BUSINESS BRIEFCASE

SIGNS OF LIFE

The local commercial real estate outlook is slightly improved for 2011, but it'll be a year or two before it really picks up, experts say.

By Judy Dahl

"There will be green sprouts of grass this year and we'll be able to mow the grass toward the end of 2012." That's how **Blake George**, principal at commercial real estate firm **Lee & Associates**, describes the outlook for the greater Madison area's commercial real estate market.

"I don't think it'll translate into rents increasing and vacancies stabilizing in 2011, but there will be a greater level of comfort or certainty for 2012, and a good, solid recovery will come in early 2013," he continues. "Then we'll be able to say we're out of the storm—and Dane County will be a year or two ahead of much of the U.S."

Matt Apter, principal at **CresaPartners**, which exclusively represents tenants and opened its Madison office about 18 months ago, agrees. "It appears we've hit the bottom and are approaching some form of market stabilization, but conditions are expected to be flat for some time," he says. "Ultimately, realism trumps optimism and pessimism, and the bottom line is that we won't enjoy a full real estate recovery until jobs reach their pre-recession level, which many economists predict will be in 2013."

Tim Rikkers, also a principal at CresaPartners, is seeing a slight amelioration in the market. "There's been an uptick in leasing activity, as many companies have pent-up demand for space, but there remains an underlying element of caution regarding the economy," he says. "And people are waiting to see what shakes out on the national and political fronts. This translates to shorter lease terms, less investment in new space and a willingness to continue to wait."

High vacancy rates and uncertainty are holding up the commercial real estate recovery. "Many companies, having cut costs and shed employees, have learned they can do more with less and are hesitant to recommit to large, long-term investments in commercial space," says **T.J. Blitz**, principal at CresaPartners.

Some companies are still expanding, Apter reminds. "It's not across the board that companies are holding off on long-term decisions; we're seeing that firsthand with some of our clients."

FINANCING IS THE BIG CHALLENGE

Jeff Bartzen, an attorney at law firm **Murphy Desmond, S.C.**, believes the market is the same as last year or even a little worse. "We represent a fair amount of developers and that's what I'm hearing and seeing," he says. "The real estate part is the easy part these days; the biggest challenge is getting financing. And in Madison, the climate isn't that conducive to getting things through city hall—it's not as easy as in years past to convince them of the wisdom of a project."

George believes banks' inability to lend is what's holding up the recovery. "I'd say 70 percent to 80 percent of banks aren't lending."

The economy is driving that issue, Bartzen notes. "Banks are willing to lend, but with much tighter terms. You have to be incredibly well secured—with substantial collateral or a second mortgage on your home—to get a commercial loan. Walgreens tried to refinance all its properties a couple of years ago, and the bank wanted 50 percent equity—it would only lend 50 cents on the dollar."

The market is in a bit of a holding pattern until banks are comfortable lending again, he opines. "Regulators are so tough on banks right now that they're a little nervous to do anything. We have staff members who sit on bank boards, and everybody is being very careful."

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NOT A DISMAL PICTURE

He is seeing a few banks with more of an appetite for commercial lending. "They may not have as big a commercial portfolio as they'd like, or they may not have been stung as badly during the real estate crisis," he says. "Lending terms will loosen up in a few years."

He expects a wave of commercial foreclosures. "Loans are coming due and lenders are being squeezed by regulators to wrap them up and not renew them," he says. "It's hard for bankers to determine the value of a property right now because everything is in flux. It'll take a year or two to work through it, and then things will stabilize."

In 2006, people suddenly realized real estate was overvalued and that they were buying at the top of the market. "A lot of the values are correcting themselves," Bartzen says. "We're coming back to more of a stable market. If you bought a property for $300,000 in 2006 and now it's really worth $225,000, if you refinance for that amount, rents and leases can support it. Rents and values are stabilizing to what the market will bear."

It's not a rosy picture, but not a dismal one, he adds. "In Madison, by and large, real estate values aren't that out of proportion to reality. It's stable compared to Arizona, Florida or other places where values have dropped by a third. It'll be like the residential foreclosure crisis—it'll hit other places much harder, but there will be foreclosures in Madison."

SOME EASIER TO FINANCE THAN OTHERS

Some projects are easier to finance than others. "We're seeing banks comfortable lending for medical offices—there are new U.W. buildings near Broadway and two more near Highway 19," reports George. "Developers and investors are chasing that business. Developers can get funding for franchises such as fast food restaurants and also for grocery stores."

Those are the bright spots, he notes. "National companies that still have successful business models are combing for good rates and we're seeing new restaurants and retail concepts. There are also start-ups taking advantage of the low rates and signing one-year leases."

Some new apartment buildings are going up, funded by tax-credit deals. "That's the only way of getting funding for that type of construction today," says George. "And there aren't many new office buildings. You can't get financing unless you have them 100 percent occupied. Banks used to lend if you had them 50 percent rented, but that hasn't happened for the last couple of years and probably won't this year either."

But Blitz cites statistics from research analysts Reis Inc. and other industry sources that showed fresh signs of life in the office market during the final weeks of 2010. "The 10-year Treasury rate, a critical benchmark for commercial real estate lending, climbed to 3.5 percent in December from the 16-month low of 2.4 percent in October. That could be an indicator the market is trending up. And the amount of occupied office space increased slightly for the first time in nearly three years."

George estimates there's a two-year supply of vacant commercial space in greater Madison right now. "It'll get absorbed over time and there will eventually be a strain on supply," he says. "We're seeing tenant activity in existing vacant spaces, mostly people moving to the same size space with lower rent rather than people expanding."

CresaPartners, too, is seeing tenants upgrade their space. "Rents in general are down and we continue to see movement to nicer, Class A space," says Apter.

MORE BARGAINING POWER

Tenants have more bargaining power today. "In the past, leases had escalator clauses where rents went up and up," Bartzen says. "But with property values declining, rents may go down a little too. There's a lot of variety in the space available, and landlords are willing to be creative and work with tenants."

CresaPartners has re-engineered numerous leases over the past 24 months. "We go out and do the homework for them, and it's allowed companies to right-size their premises and their lease rates," says Rikkers. "An interesting metric is to peg a company's occupancy costs to a percentage of their revenue. In one case we found a rent-to-revenue ratio that increased from 3 percent to 33 percent. That level of spending wasn't sustainable for the tenant, and after a review of the data the landlord adjusted the lease rate to a manageable level."

We're in a tenant's market. "That means it's important for tenants not only to understand the marketplace, it's critical to understand the motivations and limitations of various landlords," Rikkers says. "A professional real estate advisor should be equipped with more than just average lease rates and vacancy numbers. He or she must understand—and be able to act upon—the nuances under the surface because, generally speaking, that's where most of the value can be found."

Many landlords have to make difficult decisions in this market. "They have to decide if it's best to compete for tenants now, at the bottom of the market, and offer the concessions necessary to win deals," says Blitz. "Or is it more appropriate to let their properties remain vacant and wait for the market to recover? And is it wise to make capital and cosmetic improvements to buildings in this market? These are very individual decisions and depend on their unique situations."

Still, there are great opportunities for landlords to attract new tenants—provided they recognize and get out in front of the market, Blitz indicates. "There are still a significant number of options for most tenants. Landlords who aren't actively working to maintain or attract new business may find themselves with increased vacancy rates."

TIME TO FIND A DEAL

For those interested in purchasing commercial properties, there were good deals to be made in 2010 and that's true in 2011 too. "This year is the last bastion of really good deals on properties; when we get into 2012 and people feel a real recovery is taking place, those won't be there," George says. "If you have cash, this is the year to step up and buy."

If you have the ability to find cash—and you have a good relationship with a bank—you could become a millionaire in this market, Bartzen adds. "If banks won't lend at 15 percent equity, they're likely to lend at 30 percent. If you can get that amount of cash together, you can get properties very inexpensively."

It's a good time to have cash. "We're in a new type of market situation and people are getting creative and finding ways around problems," says Bartzen. "Five or six investors might pool their funds and buy a property, or if you find properties without a lot of debt on them, you could buy on a land contract."

His firm is monitoring the market and working to put potential buyers and sellers and landlords together. "We want to help them be creative until things stabilize," he says. "We reassure clients that although it's a tough time, there have been many tough periods; we can be creative and get through it."

A GOOD PLACE TO LIVE

CresaPartners' primary 2011 goal is to continue increasing its market share. "While we can't be involved in every transaction, we believe the presence of an exclusive tenant representation firm in Wisconsin raises the level of awareness amongst tenants that they have leverage in lease negotiations," says Apter. "It raises the bar for landlords to provide equitable and functional lease solutions."

The company strives to remind clients that their tenancy is a valuable commodity they can leverage to their advantage. "To be sure, there's an art to the process, but a good real estate advisor can create an environment where landlords compete for a tenant's business and where, ultimately, the tenant can make a fully informed, fully quantifiable business decision regarding its space needs," says Rikkers.

George's firm is cautioning landlords to be careful in committing to long-term deals. "They can't give things away; they have to balance their needs and those of tenants," he says. "If they only have one potential tenant at the table, it's hard to convince them there will be another. We have to give advice that enables them to make good decisions and assure them we'll get out of the woods here.

"Everybody's working harder and making less money today, but that's the hand we've been dealt," he continues. "Companies are working smarter, but maybe their competition isn't willing to. This is the year of creativity—new marketing ideas, deal structures, incentives for employees and customers—that's true of all businesses."

One of his clients commented that the recession reminded everyone how to run their businesses correctly. "Before, you could make poor decisions and recover. With real estate, if the bank would lend you money you went for it. But the projects not based on good fundamentals are the ones that have failed."

In the end, says Bartzen, "This is a good place to live, with a population where supply and demand are relatively equal, and there isn't a lot of commercial space no one wants. I think things will get better and better, and that Madison is likely to have an easier recovery than some other places." ●