

A Reprint from *Tierra Grande*



By Mark G. Dotzour

America's commercial real estate market is running strong and hot. Millions of square feet of office and industrial space have been leased since the recessionary periods in 2001, 2002 and 2003. As buildings have filled up, rents have gone up.

Have Cash Will Travel

Chasing Global Returns

Prices of quality commercial properties have risen dramatically in the past four years. The rate of increase in building values has been astounding, resulting in prices higher than any seen before in Texas or the rest of the nation. Veteran commercial market lenders, developers, investors and brokers wonder just how long this phenomenal market can continue.

Market Cycles

All real estate markets go through cycles. The commercial cycle begins when existing buildings start to fill as the economy comes out of a recession. In the second phase, low vacancies cause rents to increase. The third part of the cycle occurs when rents get high enough to prompt new construction.

When aggressive building produces more space than is needed (the fourth phase), vacancies increase and rental growth slows. In the last phase of the cycle, overbuilding runs its course and market activity subsides until national economic growth produces enough new jobs to fill the vacancies. At this point, the cycle starts again.

Where are we in the cycle today? "We are in the ninth inning of a nine-inning game," said a CEO at the Eighth Annual U.S. Real Estate Opportunity and Private Fund Investing Forum in New York. Another said, "Most deals today are based on the assumption of double-digit rent growth for the term of the loan."

Other CEOs and senior management of the world's largest real estate capital providers see changes unfolding. Many big investors are at their allocation levels for real estate; they will either have to raise their allocations or max out. Most of the money made in the past two years has come from flipping deals from one firm to the other with a 6 percent capitalization rate (cap rate) to a 5 percent cap to a 4 percent cap with more leverage. Frenzied participants have been buying at a 5 percent cap, selling at a 4 percent cap and reselling to a 3 percent cap rate. Many deals have no free cash flow for ten years. Owning a quality office building is like owning a football team: it makes no money until you sell it, said one CEO.

Large institutional investors typically have a long investment horizon known as a "holding period." However, current holding periods have been shortened.

One CEO compared the market to a game of musical chairs, with players seeking to reduce the holding period. Another called it a "hot potato market."

Commercial Lending Standards

A global glut of capital-seeking investments is one reason commercial real estate property prices have skyrocketed. At the same time, commercial mortgage lending has gotten competitive, and lenders have relaxed their underwriting standards to compete for loans. In the past few years, lenders have underwritten many mortgages with interest-only terms, some for the entire term of the loan.

Hedge fund and private equity firm managers are looking overseas for higher-yielding real estate investments.

The debt coverage ratio (DCR) is a traditional measure of the risk of a loan. In the past, lenders wanted the income of a building to exceed the mortgage payments by 15 to 20 percent. Feverish lender competition has led to many commercial loans being made with a DCR of 1.0, meaning that the income of the building just barely covers the loan payments, leaving no cash flow to the equity investors.

More aggressive lenders have underwritten loans in which the property does not generate enough cash flow to cover the loan payments. To compensate, they include a reserve in the loan to make the payments in the early years of the loan. They and the building owner hope rents will increase substantially over the coming years. If rents do not increase sufficiently, some buyers have a hard time meeting their mortgage payments.

Commercial mortgage lenders got a splash of cold water in their faces when the difficulties in the subprime residential market came to light in early 2007. Bond

rating firms were somewhat surprised by the number of mortgage loans becoming delinquent. Moody's Investor Services, Fitch Ratings and Standard and Poor's (S&P) announced in April that they would raise credit enhancement levels. The S&P report sent a shudder through lenders, and the cost of borrowing increased.

The wave of hyperaggressive mortgage lending has crested. Mortgage loan terms are reverting to historical levels, with more emphasis on amortization, some equity required and strong DCRs. There is still an abundance of investment capital to be poured into real estate mortgage lending and equity investment. But the subprime lending scare has prompted a modicum of caution in the commercial market. Many capital market experts expected mortgage underwriting standards to tighten in the second half of 2007.

The good news is that default rates on commercial real estate loans are at all-time lows. With rents increasing, space filling and prices escalating, don't expect



weakness in commercial mortgages in the next year. Only when new supply overwhelms demand will defaults increase in the commercial sector.

International Investment

Many believe commercial real estate in the United States is "fully valued," meaning it is going to be hard to earn high yields at current prices. Hedge fund and private equity firm managers are looking overseas for higher-yielding real estate investments. American institutional investors, including pension fund and endowment association managers, are convinced that overseas investments are the most promising.

American interest in Japanese, Brazilian, Russian, Indian and Chinese properties is particularly strong. Western and central European properties are attracting interest as well. At the same time, foreign investors think their markets are too high and are moving investment dollars into American real estate.

New Development Coming

With “core” real estate investments priced so high that yields have declined dramatically, investors are looking elsewhere. One fund manager commented that a lot of investors don’t want to be in core anymore. Cap rates are so low that there is basically a negative leverage situation in the market — that is, the expected returns for investors are lower than the cost of mortgages. This perception is widely held by the “smart money” in the commercial real estate investment world.

Consequently, a new energy is building. Managers of pension funds, endowment associations, private equity firms and real estate investment trusts all want to get into the development business. Yields on development deals have fallen by 500 basis points (5 percent) in the past five years, according to one report. Even with declining expected yields, the focus on building new projects is intense.

“There are a lot of crazy deals being done. It’s very risky to be initiating new joint venture strategies at this phase of the market,” said an international developer. Cap rates have dropped below 3 percent for apartments in New York City, and developers are willing to accept a 7 percent cap rate for developing a new office building. This is an extremely low return for the risk associated with development.

Even though prices are high and yields are low, investor money has been cascading into real estate funds of all types. For example, Allstate Investments LLC is reportedly putting \$600 million into real

estate in 2007, \$800 million in 2008 and \$1 billion per year afterward. Prudential raised billions for a recent real estate investment fund and had to turn away investors.

General Electric already has over \$50 billion invested in real estate and is looking to invest more. *Real Estate Alert*, an industry trade publication, has identified 385 active or planned closed-end funds seeking a return of 10 percent or more, up from a revised 258 funds a year ago. If these funds achieve their goals, they will need to find over \$600 billion worth of real estate to buy.

What Happens Next?

Returns on quality investment-grade properties have been driven to historic lows. Expect to see increasing development activity across the United States as more money continues to flow into the real estate sector and investors seek higher yields from new projects.

Over the past two years, high construction costs and land prices have served as a modest constraint on new building projects. There is a plausible scenario for the next few years in which construction costs fall and overbuilding takes off. Here is how that scenario might play out.

- The overheated Chinese property and stock markets decline significantly.
- Development in China slows after the 2008 Olympics.
- Higher interest rates in China contribute to slow growth after the Olympics.
- Global demand for commodities falls as China’s economy slows.

- Financial distress occurs in emerging countries that have sold commodities at high prices because of high Chinese demand.
- Foreign currency markets get volatile.
- Flight to safety increases global investment in U.S. treasuries and U.S. real estate.
- Ten-year treasury rates fall.
- Construction costs fall as commodity prices fall.
- Overbuilding in commercial real estate hits full speed.

In a global market flooded with cash and desperately seeking investment return, investor fear and greed plays a big role in determining the future. As long as construction costs are high and investors are infatuated with overseas investment, expect new construction to be relatively constrained in the United States. If countries like India, China, Russia or Brazil run into trouble, however, look for construction cranes in the United States. ♣

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THE TAKEAWAY

The hyperaggressive mortgage underwriting that led to historically high commercial property values has ended. American real estate investors are looking overseas for future investments. Intense interest in new commercial development projects could lead to overbuilding.

cap rate

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Capitalization rate (cap rate) is a measure of return to an investor. It is sometimes described as a “cash-on-cash return.” Technically, the cap rate is the projected net operating income from a property divided by its value. For example, if an office building sells for \$1 million and delivers \$50,000 net operating income, the cap rate is 5 percent. Declining cap rates mean prices are increasing and investors are willing to accept lower rates of return.



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Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, \$20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin.