COMMENTARY

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For Real Estate the Day of Reckoning Has Arrived

COMMENTARY

Gary London

It appears that the real estate markets have finally reached their day of reckoning. The market is taking an account of the damage that has been wrought by the Great Recession. It appears that this is the moment that a declining market is turning.

The consensus of economists and large portfolio investors involved in identifying trends — and investing money into assets — is that upward movement has begun.

Photo courtesy of The Irvine Co. LLC

With economists forecasting upward movement in the commercial real estate market, the Irvine Co.'s Executive Square Class A office towers in UTC represent the type of property whose value may recover first as the market rebounds.

Out of the Teeth of the Crisis

We now realize the extent of the economic casualty we have experienced since the "official" recession began in 2007, although the market was in decline two years earlier. We seem to have emerged out of the teeth of the crisis, even if the recession hasn't yet been declared officially over:

• Broad-based recovery. The policies to stabilize the financial markets have worked. The Troubled Asset Relief Program and the fiscal stimulus package have apparently had the impact of ending the recession sooner. At what price we don't know (inflation, higher taxes, more government?) but at least they have stopped the bleeding. Inflation is flat. Interest rates are likely to remain low for the foreseeable future.

• The stock market has risen. The Dow Jones was hovering above 11,000 as of this writing.

• Corporate profits are up. Much of this is because companies had been cutting jobs and productivity. Business balance sheets are much better. This positions companies to refinance debt, and to grow as demand allows.

• Employment is expanding: last month's 150,000-person national job gains were strong. This is not nearly enough (it should be 250,000) but jobs are being added, not lost anymore. The technology companies seem to be leading the way with substantial new hiring, so this is real. The percentage of unemployment will rise over the short term, both because it is a lagging indicator (e.g., they only can count older numbers) and because of a behavioral anomaly: People who have been long-term unemployed, and were no longer being counted, are now re-emerging, thus spiking up the numbers. The unemployment rate will go down gradually.

Splitting the Core

These are the factors that have enticed the players to play again. The numbers don't lie. The market has been in virtual shutdown throughout the recession. Few were willing to transact in a declining market. Deals weren't available, while lenders were on the run or at least frozen in place.

During the last few years, investors big and small have been stockpiling money, on the theory that this moment will arrive.

But the question they are now pondering is if this moment has arrived with a thud. While the overarching economic prognosis suggests that demand for core commercial assets will steadily grow, the availability of those assets is quite limited.

The prevailing lending practice of "extend and pretend" has mostly served lenders, and perhaps the market, well. Many assets have not been let out of lenders' portfolios principally because even though values have been driven down about 40 percent nationally on commercial assets, many of the holders of these underwater assets are still at least making the interest payments on their loans.

That has been good enough to hold off most foreclosures — for now.

As a result, there isn't a lot of core inventory available. The few commercial assets that have become available have been trading at disproportionately high values (and low capitalization rates), even though current revenue doesn't justify these high values.

Why? When employment growth resumes upward at a relatively mediocre pace, the numbers still suggest that the best office space will eventually be filled.

The Best of Class

One caveat here, and it is a big one: The institutional definition of "core" real estate starts with Class A properties. These properties are in the best locations and the most recent to have been built. To put this in perspective, of San Diego's 110 million square feet of space, roughly 35 million are considered Class A. Of those, an institutional investor might see 10 to 15 buildings in this market as "core."

These are, as they say in the dog world, the best of class.

Investors are not looking at the rest. And that is the conundrum of the market. If the first wave of the recovery involves exclusive interest in, and perhaps trading of, a few "core" assets (and then, only if they are available), what happens to the rest of it? Nothing, at least for the time being.

There is a huge disconnect between the "core" and "non-core" property assets. There will not be a dynamic trading market until a gigantic "bid/ask" gap is rebalanced. Sellers will eventually take the hit and sell their properties at the discount, or their lenders will eventually stop extending and pretending and sell it themselves out of their OREO departments. (That is an acronym for Other Real Estate Owned. That's the place where the banks park the assets they took back.)

The Five R's

Then the real entrepreneurs will take over. The opportunities are in what I will dub the "Five R's":

• Realization: First, the losses will be realized. Once the assets are sold, the new owner will have a new, much lower economic basis from which to re-launch.

• Retrofitting: Modernization and new uses will inevitably be the answer for most commercial properties. Many office buildings can stay as offices but only if they undergo a complete face-lift.

• Repositioning: Many buildings will be converted to another use. Even more retail projects and strip commercial will be converted to other uses, or mixed uses.

• Re-Entry: The old assets will re-enter the market as entirely new assets.

• Re-Pricing: A new base pricing will reflect these asset use changes and the rents that can realistically be attained.

I sense that we are now entering the incipient stage of a robust entrepreneurial period, where creative people with new, big ideas will find investors and rebuild the current stock of assets according to the Five R's.

No New Construction

But there will be few new development projects in the commercial sectors for many years, except build-to-suits. New projects will not be feasible until lease rates rise past their currently depressed levels, and then well past their last peak, then to a new peak.

Entrepreneurs and investors will most certainly take lower profits in the next wave because they simply will not attain debt unless they have 20 percent to 40 percent of their own money in the deals. That is a tectonic shift from the 10 percent or under days that ended with the last up cycle!

This market is not a "rising tide" where opportunity will abound. This is the beginning of a tough recovery period. These assets will have to be worked out one by one, market by market.

The "day of reckoning" is only the beginning of a prolonged workout period. But at least the day has arrived.

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