Real Estate: Is the tide turning?

By Mark Alexander, CCIM

Harry Belafonte crooned in one of his classic songs: “You never say yes, you never say no, you got me in the middle and you won’t let me go.” Harry’s lyrics sum up the business negotiations of many commercial real estate agents today. Too many commercial brokers are stuck in the middle between sellers who insist upon 2007 prices and buyers who insist upon 2009 prices. The problem is the calendar still reads 2008. It feels like slack tide and we are waiting for the sea to start moving again. Unless we can invent a time machine to fast forward, something has to give for commercial real estate to start moving at a more normal pace. According to a recent study by Real Capital Analytics (RCA), the USA experienced a 62% drop in Office sales volume between the first quarter of 2007 and the first quarter of 2008. RCA further reported the lone bright spot was the medical office sales niche that enjoyed a 30% increase in volume over the same time period. The flight to quality continues unabated.

Happy medical office owners aside, what if slack tide continues in commercial real estate for another six months as we wait for 2009 to arrive? Will commercial sellers still hold out for 2007 prices when the calendar reads 2009? Buyers & Sellers might gain sage financial wisdom from the immortal words of Sylvester Stallone’s character in the movie “Rambo” when he told the Sherriff:
“Let it go. Let it go.”

The U.S. real estate engine needs to start chugging again…preferably sooner rather than later to benefit everyone. But do we as individuals have any say in the matter? Sure. Just stop dreaming, stay grounded in reality and take what the market will give you. If you as a seller continue to hold out for full list price, you will have effectively bought back your own property at full list price. Would you pay full list price for your own property today? More importantly, can you afford to buy back your own property at full list price today? A piece of real estate is only worth what someone is willing to pay for it. It does not matter what you think your property would have sold for in 2007 or 1907 for that matter. It doesn’t matter how much you want. It doesn’t matter how much you previously paid for it. It doesn't matter how many gold chandeliers it has. The only thing that matters is what someone is willing to pay for it. Everything else is wiffle dust. Admittedly, we've seen clouds of wiffle dust floating around nearly every real estate office this year.

Yes, we had a market correction…a really big correction. But lately there have been some small encouraging signs. It feels like the real estate slack tide is starting to move. I think I hear the real estate engine struggling to sputter back to life in fits and starts. Has the market turned? Frankly, it would be nice just to stop spiraling downward. But recent reports in Southwest Florida indicate there may be another small wave of residential foreclosures coming in the next few months. The bottom of our market could be this summer. Following our summer of discontent, I suspect a "Leveling-Off Period" may prevail over the last quarter of 2008. I further suspect it will be a long slow road back with flat to ever-so-gradual increases over 2009 and the first half of 2010. Real estate flippers will turn to flipping burgers. Our real estate market has been rocked nearly to the breaking point. Just like the patient who suffers a near-fatal accident, our real estate market needs to stabilize before starting the long, slow road back to full recovery and good health…which will happen.

Segment Analysis
The close-up view varies depending upon the specific market segment. Co-Star shows average vacancies in Lee County now to be: 14% for Office, 9% for Industrial and 6% for Retail. Some market segments are weaker than others due to this vacancy disparity. These three commercial segments each have properties with leases in place that typically range between one and five year terms. If you own one of these commercial buildings that have little vacancy with lease terms that run through the end of 2009, you will be in good shape to avoid getting hurt in this downturn…assuming your tenants stay in business. But if you have vacancy now and/or leases due to expire in the next six months, you will face good competition to rerent your space…so expect to give competitive rent and TI (tenant improvement) concessions if you want to win back your tenant's business. In slow economic times with more vacant space to choose from, your most important tenant is your existing tenant. Tenant retention is at the top of every commercial owners "To-Do List" right now. We do not have healthy growth of new businesses in today's

economy so you cannot fully depend on new tenants coming into our SWFL market for the first time to rent your vacant space. That leaves existing tenants in the market as your primary target. Your neighbor may love you but expect him to covet your tenants who have short term leases. Communication and being reasonable are the two keys to successful tenant retention this year. Buildings with good occupancy and good triple net leases are selling well at good value. Buildings with vacancy issues and/or short term leases are trading at discounted prices. Value lies in your leases. Get good leases to get good sale prices in commercial real estate. Vacancy hurts cash flow and sales price if you sell. No wiffle dust. It is what it is.

Hospitality Segment
I attended our company Florida Conference in Orlando on May 8-9th where I listened to our Hospitality Senior Advisor Natvar Nana (NanaN@svn.com) address the Hotel/Motel (or HM) market. I learned some interesting things.

The Hospitality industry is keeping a fearful eye on gas prices since it is affecting travel patterns. The Hotel/Motel industry had a national average vacancy factor of 25% for 2007 and the first quarter of 2008. But it just hit 35% vacancy during the second quarter causing much stress amongst HM operators. Florida HM vacancies have historically followed national averages. But the weak dollar has recently caused some Florida spots to break from tradition and actually show positive growth in occupancy and average daily rates (ADR). The weak dollar has created bargain basement prices for our European friends taking holiday in Florida. The Orlando Hotel/Motel market in 2007 had 27% vacancy while 2008 YTD has improved to 21% vacancy according to the Kissimmee Convention & Visitors Bureau.

The HM property segment has very different business dynamics from the other commercial segments of office, industrial & retail. This is primarily due to Hotel/Motels having shorter lease terms. The HM market has leases that run day to day since people rent Hotel/Motel rooms on a daily basis. The HM industry is dependent upon seasons, events and market trends. HM operators must closely monitor and react to an ever changing business landscape by changing their rates as needed. In today’s unsettled economy, most aggressive HM operators have been changing their rates by as much as 2 to 3 times per day. Unlike the other commercial market segments, the HM segment owners can't depend upon long term leases of 1 to 5 year terms to carry them through these slow economic times. Therefore, the Hotel/Motel market segment has the perception of being affected more immeadiately by our slow economic conditions in the eyes of lenders. This perception has caused financing to become scarce for many Hotel/Motel deals which in turn have lead to significantly lower sale transactions closed this year. There were more than 100 sales of Hotels/Motels in Florida valued over $3 million between January and April of 2007. But Florida was down to just 25 such HM transactions over the same period this year…or a 75% reduction in deal volume.

It is ironic that financing has become much harder for Central Florida Hotel/Motel sales in light of the fact their business has actually improved over last year. Never underestimate the power of fear in the capital markets, regardless of said fear being founded on sound underlying fundamentals…or not.

Hospitality real estate brokers in Central Florida with a 21% vacancy product coupled with a more difficult market for financing are stuck in the middle between buyers and sellers much more so than Lee County's: Office brokers with their 14% vacancy product; Industrial brokers with their 9% vacancy product and Retail brokers with their 6% vacancy product.

This partially explains why you cannot paint the commercial real estate market with a broad brush and be accurate. Each segment of the commercial market has a different vacancy level and its own set of business dynamics. Each property within a commercial market segment may have… a different amount of vacant space…some leases with long terms…some leases with short terms…some tenants of high quality…some tenants of low quality…some leases as gross leases…some leases as triple net leases. Commercial real estate value is tied to the quality, quantity and durability of the cash flow derived from its leases. It is the perceived risk level of future rent-collecting potential that determines the Cap Rate and thusly determines Sales Price of each individual commercial property. Bottom Line: One cap rate does not fit all commercial properties. The cap rate reflects level of risk for each property. You can beat the system to sell at top prices by selling when your leases are maximized with highest rents, longest terms and low to no vacancy.

As a simple example, look at the case of two different commercial properties being sold that each have the exact same net annual rent. Property A has Exxon on a 20 year term, triple net lease. Property B has ABC Mortgage on a 1 year term gross lease. Property A (with Exxon) will sell for a much higher price (i.e. lower cap rate) than property B (with ABC Mortgage) because there is much less risk to getting paid by Exxon for a longer term…even though both properties have the exact same net annual rent.

A rising tide lifts all boats in the harbor. Let's hope the second half of 2008 shows the end of this long real estate Ebb tide and the beginning of a new Flood tide. We are due…and more than ready for a tide change.

Mark Alexander, CCIM
Senior Medical Office Advisor: Sperry Van Ness
6360-2 Presidential Court, Fort Myers, FL 33919
marka@svn.com
239-826-4174