FORECASTING THE INVESTMENT CLIMATE

BY STEVE BERGSMAN
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Before we begin, for those of us more "geographically challenged" who don't know the map of the Midwest, here's a quick lesson. The southern border of South Dakota is a straight line right up until it reaches the southeastern corner of the state, where it dips to follow the Missouri River, thus creating a tri-state area at the confluence of the Missouri and Big Sioux Rivers. The metropolis of this region is Sioux City, Iowa, with a city population of 83,000, but a decent-size metro of 170,000 people.

Richard Salem, SIOR, has been in the real estate business in this area for 50 years. His company, RE/MAX Preferred/ COMMERCIAL, works with other businesses to put together limited-liability companies to invest in local commercial real estate. All of which is more complicated than it seems, as his market area includes three states: Iowa, South Dakota, and Nebraska.

DECIDING ON INVESTMENTS CAN BE A BALANCING ACT.

"Most tenants want to be in Sioux City because that's where the majority of the population is," Salem reports. "On the other hand, South Dakota has no state income tax for companies or individuals, which is a real benefit. Also, the taxes on commercial real estate for South Dakota and Nebraska are half that of Sioux City, so rents are lower in Nebraska and South Dakota. South Dakota is also the most aggressive in trying to lure new companies. However, if you are a manufacturer in Iowa, there is no tax on equipment purchased for your company."

In addition to the basic market data, investment goals, and financial support, it's always helpful to review a city, county, or state's economic climate before investing. One doesn't want to be over-taxed on an investment, caught short by changes in the law, or put into an uncompetitive position vis-à-vis neighboring jurisdictions.

Investors obviously need to know their own investment model, targeted asset class, return goals, exit strategy, and lease-up strategy, as well as perform thorough due diligence, says Landon Williams, SIOR, a senior vice president with Cushman & Wakefield | Commercial Advisors in Memphis. "In addition, it is equally important to look at the local and regional economic climate to understand which way things are trending."

It's important to also look at the political climate, particularly if you feel a change would mean radical alterations to the status quo. However, Williams stresses, "Investors may not want to put too much emphasis on it [to the point that] it forces them away from a deal, since the political climate is often temporary and can shift multiple times during the life of an investment period."

Fortunately, most real estate investors don't act like day traders. Typically, commercial real estate investors hold investments for long term. "The local economic and political climates are vitally important to understand, although over the lengthy term of an investment there could be many fluctuations," Williams adds.

Like Sioux City, Memphis hubs a three-state region with Mississippi and Arkansas bordering the southwestern corner of Tennessee. "There is certainly competition to attract companies in each nearby statewide jurisdiction, but Memphis also competes with other inland cities, such as Nashville, Indianapolis and St. Louis. Investors need

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to understand both the headwinds and tailwinds as it relates to local economic and political issues."

HOW'S MEMPHIS DOING IN COMPARISON TO THE COMPETITION?

"Investors like being here," Williams says. "Memphis has always been slow and steady without the severity of fluctuations that many other markets have."

The same can be said for Sioux City. Prior to the pandemic, the investment climate in the region was strong and economy good, Salem says. That has changed.

In recent years, Salem has been focusing on apartments and commercial, but now trouble has arisen in the latter category.

"The worst for us are the national tenants; they all want reductions or no rent," Salem says. "I had gotten a letter from one tenant stating his company won't pay any rent. It was a large, national firm in a single-tenant building. The company didn't return my telephone calls. The problem was [that even] if we didn't get rent, we still had to pay the mortgage, taxes, upkeep, etc. At the point where we considered eviction, the tenant started paying rent again."

As for state governments, Salem sees it as a toss-up as all three governors are viewed as very pro-business. With an election coming up, one concern is a change in leadership in any of the states, which Salem views as a negative.

Competition even affects those states that are geographically at a distance from each other, and that can be eased or exacerbated by national politics. For example, President Trump's 2017 economic bill punished most of the "blue" states because prior to the bill's passage, residents were able to deduct most of their state and local income taxes from federal returns. Now those deductions are capped at $10,000. Without the big tax break, savvy homeowners moved their primary residence to states like Florida, which have little to no income tax.

"People are moving south because of taxes," observes Daniel Zelonker, SIOR, broker president at Z Miami Commercial RE. "The bottom line is, if you move from New York to Florida, you save 24% between cost of living and taxes. Even the bull (Merrill Lynch bull statue that was on Wall Street) moved to Florida."

There are trade-offs, Zelonker concedes. "My home insurance is $8,000 a year. If you have a mortgage on residential you can't not take insurance. The trade-offs are very small, and there is a much better lifestyle in Florida—especially in the winter. People are moving here to save money, but mostly for the lifestyle."

That's not true in commercial real estate. "It has gotten very expensive to get insurance in Florida." Zelonker continues. "In fact, a lot of industrial clients are not buying hurricane insurance, which is a minor risk for smaller properties because industrial buildings—if they are built well—don't suffer much damage in hurricanes. Also, a lot of buildings have generators because power is often lost during hurricanes. Some of the smaller commercial buildings don't because it is expensive to have a generator."

Besides state competition, there is also in-state competition amongst municipalities. In Southern California, companies looking for industrial warehouse space can choose from Los Angeles proper, Long Beach, or further east in the Inland Empire counties of Riverside and San Bernardino.

Unfortunately, none of those locations are easy to deal with politically.

"Over the last 10 years, city politics have gotten more and more intense," says Jon Reno, SIOR, a senior vice president and managing director with Kidder Mathews in Los Angeles. "There's a lot more oversight by local municipalities and jurisdictions regarding development in general, specifically industrial development. It's getting to the point of absurdity."

Prior to entering into any type of development agreement or going under contract at a site, most institutional developers or investors will sit down with a city planner, councilmember, or city manager to discuss the project to get a sense of how much of an uphill battle it will face in terms of any type of public oversight or review, says Reno.

Things get a little easier as you go east from Los Angeles, he notes. "Although in the Inland Empire, the counties and cities out there have dipped toes into development impact, construction fees, etc., especially with industrial development. A lot of pressure has been placed on city councils by local residents because there is a perception that industrial warehouses are not huge job creators. In today's e-commerce world that's not true."

Even with all that, in Southern California, key data points are still economic, so city politics doesn't really affect where a developer will place a facility.

"A developer is not going to look at which city is harder or easier to work with," Reno cautions. "The over-riding factor is demand. For warehouses and distribution, you are going to want to be in an industrial zone. In that case you might look at which are the industrial friendly cities within the Los Angeles market; places like Vernon, City of Commerce, Rancho Dominguez, Carson, or Long Beach."

With today's scarcity of land in the Los Angeles area, there aren't many choices for industrial. So when a site becomes available, a developer or investor is at the mercy of that jurisdiction wherever the site is located. "Then you will just have to fight that local battle," says Reno.

National politics don't really have an effect in the greater Los Angeles market, Reno concludes. "This is a huge machine here with built-out infrastructure and demand. The state has done its best to tax the living heck out every business. From an economic incentive standpoint, California probably has one of highest costs to do business, yet we still have an overall vacancy rate of around 2%. We are a port-driven and intermodal market, and every major institutional player and Fortune 100 company is here. I don't see them going anywhere else over the next 30 years."

MEET THE AUTHOR

Steve Bergsman is an author and freelance financial/real estate writer. Contact him at smbcomm@hotmail.com

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CONTRIBUTING SIORS

Richard Salem, SIOR

Landon Williams, SIOR

Jon Reno, SIOR

Daniel Zelonker, SIOR