COMMERCIAL CONNECTION

Are there sunny days ahead?

The sun came out even after '80s slump

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Does anyone remember driving through the West Shore area of Tampa in the late 1980s? This time and place in Florida history is where the phrase, "See-Through Buildings" became popular. "See-Through Buildings" got their name when developers built office buildings and then could not rent them due to high vacancies and tough economic times. During the afternoon, you could actually see right through the windows to notice whole floors of unoccupied space that was left in a shell condition.

At night it was even easier to see since they left the lights on for security purposes. Developers held out for their projected rents (to their lenders) as long as they could. They eventually started discounting to try and survive. I had broker buddies from my CCIM network in Tampa tell me it was common back then for developers to offer a free year of rent if tenants signed 5-year term leases.

Of course, many tenants learned that game well and started defaulting on these leases after a year, which allowed them to move to another "See-Through Building" where they did it all over again. That's one reason why they called it a "Tenants' Market".

Now I don't think for one minute that we will ever reach office vacancy rates of 25 percent to 30 percent again like they had in Tampa at the end of the '80s. After all, Tampa and many other Florida cities at that time got overbuilt because of such national problems as the savings & loan crisis. This was back when banks would lend to any developer who had a dream and the ability to write a business plan.

You didn't need "pre-leasing" back then. Oh, what fun! Of course, the federal government had to then step in to bail out these S&L's when their loans defaulted at rapid rates ... which hurt the economy for a few years.

And then we had a little thing called the Tax Reform Act of 1986 which suddenly changed all the rules for investing in real estate. This act took away all these great tax write offs so we now had to base our real estate investments on numbers that made economic sense. Put simply, we had to have enough income (i.e. rent) to pay our operating expenses and debt service in order to show a profit. I am not kidding. Prior to the tax reform and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), you could operate a commercial property at a loss and gain wonderful tax benefits that made our "after tax return" profitable. That was kind of like getting a reward for not balancing your check book. Anyway, the net affect was it caused a lot of foreclosures which hurt our economy for a few years before we learned to play Monopoly again with the new set of rules.

But the main reason Tampa and other Florida cities got overbuilt in the late 1980s was because we had this wonderfully vibrant real estate market in the early '80s. Prices kept going up, we had more demand than supply and everyone dreamed of being a real estate broker ... including yours truly. Oh, what fun! During this time, we all thought we were bullet-proof. We all had the Midas touch.

Some CPA's were retiring early because they became self-proclaimed geniuses at real estate investing — because they could make more money in real estate than in their accounting practices.

Let the good times roll, baby!

It was during this spirit of economic euphoria that developers lined up at their local S&L shop for a loan to build an office building before they had any tenants lined up. So we got lots of beautiful, state of the art office buildings — with no tenants — by the end of the '80s.

Now we don't have an S&L crisis right now, but we do have high risk loans defaulting at an alarming rate, causing many foreclosures that may hurt our economy for a few years. Plus we have a war going on that could hurt our economy for a few years.

And we don't have a national Tax Reform Act of 1986 to worry about but we do have surging gas prices and a national residential housing slump that threatens to cause rising interest rates and rising inflation which could hurt our economy for a few years. And we did have high demand and unprecedented growth in real estate values over the past four years that made every one of us a self-proclaimed genius at real estate investing.

The next time you drive around town and especially down Summerlin Road, try counting all the new office buildings under construction or the new office buildings recently finished. See if you can see through them. I can.

It was only a matter of time before commercial real estate started softening a bit. It is not falling off a cliff like the residential market. We are not dramatically overbuilt. But it is softening. We have a good amount of new office space entering the market at a time when we have slowing demand because of an uncertain economy. We have many local businesses in Southwest Florida who are tied to the welfare of our severely slumping housing market like Realtors, title firms, architects, engineers, surveyors, attorneys, etc. All of these firms rent office space in our market.

During wonderful economic times like we had these past four years, the top end (i.e. most expensive and new) office space is most active because money is no matter. We all have it and can get more of it, right? But during slow economic times when survival becomes a conscious daily thought, the lower end (i.e. more affordable and older) office space becomes most active. I have been though these cycles before. Our office market is starting to shift from an owner's market to a tenant's market. Our one constant is change. Real estate moves in cycles ... residential and commercial.

Commercial income properties are valued by the income they produce using the cap rate formula. A high rent will bring you a high price and vice versa. It's the vice versa that I am concerned with now since rents should be softening over the next 12 to 18 months in the Southwest Florida office market due to increased supply and diminishing demand. Cap rates (or buyer's yield) always follow interest rates historically. If interest rates continue to increase, cap rates will follow them up. If the cap rate or buyer's return goes up, the seller's sales price goes down proportionately. The net effect over the next 12-18 months should be that we see slightly lower valuations for office properties ... if market rents continue to soften, and if interest rates continue to rise.

Having said all that, I remain your eternal optimist. I'm confident that a good commercial broker will still be needed to rent and sell these office buildings for best possible value. You know, this writing gig doesn't pay that well.

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