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Creating value in a transitioning market: Finding the opportunities that work well

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We have crossed the finish line of 2007 and begun the race of 2008. Trade publications like this one have been dominated by "review/preview" articles referring to the golden era and the wonder years of the commercial real estate market of the past few years.

We're coming out of a time when the economy was flourishing and many people were making money. Buyers were willing to pay top dollar for retail projects knowing that market rents in most areas were increasing rapidly. Big chains such as Wal-Mart and Target were growing their store locations at an unprecedented rate. Quick casual restaurants like Cosi and Panera Bread were popping up at every street corner while local chains were paying high rents to compete with the market. This allowed owners and sellers of retail real estate to capitalize on a very strong market.

However, the days of sellers being able to achieve low cap rates with little marketing other than just placing an ad on the Internet are over. Today, many deals are sitting on the market for a much longer time and are being repriced as the capital market weakens. The credit crunch resulting from the sub-prime mortgage crisis has snowballed resulting in a slowdown of investment sales volume across most of the real estate industry. There has been a corresponding slowing on the construction front. Lenders have created much tougher standards making it more difficult for a developer or an investor to obtain financing to achieve positive leverage on a deal-whether that deal is an existing center or a speculative ground up project. This has caused most investors to question their future investment strategy. No one can be sure where the market is going...or at least how low will it go. Some speculate that there will be a recession, while others hold a more optimistic view about the ability of the market to bounce back.

This week PriceWaterhouseCoopers (PWC) released its Fourth Quarter 2007 Korpacz Real Estate Investor Survey findings. Citing, "continued instability in the financial markets and ongoing uncertainty about the state of the U.S. economy," PWC predicts that investors throughout the whole commercial real estate industry will face challenges this year. The survey also revealed several key findings specific to the retail sector of the industry. Because most consumers, especially middle-class and lower-end consumers are spending less, many investors are being cautious about what they buy. Older class B and class C regional malls will become less attractive investments, while high-end retailers can expect strong growth. Secondly, the national power center market is also feeling the effects of the decline in consumer spending. As would be expected, properties in high-growth and affluent areas should be in a better position. As a result, big-box retailers are lowering their retail sales expectations. Finally, predictions about strip shopping centers are bleaker. PWC reports that the vacancy rate for strip centers has steadily increased from 6.9% in the first quarter of 2006 to 7.4% in the fourth quarter of 2007. They conclude that, "with a slowdown in absorption expected thanks to the drop in consumer spending, that vacancy rate is not expected to decline anytime soon."

The market was good to many companies, including Katz Properties; however, we are entering a new era. This era will look familiar to the veterans of the business, as the ebb and flow of the industry cycle again. It should come as no surprise as the real estate market again starts to transition. Transactions in this new era will be dominated by companies who have the knowledge and experience to work through a transitioning period. Katz Properties, like several other investment groups, view this change in the market as one that can bring great opportunity to investors that are able to take risks and see a slowing economy as an opportunity to invest in real estate at a reduced price than what was available in the past few years. Over the next few months, patience, diligence, and creativity are paramount to forging the gap between buyers and sellers who seem to be at in impasse.

As we look ahead, it will be imperative to figure out a strategy that enables buyers and sellers to best deal with a market that is clearly in transition. The opportunities are out there, it is just a matter of finding the ones that actually work and by work I mean work well.

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