

The stimulus package includes money for green technology and communications, but aside from making public buildings solar and giving rural areas broadband, where does that leave the rest of us?

What lies ahead for technology in America?

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