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ARTICLE

Financial realities alter future for commercial real estate

By Rob Murray III, SIOR, CCIM
Vice President of Springfield-based RB Murray

At the recent world conference of the Society of Industrial Realtors (SIOR) in Minneapolis, the key topic of conversation and debate was not how the financial collapse on Wall Street happened, but where commercial real estate is headed.

Driving the industry
Fundamental drivers of commercial real estate growth and property values are: supply versus demand; big picture ties to gross domestic product; jobs and retail sales; and access to capital.

Two contributors to those drivers – commercial mortgage-backed securities and real estate investment trusts – have a major impact on how commercial property values and developments evolve.

Until the recent financial meltdown on Wall Street, more than 40 percent of commercial mortgages have been packaged, sliced and diced as commercial mortgage-backed securities. Commercial mortgages were originated in local markets then packaged with other mortgages into pools sold on Wall Street.

In 2006, there were $202 billion worth of loans originated in the CMBS market. In 2007, the number increased to $230 billion. Then came this year's iconic financial collapse.

The projected CMBS figure for 2008 is $12 billion, representing a $218 billion decrease in funds lent to commercial customers. The glory days are gone. Lender requirements have changed from originating loans with nothing to 10 percent down on "projected property values" to new requirements of 20 percent to 40 percent down on "actual property cost."

Alongside the easy money available from the CMBS market, real estate investment trusts started using this money and shareholder money to drive up real estate prices. REITs typically own name-brand, income-producing properties.

Springfield's Battlefield Mall, for example, is owned by Simon Property Group, a publicly traded REIT.

As money flowed into Wall Street, many small and institutional investors have purchased shares REITs, providing liquidity for these firms to aggressively acquire real estate assets. Demand outpaced supply, and cash-flush REITs began to bid against each other for trophy properties, pushing the price of these properties to historic levels.

Since first-quarter 2007, the market capitalization of the REIT industry has decreased from $465 billion to $293 billion as of October, a decrease of 37 percent in fewer than 18 months.

General Growth Properties, one of the largest REITs on Wall Street, was trading shares 12 months ago at more than $50. In late November, General Growth shares were less than 25 cents. The company was delisted from the stock exchange and has since filed for bankruptcy.

The more than 800 malls General Growth owns are now waiting for savvy investors and REITs that have not overextended themselves.

Local Impact
How does this affect the commercial property market in southwest Missouri? Speculative development has slowed and will not return to its previous vigor until there is demand from retail, office and industrial users for new properties. When demand returns, the cost of entry for a developer will be as it was in the 1980s and 1990s, with banks mandating down payments of 20 percent to 30 percent and solid tenant commitments in advance.

One way to facilitate development and community growth in times like these is a progressive and open-minded position with regard to public/private partnerships, such as tax increment financing and community improvement districts. These partnerships are incentives for businesses to locate to Springfield instead of other communities, bringing in more tax revenues and new jobs.

Property valuation is changing daily, and data point toward capitalization rates increasing nationally. Capitalization rates provide a very simple snapshot of an income property's value based on the net income received by the landlord after all expenses.

Changes in capitalization rates and lending requirements have a significant effect on the value of income-producing property.

Fortunately, Springfield does not have significant vacancy in the commercial real estate sector, and property owners are not motivated to sell performing assets, due to higher asset replacement costs and a poor stock market alternative for sale proceeds. In Springfield's solid commercial market, there is limited supply of income properties available for sale, therefore keeping cap rates relatively low, and helping to insulate Springfield from the rising cap rates that other overbuilt markets are experiencing.

None of the city's commercial segments are significantly overbuilt, and commercial foreclosures have been rare. The multifamily sector continues to maintain strong occupancy levels. We are seeing an increase in energy efficient "smart/green" buildings for owner/occupants, which will help keep the construction trades busy as speculative projects slow.