Fort Worth Business Press

Commercial real estate uptick several years away

BY ALESHIA HOWE
August 10, 2009

Just as the nation’s housing sector is said to have led the overall real estate industry into its current downturn, the housing sector could be set to lead commercial real estate out, according to a recent presentation by Texas A&M Real Estate Center Chief Economist Mark Dotzour.

Dotzour, in addition to several real estate industry leaders, presented his findings at the 2009 Society of Texas A&M Real Estate Professionals’ Annual Conference at the Fort Worth Omni Hotel from July 30 to Aug. 1.

“More and more I’m thinking it’s the right time to buy a house,” Dotzour said. “With interest rates so low and the inventory is getting lower, I’m kind of tempted to tell people to pull the trigger,” Dotzour said.

According to David Craig, founder and developer of McKinney’s Craig Ranch, Dotzour may be right. Craig said thanks to recent reports of North Texas’ single-family residential units having a lower inventory, he has had two inquiries from custom home builders looking to build.

“That says they’re looking – but they’re looking in ‘A’ locations,” he said.

Dotzour said the nation’s residential foreclosures have wreaked havoc on the industry and will continue to do so until the situation is rectified.

“There are somewhere between 2 million and 6 million foreclosed homes in the nation and we’ve got to get these vacant foreclosures taken care of,” Dotzour said. “Either we need some tax help or we need a hurricane to land in Phoenix and go through Vegas and San Diego.”

A timeline for recovery

Contrary to earlier estimates that the nation’s real estate market could begin to rebound next year, Dotzour said the industry should be prepared to weather the storm for longer.

“Once we get price discovery for commercial real estate and the government backs out, prices will reset,” Dotzour said. “And when they do, they will firm up and core buyers will be back in and we will snap off those prices.”

Dotzour estimated prices for commercial real estate would continue to fall in coming months as cap rates revert to 2002 levels, occupancy drops on high job loss numbers and rents fall as “owners covet tenants.”

Ron Gafford, president and CEO of Austin Industries Inc., said he has not seen any stimulus money to date, but he does expect it to begin “dribbling in” via asphalt and infrastructure projects.

“We’re just not seeing the dollars now, but I do believe it will come. It just hasn’t had an impact it was pronounced to have,” Gafford said. “The ‘shovel-ready’ projects have been mostly asphalt for us.”

“We see a trend in that pricing is volatile right now. It’s a little more stable in Texas. We think Texas is an oasis for the nation and North Texas is an oasis for Texas,” Gafford said. “The good news is that as prices start to settle, there will be consolidation among sub-contractors and specialty trades.”

Steve Saxon, a partner at real estate investment advisor firm Realty Capital Partners, said while many projects are simply not moving forward in today’s economy, he has seen several ‘special situation’ projects getting a green light in recent months. One such project is a hotel at the University of California-Davis campus, where there is not an other hotel near.

“It’s a special situation,” he said. “… But [banks are] not going to finance an Embassy on the freeway.”

Saxon said his investors are still looking for projects, but now they want a “special story.”

“Deals that go out to our investors are the ones in the sweet spot – income producing,” Saxon said. “… We don’t know how a deal will be received by a high net worth investor until we go to them with the deal. And what they want changes from month to month. But right now they are staying away from anything single family and they like income properties. A lot of them are on the sidelines and it just takes a special kind of deal now to get that high net worth individual off the sidelines.”

Saxon said, in general, there are three areas of real estate that are still out-performing: medical office buildings, education and senior residential.

Craig said his development still is seeing good activity, but when a buyer is applying for credit to purchase land from him, that’s where the “rubber meets the road.”

“They can’t get acceptable credit,” he said. “But that’s good news because 12 months ago, they couldn’t get credit at all and now they can’t get acceptable.”

Craig said he makes an effort to educate his employees on the opportunities during a downturn.

“We’re still seeing deals being done and being in a recession is not an excuse,” Craig said. “Deals can be done, you just have to find a way to do them.”

Next year, Dotzour said the banking system will become even more of a focus as commercial real estate financing drives the industry. He expects foreclosures to increase in both residential and commercial properties and refinances will be recycled to be dealt with as the economy improves.

According to Dotzour, banks tend to stop lending when its Tangible Common Equity (exposure to real estate investments) reaches 300 percent. Currently, Dallas-Fort Worth banks are “on the bubble” at 290 percent and Houston banks are at 287 percent. For real estate professionals looking for financing, Dotzour suggested they look in markets where banks still have room to expand real estate exposure, such as in the Panhandle, where banks are at 104 percent.

“Right now banks are so exposed that they simply can’t follow through on threats to take properties back,” Dotzour said. “…Right now the buzz words in the banking system are ‘extend and pretend.’”

Dotzour told Aggie real estate professionals to expect slow job growth to begin to be soaked up in 2011 with no new real estate supply and rents stable. In 2012, he estimated rapid job growth with some properties still succumbing to foreclosure as mortgages continue to reset. Though there probably won’t be any new supply for the year, property values should begin slow growth, he said.

And in 2013, Dotzour said he expects property values to go up and cap rates to fall.

“You’ll have those high net worth individuals who are the first buyers in. Those people are not your core buyer,” Dotzour said. “They will buy and sell and make 25 percent return on their investment. But once those first buyers have come and

gone, here comes the endowments, the pension funds come in – and there’s your market.”

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