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Worst May Be Over for Commercial Real Estate

Prices aren't exactly soaring, but after three years of declines investors are on the prowl again and prominent properties are sparking bidding wars.

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By Roger Vincent

After nearly three years of declines there are signs that Southern California's beaten-down commercial real estate market has struck bottom — setting up the possibility of a rebound later this year.

In a sign of the easing, heavyweight investors armed with buckets of cash are on the prowl, looking to snap up office buildings, warehouses, shopping centers and apartments at the market's low, industry observers say. the buyers are choosy, but the most desirable buildings elicit bidding wars when they come up for sale.

The auction earlier this year of Wilshire-Bundy Plaza, a prominent Brentwood office building, drew 40 bidders. the 14-story building will sell for $111 million to Santa Monica landlord Douglas Emmett inc. if a Bankruptcy Court approves the deal, said real estate broker Bob Safai of Madison Partners.

"That's an incredible price in today's marketplace," Safai said. now he is trying to sell 801 S. Figueroa St., a 25-story tower in downtown Los Angeles that he hopes will garner $180 million.

Although commercial building landlords in many markets are still struggling with high vacancy rates and weak rents, the erosion in some sectors has slowed, piquing the interest of buyers. in addition, reinvigorated banks have been able to postpone or avoid liquidating billions of dollars' worth of distressed real estate loans sitting on their books, helping to solidify prices.

In a similar fashion, Southern California's housing market hit bottom more than a year ago and prices have been trudging higher ever since, partly because a feared wave of fresh foreclosures hasn't materialized.

If the commercial real estate market continues to gain strength it would represent a significant shift in economic risk because many experts had feared that mass defaults by landlords on their loans could cripple banks and drive the country deeper into recession.

“It’s true that thousands of commercial loans must be worked out and some of these properties will enter the market in 2010,” investment banker David Rifkind said. But “federal policy has been accommodating to banks and they are not being forced to realize losses.”

With rents falling and the economy trembling, commercial real estate transactions had been rare during the downturn. Owners were holding on in hopes that prices would stop falling and buyers were holding back, waiting for the low point.

But a philosophical change has become apparent among investors, Rifkind said.

“There is so much money sitting on the sidelines that when distressed assets or even small pools of loans come to market, there is a flood” of interest, said Rifkind, managing partner of George Smith Partners.

“That became palpable to us in the first quarter,” he said. “Money can’t stay on the sidelines for long periods of time. it has to retool and be put to use.”

That’s not to say property values are leaping up across the board, however. Researchers at the Massachusetts Institute of Technology said that prices of commercial property sold by major institutional investors nationwide fell slightly in the first quarter compared with the last quarter of 2009, according to its index.

Prices were 41% below their mid-2007 peak, MIT said, but not down significantly from the temporary bottom reached at the end of the second quarter last year.

“Overall, the behavior of the index since mid-2009 is not inconsistent with a pattern of bouncing along the bottom, essentially moving sideways,” said David Geltner, director of research at MIT’s Center for Real Estate.

Similar conclusions emerged in another popular index tracked by Moody’s and Real Estate Analytics. Prices were down overall in the last quarter from a year ago, including a 3% dip in office prices. Apartment and industrial buildings, however, both increased in value for the second consecutive quarter.

“The past four or five months have shown us the market is establishing a base,” said Neal Elkin, president of Real Estate Analytics. “Whether it’s a bottom or not remains to he seen.”

Healthy properties — buildings in good locations that are nearly fully leased — have lost about 35% of their value from the peak, while distressed properties are down about 60%, Elkin said.

Investors naturally want to snatch up bottom-of-the-cycle bargains, but so far there haven’t been a lot of big bargains to be had. the expected wave of bank-owned foreclosed properties hasn’t materialized because lenders have been extending loans to building owners instead of calling them in as many investors expected.

A huge amount of capital for acquisition was assembled over the last year on the expectation that as much as $1 trillion worth of real estate loans were in distress and banks would be forced to dump properties to clean up their balance sheets.

“The debt hasn’t gone anywhere, but how it’s going to play out is proving to be much different” from what investors hoped for, Elkin said. Banks won’t have to take losses until they complete the process of healing their balance sheets and build up their capital reserves, he said.

“It’s not going to be another RTC.”

The federally owned RTC — Resolution Trust Corp. — liquidated billions of dollars’ worth of real estate assets including bad loans that came from institutions that failed during the savings and loan crisis of the 1980s. many of the assets sold at deep discounts from their previous prices.

Among those looking to pounce on deals is BH Properties, a Los Angeles investment firm that obtained an eight-figure revolving line of credit from Wells Fargo Bank last month for the purpose of commercial real estate acquisitions.

Such credit lines have been virtually unheard of for the last year and a half, said Steve Jaffe, executive vice president of BH Properties. “We are cautiously bullish on today’s market,” he said.

The firm is targeting the Inland Empire, Phoenix and Las Vegas, markets where the recession hit real estate hard. they haven’t done any deals yet but they are hardly alone among investors. With most banks now stable and property owners desperately hanging on, there has been no tidal wave of cheap real estate coming up for sale.

“This is going to be a slow trickle,” Rifkind said, “not a rush.”