

How to Profit in a Slow Economy Rates, Recession, and Real Estate

by Ray Alcorn

The question of the day for commercial real estate investors is: What is the effect of a slowing economy and possible recession on valuations? The run-up in values for some sectors has raised alarms, and opinions range from "no more than a ripple" to "impending doom." For investors, there is much to consider in plotting our course.

Along with general economic conditions, valuations in commercial real estate are driven by four factors:

1. **Capital availability:** Real estate is a capital-intensive industry, and its health rises and falls with capital availability. Currently the capital markets are so flush with cash, they can't find a place for it all.
 2. **Supply:** Boom times typically engender oversupply of product. But construction prices have skyrocketed due to natural disasters and rising commodity prices, which has tempered new building in all property types. That lack of new supply increases rental pricing power and occupancy levels in existing properties.
 3. **High demand from investors:** Stable performance and ample capital have spurred high investor demand, with no letup in sight.
 4. **Interest rates and the economy:** The lone head wind for commercial real estate is higher interest rates and their potentially negative effect on economic growth.
- Let's look at the current economic conditions and outlook, the capital markets, and the likely effects on commercial real estate valuations and performance.

Interest Rates and the Economy

Interest rates are the source of greatest concern among real estate investors. The Fed has expressed their intention to contain inflation at the risk of raising rates too far before stopping.

But the Fed only controls the short end of the yield curve. Real estate loans are generally quoted as a spread over the 10-year Treasury bond.

Due to the global capital glut (discussed below) and a tendency for a flight to quality (i.e. government bonds) by investors during a slowdown, there is a strong case that 10-year rates will range from 4.5% to 5%. That is not a crisis in capital by any definition, but will fully invert the yield curve, which is a predictor of recession.

Rising consumer interest rates will further slow consumer spending and the housing market, and may produce the desired soft landing. Best guess is that the economy will continue to cool with GDP growth possibly falling into negative territory in late 2007. My working assumption is that a recession is inevitable at some point, and history suggests that's a safe bet. But it doesn't seem to be an immediate prospect, and more important is the reaction of the capital markets to a slowing economy.

Capital Markets

Commercial real estate values depend heavily on the availability and cost of capital. Historically, contractions in capital have a negative effect on valuations, and current rumblings from government regulators aiming to trim commercial banks' real estate loan exposure are worrisome.

Banks are experiencing shrinking profit margins due to higher yields on deposits, and

many have turned to commercial loans to offset the decline, hence the regulator attention. But before jumping to the conclusion that capital will become scarce, consider the bigger picture.

Global markets are literally awash in capital, all of it seeking yield and stability.

Fortunately, commercial real estate offers both, and even if banks are constrained there is a surfeit of capital to fill the void.

Securitized loan originators are steadily increasing market share, now over 25% of commercial lending. Hedge funds are pouring capital into real estate backed securities for debt and equity. Pension funds are increasing their exposure to real estate loans.

Large private equity funds are rapidly expanding, more nimble than Real Estate Investment Trusts (REITs), with none of the regulation, higher leverage maximums, and a vulture mindset. Independent investors have taken advantage of historically low rates to access equity.

The 1031 market continues to thrive, driven by the explosion of Tenants-in-Common (TIC) syndications. For lenders and owners alike, commercial real estate is an enticing play—a secured investment with predictable performance.

Simply put, there is more money than deals. All of these capital sources are under extreme pressure to produce returns, evidenced an ever-expanding array of specialized debt and equity products that extend further out the risk curve every year.

A 100bp rise in average permanent loan rates results in about a 50bp (0.5%) increase in cap rates (bp = basis point; 100bp = 1%), which is easily offset by increasingly creative capital structures.

It is a financial axiom that money flows to where it is well-treated. Commercial real estate has been a very hospitable home for capital, and the outlook is for more, not less.

Fall and winter of 2006 shaped up to be a borrower's market.

We discussed economic conditions and the outlook for capital availability for real estate investment. Now let's turn our attention to the effects of those conditions on various commercial property types, and specific strategies that can profit from the current trends.

Supply and Demand

Supply and demand works on two levels in real estate. First there is the obvious issue of the number of tenants seeking a certain kind of space. As previously mentioned, construction costs have gone through the roof in the past year due to sequel natural disasters and increased commodity prices.

The good news is that the lack of new supply increases rental pricing power and occupancy levels in existing properties. More tenants for fewer units equal improved rent and occupancy levels, known as the “fundamentals” of investment real estate performance.

On a second level is investor demand for income-producing properties. As fundamental performance improves, more buyers are seeking to acquire properties, but supply is subject to the same construction-cost constraints. This creates sustained upward pressure on valuations. The question is whether the trend can or will continue.

To find our answers, let's consider the recent conditions and outlook for specific property types. But as we do, please keep one thought in mind: real estate of all types is subject to local market conditions, which trump the average trend data presented here.

Multi-Family

Apartments and mobile home parks are best positioned to weather the storm of a slowing economy. High construction costs and condo conversions have reduced new supply and a slowing housing market increases rental demand. Owners can now flex their muscles with rent increases, and those who bought at high valuations may yet get the last laugh.

Mobile home parks are already benefiting from the return of capital sources for manufactured home buyers, and severe zoning restrictions continue to create a government protected franchise for existing parks.

For most areas, the improving fundamentals and high demand will sustain values. If you're considering selling, the time to name your price is past, but you'll find plenty of interest at just-off-peak levels.

However, multi-family performance is highly sensitive to demographic shifts. Plainly stated, people live where they work, and a one-year lease makes it easy to move. Areas with declining employment and population will experience an acceleration of those trends, and investors will not acquire properties in such markets without good reason to believe a comeback is in the offing.

The wild card in the multi-family sector is oversupply, but not in the traditional sense of new projects. The condo glut will have a negative effect in many metros as unsold units enter the rental market. Given the amount of supply, it is easy to imagine a scenario for reverse conversions to make sense.

Retail

Consumer spending is contracting, evidenced by decreasing retail-sales growth trends. For retail properties, that typically increases tenant turnover and decreases operating income after the Christmas season. However, the effects on valuations will be uneven because the benchmarks for the sector have dramatically changed.

Triple-net, credit-tenant properties are now the baseline for retail valuations. These properties are valued nearer corporate bond rates than bricks-and-mortar values. Long-term leases with corporate guarantees and no landlord responsibilities produce pricing with very low risk premiums.

As consumer spending slows, new supply will decrease, but continued demand from institutional, 1031, and syndication buyers will sustain high transaction volumes. Effects on value for the strongest credits will be negligible, but weaker credits are trending to a 50bps-75bps rise in cap rates.

Declining consumer spending increases tenant turnover and decreases the potential for rent growth, suppressing appreciation. The halo effect from triple-nets supporting high valuations in multi-tenant Class A retail properties will suffer as owners rediscover risk as a component of value.

However, most of these assets are owned by REITs and well-capitalized private equity groups that can easily ride out the storm.

A growing retail niche is mixed-use projects. Local governments love them. They are easily financed and suitable for value-added strategies. Closely related to mixed-use properties are retail condos.

With \$500 billion in sales last year (through June), they provide a lucrative exit for owners and are beginning to compete with triple-nets in investor popularity, offsetting

declines in valuation from declining fundamentals.

Additional opportunities for retail investment can be found in Class B and C properties, like neighborhood strips and older centers. Their vulnerability to changing market dynamics and tenant closures can create opportunities for repositioning, change-of-use, and mixed-use redevelopment in areas with sound demographic trends.

Office

Office rent rates and occupancy levels continue to increase in large and small markets alike. Usually when rents and occupancies increase, development increases. But due to the extended weakness following the 2001 recession, condo conversions, and soaring construction costs there is very little new supply in the pipeline.

The sweet spot could be tenuous. Office occupancies are driven by employment levels, and if job growth slows dramatically (as some data sets indicate), then rents flatten and vacancy rates increase. But most signs point to healthy corporate hiring, and continued moderate employment gains without wage inflation. A prediction for 2007 job growth of 1.45 million bodes well for the sector.

Recent pricing of the office sector produces yields well above other property types, averaging 8.5%-9.5% cap rates. This has not gone unnoticed.

According to a recent survey by CBRE, a national brokerage house, there has been a marked rise in sales of office properties held less than four years, compared to prior average hold times of eight to twelve years. Surprisingly, downtown properties have generally performed better than suburban locations, so opportunities may exist in the latter.

The Keys to Profit: Markets and Strategies

Real estate produces leveraged returns from a predictable income stream, appreciation, equity growth and tax benefits. However, acquisition of stabilized properties at low cap rates with little potential for rent growth is a sure recipe for below market returns.

Given current conditions, wholesale discounts in valuations are unlikely. Some easing is certainly in the cards, especially from owners who get edgy about riding out a downturn. But if you expect 25% discounts, it may get lonely on the sidelines. Rising demand from foreign investors--an effect of the soft dollar--is rapidly taking up the slack.

Weary of high prices in the metros, investors are now targeting secondary and tertiary markets. The most promising small markets are in the West, Southwest, and South Atlantic regions.

All are projected to outperform predicted nationwide employment growth of 7% through 2010, according to Reis, Inc., a real estate data research firm. Recent census data offers confirmation. Four of the ten fastest growing counties in the nation are outlying from metro Atlanta.

For above market returns, savvy investors will focus on creating a product that fills investor demand. Value-added and opportunistic strategies, wherein under performing assets are revitalized and brought up to market rents and occupancy levels, are perfect candidates for using the valuation trends to profit.

A value-added project has less risk than acquisition or development, can generate revenue during the improvement phase, and exploits the fact that while most markets are not over-built, many are under-demolished.

This strategy requires thorough due diligence at both the market and property level, and a deal structure that supports the investment plan. Once completed, the high demand, high-valuation market is the opportunity investor's best friend, creating a ready and profitable exit.

Changing conditions require adaptive strategies, and by matching the right strategy with local market dynamics, investment in commercial real estate continues to be a highly rewarding proposition.

Ray Alcorn is the Chief Operating Officer of Park Real Estate, Inc. in Blacksburg, Virginia. With holdings in the retail, office, and hospitality sectors, the company specializes in acquiring and developing high-quality real estate assets in the southeast United States. This article is reprinted here with permission from Creative Real Estate Online at <http://www.creonline.com>.