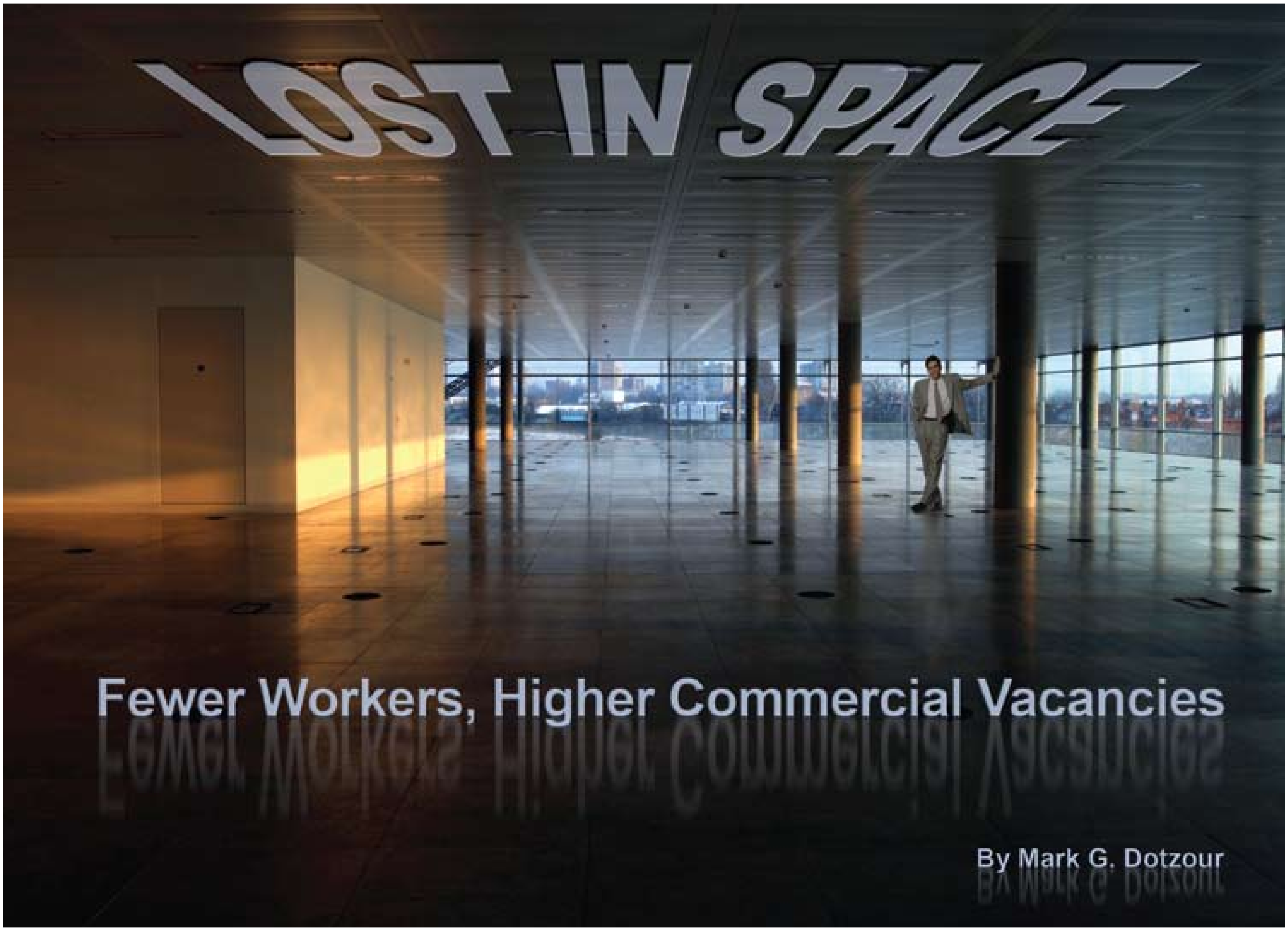
A Reprint from *Tierra Grande*



Is now a good time to lease more space? Is it a good time to build another building? Should commercial property owners refinance their buildings or wait? Should they sell their portfolios? If so, how should they invest the proceeds?

Thanks to confusing market conditions, commercial real estate professionals are likely to hear such questions frequently in 2009. They stand to gain market share by providing sound advice to bewildered and harried clients.

Principal questions of perennial interest to the entire commercial real estate industry are, "Will more space be absorbed this year?" and "What is likely to happen to commercial property values?"

Employment is Key

Absorption is a primary concern for all building owners. At the basic level, commercial real estate absorption is determined by the trend in corporate profits. In a free-market, capitalistic system, when profits are on the rise, companies want to hire more people to increase profit. Conversely, when corporate profits are flat or declining, firms often lay off workers until profits rebound.

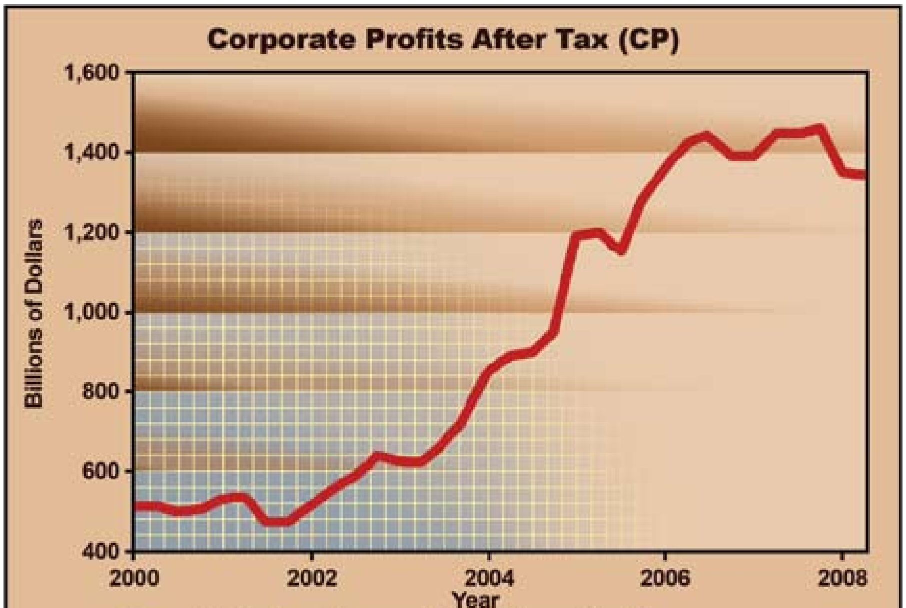
Corporate profits peaked in early 2006 and started to decline in second half 2007 (see figure). U.S. employment has been declining in step with profits. How long will this trend continue?

History shows that in the last four U.S. recessions, employment fell for an average of 17 months from peak to trough. Employment hit its last peak in December 2007. If this recession is average in scale, employment should stop declining sometime around May 2009.

The unemployment rate increased for an average of 35 months during the past four recessions. The U.S. unemployment rate hit its cyclical low at 4.4 percent in December 2006. Consequently, if this recession is "average," the unemployment rate should crest around November 2009. This average scenario can occur only if the federal government is successful at solving the banking crisis.

Keep in mind that most commercial Realtors are much more interested in employment than gross domestic product (GDP) since they have never rented a square foot to "GDP." So, in this instance "recession" is a decline in employment because fewer workers mean more vacancies in commercial real estate space.

Absorption of office and industrial properties will be sluggish in 2009. Tenants likely will be able to drive hard bargains all year. Retail absorption is likely to be slow as well because American consumers have less discretionary income to spend. After buying groceries and filling up gas tanks, there is not as much money left to buy clothes, books and cappuccino. Retail bankruptcy is likely to hit a peak in the first half of 2009.



Sources: U.S. Department of Commerce, Bureau of Economic Analysis; 2008 Federal Reserve Bank of St. Louis (research.stlouisfed.org)

Falling Prices Not Likely

Value determination is much more complex than the absorption issue. Some think that commercial property prices could fall dramatically. I don't agree with that assessment for the following reasons.

First, trust and confidence in Wall Street is gone entirely. This means investors are wary of stocks and corporate bonds. Consequently, real estate is an attractive alternative.

Second, when the federal government prints money rapidly to *stimulate* the economy, one of two outcomes is likely: inflation in consumer prices or inflation in investment vehicles. If prices go up and wages do not, the economy weakens, and there is little likelihood of consumer inflation. If the government prints money, and it does not go to workers and consumers, where does it go? It goes to banks that loan it to investors.

When former Fed Chairman Alan Greenspan dropped the interest rate to 1 percent and left it there too long, a residential real estate bubble developed. When current Fed Chairman Ben Bernanke dropped the rate to 2 percent, a commodities bubble occurred.

So where should investors put their money in 2009? Probably into U.S. stocks. What other asset class is currently selling at a 50 percent discount from its previous high? This recommendation is, of course, predicated on the ability of Wall Street to regain investor confidence, which is a tall order. If the Fed keeps interest rates too low for too long, another bubble will inflate. Most likely it will be in stocks, but it could create another bubble in commodities.

Waiting for the Rebound

As for what is ahead, there could be a rerun of what happened in the late 1990s, when stocks skyrocketed for a few years, the stock market bubbled over and then investors again started to focus on commercial real estate.

Pension funds have been major buyers of commercial real estate in the past decade. Because of the decline in stock prices, the real estate portion of their portfolios may have become too large. Some now have to wait for stock values to rebound before they can buy more real estate. Commercial real estate prices could be flat for several years while investor focus shifts to U.S. stocks. Sure, there will be newspaper headlines focusing on commercial real estate selling for prices lower than 2007, but those prices were not real to begin with.

Another issue buffeting the commercial real estate industry is the wait-and-see attitude that was pervasive in the economy for most of 2008. Tenants and investors were hesitant to make major decisions last year because of the political uncertainty inherent in an election year. Many U.S. industries could be in for dramatic regulatory and tax changes in 2009. Until the new administration proposes legislation, the business environment will remain unsettled.

Many real estate professionals nervously remember when Congress changed tax laws in 1986 and the negative effects the changes had on commercial real estate values. Today, if the capital gains tax rate were increased from 15 to 24 percent, the value of all investment real estate could be reduced by 11 percent overnight.

Typically, a new president has a 100-day honeymoon to initiate significant legislation. So by April 2009, businesses will have a much clearer view of their futures. Those that have been sitting on the fence waiting to see what the new administration will do are likely to make their moves.

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THE TAKEAWAY

It appears the economy could bottom out in the summer. Employment may hit its low as political uncertainty is resolved. Corporate profits could look good as well, compared with year-earlier performance. Release of pent-up demand from businesses that have been postponing decisions since January 2007 could result in a pleasant surprise in summer 2009.

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