# FOCUS ON COMMERCIAL REAL ESTATE

## Real Estate Sector Faces Tough Challenges Ahead

*by Dale Anne Reiss*

In the aftermath of the terrible tragedies that took place in this country on September 11, 2001, the issues surrounding the commercial real estate industry seem exceedingly small. However, real estate is a key driver of the U.S. and global economies and the economic challenge to this country, in particular, has been intensified as a result of the terrorist attacks. One way we can lessen the economic impact of terrorism is to build and maintain a strong economy. In this, real estate—as the house for business—has a critical role to play.

Prior to September 11, it was evident that the commercial real estate sector was coming to the end of an unprecedented run-up in values. The cyclical nature of this industry was apparent across almost all sectors from downtown office buildings to hotels and shopping malls.

Business and leisure travel was already on the wane before September 11, and hotel operators were girding themselves for a tough year ahead. September 11 compounded that trend.

The demise of the dot.com sector brought huge amounts of sublease space onto office markets across the country. Some estimates have the amount of available sublease space now at 87 million square feet nationwide. Those numbers resonated throughout the sector, putting further pressure on rents and the events of September 11 have, for the time being, compounded that trend.

Some months before the attack on the World Trade Center, there was a whiff of restructure in the air. While we don't think the depth of restructuring will be anything like the last cycle, we are already seeing some owners having to reposition assets to reflect market changes. Beyond that, market conditions indicate that the potential for some restructuring exists: money is tight and over the last 10 years, more and more real estate loans have been securitized and sold to investment groups rather than held by friendly local lenders. With most of these securitized loans having specific collection procedures written into their documentation, it won't take much to trigger action by the lenders.

### IT'S THE PACE OF THE DOWNTURN THAT CAUSES WORRY

The failure of the New Economy to live up to expectations and a slowing Old Economy has forced dramatic slowdowns in many commercial real estate markets. The one bright spot in the numbers is that sublease space isn't as bad as overbuilding, purely by virtue of the fact that most tenants keep paying rent. Vast amounts of sublease space continue to come onto the market and rents are in decline. So far, the real estate impact has largely been restricted to so-called "cool space"—older industrial and warehouse space often on the fringes of downtown converted to open-plan office space by start-up technology ventures. Market reports are now showing an impact on more traditional

downtown office space as Old Economy companies feel the pinch of a slowing economy and cut jobs and their need for space. In recent months, companies like retailer The Gap and entertainment giant Viacom have announced plans to shed headquarters' jobs resulting in more space coming to market in downtown San Francisco and Manhattan.

## REAL ESTATE STILL HAS VALUE

However, there continues to be real value in bricks and mortar. Many businesses are sitting on substantial long-term space commitments negotiated when the economy only looked like it was getting hotter. Companies facing the economic downturn should move quickly to wring as much value as possible from one of the most valuable assets on their books: real estate. Outright sales aren't always the best strategy. Innovative off balance sheet financing techniques such as synthetic leases, sale/leasebacks, and other capital strategies can allow companies to access equity in property assets while still maintaining some control over the real estate. Capital obtained in these ways can then be redeployed in the company's business plan to fuel future growth or to cover necessary cost reductions in a down market.

A good example of this trend toward capital redeployment is evident in the health care sector. At a time when many health care systems are seeking new competitive strategies, capital is often the constraining factor. Health care systems, particularly not-for-profit systems, have limited access to capital, primarily debt and earnings. Many systems, having invested heavily over recent years, cannot exceed their current debt levels without the risk of being downgraded by the rating agencies. In addition, with current pressure on earnings, systems are not able to generate the amount of capital from operations necessary for reinvestment in their core operations.

One strategy that a number of health care systems have used successfully to address their capital needs is to look toward their medical office buildings and other non-core real estate assets as a source of capital. Refinancing, off-balance sheet treatment or outright sale of non-essential assets has allowed some health systems to unlock funds for reinvestment in core operations, strengthened financial statements, improved financial flexibility, and uncovered hidden asset value. Look for more corporations in health care and other sectors of the economy to adopt similar strategies as access to capital becomes even more crucial in the months ahead.

As a result of the natural real estate market cycle, real estate owners, brokers, and leasing specialists have to get back to basics. Making deals happen will be just as hard in the next few months as it was in the first six months of this year. Look for smaller deals, more innovative transactions involving sublease space, and a heavier emphasis on warehouse/industrial and flex space suitable for biotech and other "growth" industries. Owners will focus hard on the bottom line, analyzing their costs and cutting back where appropriate. Construction projects may be put on short-term hold as the direction of the economy plays out. Companies that have committed to new capital projects will pay far closer attention to project cost management. In a down market, keeping the costs to a minimum and bringing projects in under budget can be vital. Companies are already outsourcing more and more of their project management and construction oversight work to outside advisors. The trend will deepen as these "project managers plus" bring tax and accounting skills to bear in an effort to pare down costs and make new construction projects even more efficient.

Finally, we expect a return to innovation in the real estate sector over the coming months. When times get tough, the tough get going, but they are also more creative, thinking in non-conventional ways. One example: there has been a steady growth over the last 12 months in mezzanine financing—lenders providing hybrid debt and/or equity to developers or buyers to cover the gap between traditional first mortgage financing and the actual equity in a deal. This financial technique, which has been accepted by an enthusiastic real estate market, is more than just a financing tool; it is also a way for capital-rich real estate owners to further develop their acquisition or development pipelines. Don't be surprised to see more major institutional owners using this technique in the future. REI

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