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Office outlook for real estate in 2010: The stage is being set for a sustainable recovery

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Every week I speak with various clients, owners and industry professionals and am often asked my opinion on market trends. In many respects the office market, like the broader market, has floated along in suspended animation over the past 18 months. I think life returns in 2010, and we will see the beginning of the market that emerges over the coming years. The constant barrage of negativity too often ignores that the stage is being set for a sustainable recovery.

In 2010 there will be high unemployment, increased owner and investor activity, de-leveraging and distressed assets, and increased credit availability. I think it will mark the beginning of a "U" as opposed to a "V" or "W" shaped recovery, with little downside. I feel much of the "searching for a bottom" has already occurred, a pattern I often saw in my 10 years at Lehman Brothers. Pricing will stabilize around a "moving median" not far from where I am seeing bids for office buildings now, though perhaps a bit lower than recent comparables suggest. Acquisition capital grows daily, and the relatively limited supply of properties could give unexpected price support to sellers in 2010. Values have fallen 25-50% depending on property, tenant, and location, often to levels roughly along a decades-long trend line. It always surprises me how many economic processes 'mean-revert' this way.

Ultimately, jobs drive the office market and unemployment will remain high. In two years, the U.S. lost approximately 4-5 years trend line job growth. Although the loss rate has decelerated, hiring will be tempered by companies focusing on employee and workspace efficiency improvements and will lag signs of recovery. However, government has recently signaled a strong jobs focus whereas 2009 efforts appeared to center on healthcare, tax and other regulatory reforms.

Rent and concession pressure owners faced in 2009 will continue in 2010, but without a dramatic increase. Unlike other cycles, this one is dominated by lack of demand, not oversupply, and vacancies are found everywhere. Additionally, significant 'shadow' space will remain and few can afford the accounting charge that a formal sublet at a lower rent could force. Some 'new' demand will be tenants trading up for quality or price improvements.

Credit availability will improve slightly in 2010, but insufficient to meet demand. Back to basics underwriting will remain and "out of guideline" properties will be punished disproportionately. CMBS volume will return building on December issuances as yields have fallen to competitive levels and underwritten valuations are sufficiently conservative.

The well intentioned government sponsored stabilization efforts, while narrowing and stabilizing credit spreads, have also delayed bank balance sheet repair. Many borrowers have relied on low interest rates and term extensions. Many banks have avoided write-downs while simultaneously borrowing cheaply against impaired collateral.

In 2010, capitulation will begin as near term hopefulness dissolves into realization that serious issues won't resolve quickly. Additionally, stimulus measures will likely reach their limits and could pressure inflation and interest rates. Bank examiners are already increasing commercial loan portfolio reviews and some distressed inventory has already hit the market with more to come.

However, 2010 likely won't see the flood of distressed assets buyers have anticipated. Uncertainty around the volume and quality of assets will initially stall some buyer activity, and it could eventually depress comparable sales and market pricing. But many of these deals will likely be hard to replicate and/or be creatively structured. Recently, I have worked with several buyers to structure forward purchases that are subject to the property achieving milestones (e.g., occupancy) before title is passed.

The anticipation of distressed inventory that will have to be worked off before 'market' pricing returns will artificially widen bid ask spreads, dampening transaction volume. This may also delay transaction if owners remain confused between fundamentals-based bids and simple buyer opportunism. In any event, two unrelated forces will boost seller activity: 1) recent low transaction volumes mean a large volume of pent-up frictional trades awaits in the pipeline, and 2) the impending 2011 capital gains tax increase.

While a "bottom" will only be seen in hindsight, 2010 should be remembered as the year that the market got off the floor.

Andrew Lester is the managing director of investment sales, CPEX Real Estate, Brooklyn, N.Y.