NICK NICHOLAS
nick@nicholasco.com

Nick Nicholas, CRE, CCIM, MAI is a commercial real estate broker, investor, counselor and consultant with 34 years in the commercial real estate industry.

An Uneven Recovery

The last four years have taken us through, and brought us to, an interesting market reality characterized by inconsistent juxtaposition.

The entire commercial real estate market has suffered since 2008, with across-the-board drops in property and improvement values (albeit with a slightly muted impact in Texas). And, for the most part, the recovery has not been even in all asset types and classes. The technology industry has bounced back, to be sure, with Apple vying with Exxon to be the largest company in the world (by market capitalization) and smaller innovators returning to the market; however, the financial and most real estate sectors continue to see anemic growth and have not returned to their pre-2008 levels.

Even within particular sectors we have seen an uneven recovery. In the financial sector, smaller institutions struggle to consolidate and purge bad assets; larger ones face issues of liability over mortgage lending and uncertainty over future margins from fee-based income.

In real estate, this dichotomy has emerged as an unequal return to prior value across property classes. Class A properties, at least in the North Texas market, have largely returned to their historic 2007 prices, while most B and C property values have continued to struggle to return to a sustainable equilibrium. Identifying the source of an inconsistency like this is difficult, but it is likely the result of bank lending and investor risk appetite.

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The issue of lending probably has the larger impact. While politicians and bureaucrats at many levels of government are agitating for increased credit liquidity (including in the real estate sector to bolster property values), they are simultaneously allowing their regulating bureaucracies to criticize and punish lenders for making real estate loans. Despite the fact that, historically, real estate loans have accounted for a large portion of banks' portfolios, bank investors are still wary of real estate loans, and will discount banks' valuations based on their individual holdings of real estate-related loans.

Capitalizing on the situation, especially with their access to inexpensive capital, these financial institutions may charge higher rates to the less-risky class A properties, while rationing credit to projects involving class B and C properties.

Exacerbating these financial institution lending practices, the Fed's measures to hold interest rates low have undercut non-government investment. With bank borrowing costs (the 'cost of funds') at all-time lows (near zero for certain sources), even the low return on treasury securities is an attractive investment for lending institutions, as the low borrowing costs allow for a decent margin on government securities. With a decent 'risk-free' return and a de facto penalty on increasing real estate lending, it's no mystery that banks are decreasing their portfolio allocation of real estate loans in favor of less risky investments that also provide a not-so-trivial return.

LOCATION MATTERS

The second salient aspect is real estate investors' aversion to risk. While class A properties carry less risk (though theoretically a correspondingly lower return), class B and C properties might involve the risk of stagnating or dropping prices, especially given the fact that their values are dependent on the 'micro-economy' of their geographically immediate market areas.

This confluence of factors has worked against the real estate market over the past few years, but it also represents opportunity for those willing to put in additional effort. Local financial institutions that have resolved their asset issues are willing to offer competitive rates for well-planned and adequately equity-financed projects - and compressed prices on class B and C properties can offer attractive returns for savvy investors. In fact, according to a recent report by CoStar, which tracks certain indices related to the commercial real estate market, although the investment-grade real estate was faster to rebound and stabilize after 2008, the demand and net absorption rates for general commercial property actually caught up with and exceeded those for investment-grade properties in 2011. This suggests that while investment-grade capitalization rates are still lower than expected when compared with commercial property in general, we should expect a convergence over the next two years.

Ultimately, the equilibration of capitalization rates will be driven by disappearing disparities in value, as real estate lending returns to the 'new normal' and investors begin taking advantage of the remaining arbitrage opportunities. Until then, the real estate sector should not be avoided by investors; the reward for a little additional research and work may be an outsized return.. n

Billionaire Warren Buffett said the U.S. economy is "coming back" and doesn't need more stimuli, despite an uneven recovery that mirrors the fortunes of businesses at his company, Berkshire Hathaway. Improvement in the business environment is likely to be reflected by a decline in the unemployment rate, he says, probably to the low 7% range by the November 2012 elections.

I wondered why the baseball kept getting bigger. Then it hit me.