

Fundamentally Sound: Commercial Real Estate

By Mark Alexander, CCIM

According to sports lore, "It ain't over until the fat lady sings." Just ask any New York Giants fan. But when it comes to the property market, the fat lady may clear her throat often but she never sings. That's because the market just keeps going. It's like an extra inning baseball game that just doesn't end. It keeps going through these natural cycles that we can anticipate. But the property market never keeps going up forever as many people acted like it would when the calendar read December 2005. And it never keeps going down forever like many seem to think it will today. That's only because we are human. It is often our emotions that we allow to get in the way that fog the true picture of what's really going on.

When commercial and residential property vacancies were lower than interest rates in 2005, the southwest Florida economy was booming and you could have thrown a dart at a Lee County map to decide which property to purchase...and you would have made money. With a business model like that, is it any wonder that everybody...and I mean everybody...wanted a piece of the action? Well, we found out what happens in a quest for riches when everyone jumps into the same (real estate) boat and runs in the same direction (as buyers) to one side of the boat. Prices get inflated until we reach a point where the boat eventually starts to tip over. Realizing this precarious perch, we reversed course and have started running frantically towards the other side of the boat (as sellers)...causing prices to drop precipitously. We're actually pretty good at this "running" thing. We have been doing it for a long, long time. It's a driving force in our market cycles.

In a perfect market/perfect world, the masses in the real estate boat would not run wildly towards one side of the boat causing it to almost capsize. The masses would simply hire a Captain for this boat who would post a third mate on the bow to keep watchful eye on the ever changing sea and weather conditions. This constant watch would enable the billeted masses to anticipate sea conditions and cautiously move about the vessel to maintain balance and reach targeted ports of call safely. While we are still in this watery dream sequence, I may as well have my New England Patriots win their fourth Super Bowl in

seven years to achieve a history making “Perfect Season”. All it takes is to close your eyes, click your heels together and whisper, “There’s no place like home.” Or so I thought. I tried it. It didn’t work. But you have to admit, it can be easy to convince yourself of just about anything. And therein, begets the problem. Our emotional “follow-the-herd” mentality, regardless of underlying market fundamentals will continue to run prices too high in “up markets” and run them too low in “down markets”.

Price Run Up:

In 2004-2005, business was growing, the economy was strong, so the masses felt over confident and over-heated the real estate market (i.e. ran in mass towards the other side of the real estate boat) causing much higher prices than true intrinsic values. As news revealed people profiting from this escalating real estate market, it caused more fuel to be fed to the fire....so more and more people dove head first into this real estate investing frenzy causing prices to continue to soar even more...reaching unheard of price levels that were much higher than it really should have been. Some parts of the country had bigger run-ups in real estate prices than other parts of the country. Since Southwest Florida is a lovely place to live, vacation and retire...we had more people buying homes for investment purposes here than in other parts of the country. This explains why SW Florida home prices during this time period shot up much higher than they did, say in Detroit. And it also explains why SW Florida residential got so overbuilt with help from these optimistic speculators. Many more people understand and are comfortable with residential property investing compared to the more esoteric commercial real estate investing. This higher demand for residential property investments lead to a “Run-Up” of home values. This is one reason why residential real estate values grew much faster than commercial real estate values during these wild days of 2005. But what goes up, must come....you get the idea. The higher the “Price Run-Up”, the further you have to fall when adjusting back to earthly values based upon sound underlying market fundamentals of supply and demand. Since Commercial real estate values did not “Run-Up” as high as residential real estate values, commercial real estate values do not have as far to fall now to reach earthly values again.

Price Run-Down:

We had a difficult recession at the beginning of the 1990's caused mostly by three things: the Savings & Loan crisis, federal tax law changes that gutted tax benefits from commercial real estate investing and vast overbuilding of commercial real estate market segments causing very high vacancies. During this early 1990's recession, office vacancy rates reached 30% in Orlando, 33% in Tampa and 22% in Ft. Myers.

According to Co-Star, today we have office vacancy of 10% in Orlando, 9.4% in Tampa and 11% in Lee County. The underlying fundamentals of the Florida office market today are much stronger than they were back in the early 1990's during that rough recession. Yet many people seem to believe that today's "down market" is much worse than any previous time over the past decades. Here we go again, getting carried away with emotion while ignoring market fundamentals. We all seem to be sprinting towards the other side of the boat...yet again. Chicken Little has shouted, "The sky is falling, the sky is falling!" But is it really?

No. I don't believe it is. It just seems like it is because residential homes took the hit this time instead of commercial real estate. Today's "down market" hits closer to home this time...because it was our homes that got hit this time. So it is easy to understand why emotions are near manic levels with all these highly publicized residential foreclosures which in turn have acted like the starting gun for the residential masses to sprint as Sellers towards the other side of the boat causing the boat to tip and home prices to fall. I suspect many may prefer to keep their heads down and keep charging wild-eyed toward the other side of this residential boat causing residential values to sink even further. But while we are doing this, let's take a side peek at the underlying market fundamentals, just for the heck of it. National studies have shown just one percent of the homes in America were in foreclosure during 2007. That's right...just 1%. If you ate 1% less food than you did last year, would you starve? Nope. It will probably do you some good if like me; you had an overzealous appetite last year. But let 1% of the homes in this country go into foreclosure and suddenly the sky is falling and residential real estate prices are plummeting by 20% to 40% in some cases. If you like roller coasters, you must really be enjoying this ride. You don't need to buy

a ticket to scary movies these days. It's cheaper to buy a newspaper to see what the market is doing.

The sky is not falling. It's just a good rain. It will pass. The fat lady has no plans to sing. In fact, she went home to watch another Presidential debate. There will be another inning coming up soon and there are two strong pitchers warming in the bull pen. We have a wily old veteran right handed pitcher named McCain who is a lock for the future Hall of Fame. The lefty is a brash rookie flame thrower named Obama who is smooth as silk. So stop running to the other side of the (residential real estate) boat so fast or you will tip us over. Remember what your parents used to shout when you were running wildly through the house: "Walk." As a "Youngie" (i.e. Freshman) attending my first seamanship class taught by a crusty old Chief Mate at the Massachusetts Maritime Academy in the fall of 1976 aboard the U.S.S. Patriot State on a cold grey Cape Cod morning, I listened as the Chief growled over his paper cup of steaming hot coffee, "Lesson number one: The most important thing in a life boat is...discipline."

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