Rising Tide

2013 CRE Investment Market

When the capital and leasing markets collapsed in 2008, we predicted that it would be 2011 or 2012 before they started to recover. While 2011 was a slow year for leasing and sale of commercial properties, there was a noticeable acceleration in 2012 as a result of a rapidly improving housing market and a stronger economy. This increased activity included strong sales of core and stable assets, active lenders and robust leasing activity. These trends continued through the first quarter of 2013; but what can we expect for the last half of the year and how should an investor take advantage of these market trends?

So far in 2013, many economic indicators are pointing to a sustainable recovery; however a rising tide doesn't necessarily raise all boats.

We see a tale of two economies. On one hand, large corporations are apparently doing well. On the other, small businesses and entrepreneurs still appear to be struggling. Most economists believe that entrepreneurial growth will remain anemic and strain the economy throughout the year. These trends bode well for the owners of core and institutional properties, but raise a yellow "caution" flag at investors of non-core, less stable assets.

Leasing

PREF Prediction: Limited new development combined with an improving economy will result in higher occupancies and escalating rents in all sectors with some variation.

Office: In the office sector, high quality properties in a solid location with great access will benefit from corporate consolidation. Older office properties in generic locations will continue to experience high vacancies and stagnant rents.

Retail: Shop space at grocery-anchored retail centers will finally start to lease-up. Retail strips catering to small "Mom and Pops" and service-oriented retailers will continue to struggle except in" in-fill" locations. Restaurant leasing should remain strong.

Industrial: Institutional industrial properties will attract online retailers who require large distribution facilities and data centers. Small-bay warehouses, particularly those in urban and close-in suburban areas will experience an increase in leasing activity.

Medical Office: Medical office space either on or near hospital campuses should lease well. However, non-medical buildings with small practices could have problems as these practices are absorbed by

larger operations or hospitals and landlords have to replace them with non-medical tenants that pay lower rents.

Investment Sales
PREF Prediction: There will be a continued demand for a limited supply of institutional core assets, single-tenant, net-leased buildings, medical office and multi-family properties. Cheap capital, coupled with demand, will keep these assets at historically high price points. Servicers for lenders are more inclined to hold onto and lease-up the higher quality assets rather than sell at steep discounts. At the lower end of the market, many banks sell notes to hedge funds which reduced the availability of distressed properties for sale. For investors this means a slower release of and higher prices for properties for sale.

Existing Loans
PREF Prediction: The loan maturity bubble will continue and many borrowers will struggle to pay-off or meet the terms of existing loans. This situation should gradually ease as the number of outstanding loans made between 2005 and 2007 decline, leasing fundamentals improve and interest rates remain low; however, many borrowers still lack cash reserves to lease and cover the gap between the current loan and the new loan which is based on a lower value.

Financing
PREF Prediction: Acquisition financing – particularly for core assets – will be readily available (and cheap) albeit with strict underwriting and terms. With clean balance sheets, commercial banks are becoming more active in the "value-add" segment of the market. Underwriting will be tough, loan to value ratios will be well below previous highs and borrower credit will receive heavy scrutiny.

WHAT DOES THIS MEAN AS AN INVESTOR?
With the strengthening of the economy, leasing risk is beginning to wane and good, financeable deals are on the rise. Yet, turbulence still exists. Now more than ever, real estate fundamentals are the guideposts to strategic, long-term real estate investment that delivers reasonable returns.

Our Tips:

- Evaluate all investments on an "all cash" basis. If it makes sense without debt it is probably a good deal.
- Investments that yield mid-teen returns or higher are VERY RISKY. These deals either carry significant leasing risk or use aggressive, short term financing to achieve the desired return.
- Make sure the deal sponsor has "skin in the game" and that the financial benefits they are receiving are activity and success based.
- Buying "below replacement cost" is meaningless if the property fundamentals are poor.
- Always compare the current rents to market rents. Properties currently leased at "above market" rents produce great short term yields but can present long term problems.