CRE PERSPECTIVE

Will Real Estate Be Overbuilt Again?

by Richard F. Muhlebach, CRE, CPM

Even as the real estate industry and the U.S. economy in general continue to enjoy prosperity and growth, real estate experts and field personnel alike are already beginning to worry about the next down cycle.

And to some extent, these concerns are justified. Real estate is a cyclical business. There have been four real estate cycles since 1969, and even with the significant changes the industry has experienced in the last few years, that pattern is unlikely to change.

Does this mean that we are already on the road to another real estate crash equal to the disaster of the early 1990s? Absolutely not!

A Different Sort of Expansion

Most of the conditions that contributed to the overheated atmosphere of the 1980s no longer exist and are unlikely to repeat themselves—

- Despite recent capital gains reductions, federal tax laws do not provide unsupported incentives to build regardless of demand;
- Overeager institutions and foreign investors have learned that buying without regard for cash flow is a prescription for trouble; and
- Banks and bank regulators have adjusted lending criteria to ensure that building pro formas bear a relationship to reality.

Still Room for Miscalculations

Nevertheless, some real estate markets may already be moving from improvement toward overheating.

- According to Torto Wheaton Research, the construction of office space, which came to a virtual halt in 1992, has more than quadrupled between the last quarter of 1992 and the last quarter of 1997, and jumped by almost 50 percent between mid-1997 and mid-1998. While this new construction is less than 50 percent of the volume during the boom of the late 1980s, the trend has been consistently upward for the last nine quarters. And while absorption continues, vacancy declines are already slowing in suburban office markets.
- Anchored malls have experienced a similar fluctuation with national average price per square foot falling by 15 percent from 1990 to 1993, to a national average of $96.24 per square foot in fourth quarter 1993 before rebounding to $116.69 in second quarter 1998, according to the *National Real Estate Index*.
- Apartment properties respond more rapidly to real estate cycles because of shorter lease terms and easier construction of new supply. Consequently, multi-family has already shown a 29 percent gain in price per square foot from 1992 until late 1996, and reached a decade high average national price of $83.38 per square foot, according to the *National Real Estate Index*.

If real estate cycles are the inevitable result of the industry's structure and entrepreneurship, we, as real estate practitioners, should not just sit back and accept that another bust cycle is coming over the horizon.

Not Making the Same Mistake Twice

To a great degree, the severity of future real estate cycles depends upon our willingness to exercise judgment and common sense in our activities, during both the up and the down portions of the curve.

The key is not **if** overbuilding will occur, but **to what degree**. The skyrocketing expansion of the mid-1980s was mirrored by the dramatic fall of prices in the early 1990s. In contemplating real estate cycles, it is important to remember that the height of the upward curve usually dictates the depth of the decline. If we can exercise restraint during the good times, we can, in all probability, ensure that the bad times will not be as bad after all.

Arming Against a Repeat

The first, and perhaps the most important, line of defense against another real estate free fall are lenders and other capital sources. Lenders are the gatekeepers of the development process. Although underwriting criteria are already loosening somewhat from a year or two ago, caution remains the watchword. When developers must supply between 25 percent and 50 percent of the costs of their projects and have signed leases from between 20 percent and 60 percent of the space, overbuilding is much less likely to get out of hand.

Lenders and investors alike must pay more attention than ever to the information on which they base their decisions. Good market knowledge has always been the cornerstone of successful real estate development, but today

personal computers, compact disks, and the Internet make good market data more accessible than ever before.

At the same time, local real estate managers and brokers who have always been a great source of the local market information that is the basis of real estate investment, have become even more sophisticated in applying their analytical skills to market and economic data. Thankfully, the days when real estate deals could be penciled out on an envelope are over—and the industry is better for it.

The renewed expansions of REITs and other securitized real estate has also attracted the attention of a battery of Wall Street analysts whose scrutiny has helped increase accountability and encourage restraint. The public market's tendency to recognize overbuilding quickly and immediately penalize share prices act as powerful deterrents.

Another vital factor in reducing the negative downturn of real estate cycles is recognizing that an accurate picture of supply and demand depends on more than the gross availability of space. Determining the suitability of existing space to meet the physical needs and interests of users is just as vital in assessing the demand for new supply. For example, in the strictest sense, the small, B and C office buildings found in many downtowns are part of the overall supply of office space. Yet, because most of these properties are unsuitable for today's business users, they can, in fact, distort actual vacancy rates. The market has already recognized this discrepancy and is supporting the conversions of these properties into housing, hotels, and other alternative uses.

And just as market-obsolete properties are subtracted from the supply, the demand for innovative new building options fuels the need for **some** new construction. Retail properties with multiplexes and other entertainment options or with life-style components that respond to today's market serve a real demand need, even at a time when some retail space is languishing.

Maintaining a Balance

It is little wonder, then, with so many factors to consider, that smoothing out the ups and downs of the real estate cycle becomes an almost impossible task. No expert can unfailingly predict the direction of future need perfectly enough to maintain the delicate balance of supply and demand. When long construction times, zoning requirements, and government regulations are factored into the equation, the accuracy of such predictions becomes even more suspect. However, what real estate professionals can bring to the next round of development and expansion is sound business judgment based on current, reliable data. In this way, we can help ensure that those never-ending real estate cycles are just minor waves on an upward course of prosperity. REI

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