COMMENTARY

Editorials, letters, columns and other opinions

Sam Zell No Longer the Property Grave Dancer

COMMENTARY

Gary London

According to an audience poll of attendees at the recent University of San Diego Burnham-Moores Center for Real Estate forum on the state of the real estate market, only 5 percent of the approximately 700 people in attendance felt "suicidal" about the prospects for the commercial real estate market in 2010.

That is down from 21 percent who felt "suicidal" about the state of the commercial real estate market in a similar poll at last year's conference. Burnham-Moores Executive Director Mark Riedy seemed genuinely pleased with the uptick in attitude. I'm not sure why. It may only mean that the other 16 percent actually acted out their death wish last year, and are no longer around to vote!

In all fairness, most players in the real estate market are more upbeat this year, particularly Chicago real estate billionaire Sam Zell, who made his second appearance in four years at the conclave. The last time he was here, in 2006, he couldn't talk about much. That was because he was under a gag order while the sale to The Blackstone Group of his $39 billion Equity Office Properties Trust portfolio, the largest commercial office REIT in the nation, was being consummated.

That deal got done, and those of us who had been "around the block" intuitively understood that that was as clear a sign as any that the real estate market had peaked. One of the smartest guys in the business was out. Sure enough, after the portfolio was sold, the market crashed. Zell made a lot of money, if only to forfeit some of it away on an ill-timed purchase of the Tribune Co., owners of the Chicago Tribune and Los Angeles Times.

Today Zell isn't building, and appears to be buying mostly in South America. He cautions that that real estate development won't be back for five years.

This state of affairs is quite different from the normal Zell investment strategy, long known in real estate circles as the legendary "Grave Dancer," whose adroit purchases of distressed properties at the bottom of the cycle stamped his imprimatur way back in the 1970s. I distinctly remember hearing him speak at a San Francisco conference in the late '70s — he was probably only a multimillionaire back then — about the strategy of buying when others are not.

Fewer Graves To Dance On

This time around, a much older and just as wise Zell promises that there will be no grave dancing. It's not that he doesn't want to; it's just that there are fewer graves to dance on.

It is hard to buy, because there has been such a substantial drop in the value of commercial real property assets that have wiped out so much equity that the owners of those assets simply have no incentive to sell. The best investment strategy is to purchase the underlying notes from the lenders, if and when they become available. That is a very different strategy than buying the equity positions of property owners.

Lenders continue to play out a strategy of "extend and pretend." They will mostly not foreclose on these assets because their investment is too high.

Instead, they will wait out the crisis, anticipating that values will eventually stabilize and increase. In other words, the commercial markets are not going to engage in a replay of the residential crisis where so many properties have gone into foreclosure. They will extend and pretend. Many lenders will try to hold until the market clears as a strategy to minimize their losses.

This means that investors, big like Zell or small like most of the rest of us, will not see many of the kinds of discounted deals that are characteristic of a market in free fall. This will be an undynamic recovery. There will be fewer transactions and fewer foreclosures by the banks.

The Holy Land

There are always exceptions, and the retail sector may be the major one. As I have recently suggested, the retail sector is in deep decline and transition. Many of the retail big boxes, anchors and entire neighborhood centers will not see demand return for the products that were formerly sold under their roofs.

The "winners" as we start to emerge from the bottom of the cycle during the next 24 months are those who recognize the problem now and take action to solve it. This means that if you own retail property, you must determine what to do with it.

It also means that if you are positioned to purchase properties, it is not as simple as making an offer, presumably deeply discounted, on these properties. That offer has to come with a clear understanding of the risks inherent in acquiring the property along with a clear recognition of the need to reinvent land use of retail properties. Mr. Zell suggested that many former "big-box" buildings might become churches. If that is the case, San Diego is in relatively good shape. According to commercial retail leasing brokers, approximately one year ago there were 50 empty formerly retail "big boxes" in San Diego County, of which one-half have re-leased. In contrast, Phoenix is primed to become the Holy Land of the U.S. with 500 big boxes still to be re-leased or redeveloped!

The point is that another income producing use must be discovered for these existing commercial buildings or they simply cannot and should not be purchased.

New Demand Paradigms

The other theme of the moment is the concept of a "demand driven" recovery. This essentially means that the good properties will be those that either have or will have uses that meet the needs of the market. And the market doesn't return until consumers spend and companies expand.

It is homework time. Looking to the past does not work. For instance, in the office sector, the amount of office space per employee has compressed to one-half the need from 20 years ago. This alone brings down the demand for space. This does not even take into account how computers have replaced file cabinets, receptionists, accounts and other support and professional staffs. Or how mobility (and Skype) allows for shared office space.

There is a great discussion among pundits, experts and practitioners on whether the current retail implosion is permanent or temporary. I have opined that much of the consumption patterns have changed permanently. This is not to say that people won't shop. However, how we shop has permanently changed. Now, not only can we choose to shop at competing centers, we have online shopping options as well. There are implications related to this in terms of how and where we spend our money.

This is a very new demand paradigm.

It's far better to think through your strategies and study the markets. It's a higher risk environment to be sure. But it is hardly the time to feel suicidal.

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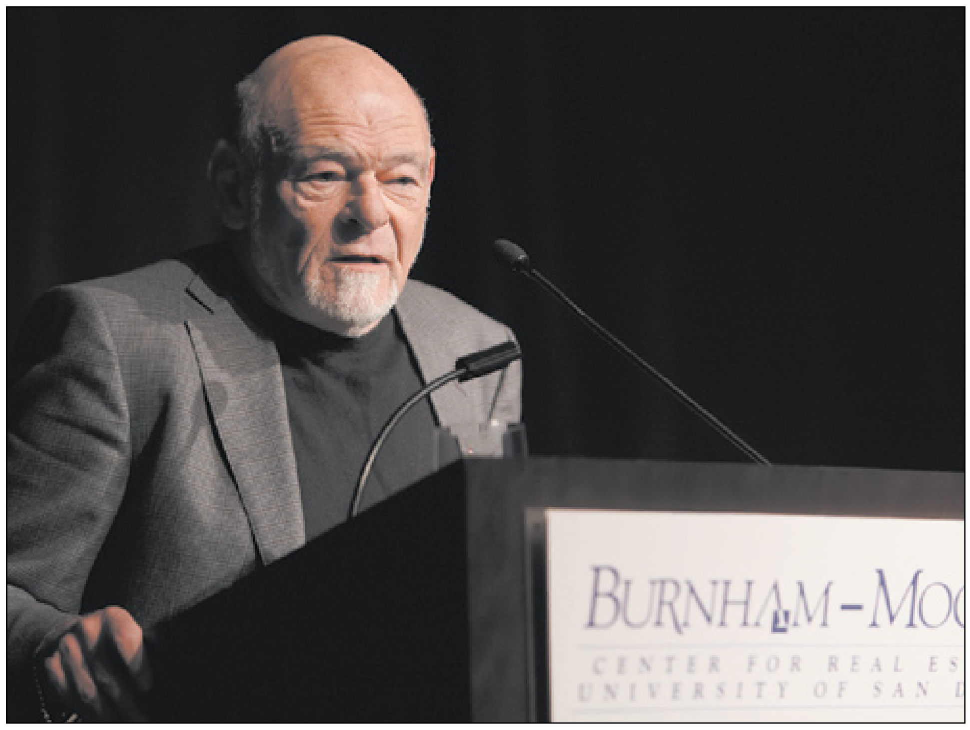

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Changing market conditions call for strategic maneuvering by billionaire real estate investor Sam Zell, who spoke at a recent Burnham-Moores Center for Real Estate forum.

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