PROCEED WITH CAUTION

By John Salustri

The commercial real estate industry isn't exactly famous for its long-term memory and ability to learn from lessons of the past. But is it possible that we're already forgetting the recent economic unpleasantness as the recovery gains an increasingly solid footing?

The thought came to me at the December ICSC Dealmaking Conference in Manhattan, where the tone may not have been irrational, but was by all means exuberant...interesting for a market segment—retail—that not long ago served as the poster child for the downturn.

Needless to say, we're in a much better position economically than we were even a year ago, and the market as a whole is responding. Fundamentals are shoring up, capital is flowing again, deals are getting done, and life is good, or at least, better.

And here is where we have to start watching our steps. It's here that the mistakes can be made before we find ourselves too far out on a limb to correct them. Or as author Jonathan Miller said in this year's edition of Emerging Trends in Real Estate (his annual opus for ULI and PwC):

"The generally positive outlook flowing from this year's Emerging Trends interviews and survey does have a dark side. Upcycles breed optimism, but excessive optimism can promote recklessness. Some interviewees asked, with good reason, whether real estate will soon forget the hard-learned lessons of the recent past. Such prophets of caution are worth listening to, if the respondents to our survey are right. Equity underwriting will be less rigorous in 2015 than in 2014, say 40 percent of the responses across all sources of equity. Easing of standards on the debt side will be even greater, with 42.1 percent seeing lenders loosening next year. And this is happening at a moment when mortgage spreads are already tight, and Treasury rates will inevitably rise.

"But our interviewees detected that pricing, underwriting standards, and deal economics have gotten ahead of market fundamentals. The macroeconomics for 2015 are looking favorable, and fundamentals may catch up. Or may not. Cyclical risk needs to be watched."

Indeed, and now's the time. "I have yet to see any viable trends with adequate velocity to justify any sense of exuberance--in all sectors." So says Wayne D'Amico, CCIM, president and principal of PropertyPolitics.com, a development and advisory firm. The major players are making deals, he notes, but these are "not translating to the secondary and tertiary markets."

But, if Emerging Trends predicts a softening in underwriting, D'Amico isn't sensing it yet: "I don't see a big push beyond the 75 percent threshold. That is holding pretty solid." But there are areas of concern, interest rates, for one. Every year predictions arise proclaiming that this is the year rates will come off the floor, and if the soothsayers are finally right, it will have some impact on values.

Cap rates generally have D'Amico on edge. "Five percent cap rates just don't make sense in real estate," he says. "The external impacts on the market and the valuation are not accommodated in a capital-markets cap-rate environment."

And, on the CMBS side (talk about your poster child), D'Amico, like so many in the market, are still waiting for the recessionary extend-and-pretend shoe to drop in a $1.4-trillion descent.

But to look at life from the other side, for SIOR's president elect, Allen Gump, SIOR, CCIM, the glass is half full. The Dallas based industrial EVP for Colliers International says the proof is in the leasing. "It does seem at times we get over our skis," he says. "But the numbers don't bear that out. We have the lowest vacancy we've had in my career." And while his focus is on industrial, he sees office performing roughly the same.

Although he is seeing what he refers to as "head-scratcher" deals, such as a few tertiary submarkets where someone decides to build despite significant vacancy, with the justification that they are "anticipating where the market will be in 18 months. In my definition," he says, "if you forget the things that happened in the last go-around, you overbuild. Period. That is a function of developers charging fees, and the way to get fees is to build. Their job is to build whatever possible whenever possible. There was an old saying by one of the old-line Dallas developers that a dollar borrowed is a dollar earned and a dollar paid back is lost forever."

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pad-ready site than with a vacant spec building.

It hasn't been that long ago when 150 parking spaces and 25 extra trailer parks for a 500,000-square-foot building seemed adequate. Today, with multiple picking methods, large numbers of SKU's, and intensive parcel volume that come with omni-channel distribution, parking and truck flow are often the first criteria, after location, that cause existing buildings to be cut from the short list. Pad-ready sites with proximity to online shoppers, flexibility to accommodate both flow and parking, as well as immediate interstate access are certain to be preferred for many such requirements, and several are already in play.

Even so, if a tenant were looking for a 32' clear space over 600,000 square feet in the Atlanta market that is both vacant and available; as of the fourth quarter of 2014 there would have been exactly one option in this 655 million square foot market. Atlanta's development community is diligently working to ensure that type of supply imbalance is temporary. 2015 is setting up to be a year when Atlanta is open for business on every level; tenant activity, investment capital, and now spec development are all starting the year on optimistic notes, a scene welcomed by tenants and brokers alike! ■

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And he has seen a number of what he calls wanna-be developers swoop into Dallas. They come not knowing the local market and armed with concepts that they say worked in California and the attitude that, "the yokels here don't know enough." But these, he says, are few and far between, and the majority voice is that of well-financed and savvy developers with the wherewithal to sustain an economic blow should – or when – one occurs, names like Duke, Prologis and IDI.

And while Gump is not on the front lines of capital trends, he measures the stability of that market by its production: "What I see every day is solid projects being built by extremely qualified developers. Given the leasing performance, it's hard to argue that they're making a mistake."

And as the market continues to accelerate, the percentage and volume of such deals is sure to rise. Which further underscores the need for caution, for so too will the volume of wanna-be deals and dealmakers, and without a careful eye to see through the growing roses, we might very well be left in the weeds. Excessive optimism, to reprise the words of Emerging Trends, can lead to recklessness. And at the end of the day, who wants to party like its 2007? ■