# Economic Peak? What Economic Peak?

## SIORs Still Bullish

By Steve Lewis

Sponsored By SIOR Foundation

As the fourth quarter of 2018 unfolded and interest rates rose, the market tumbled. Rumbles of a recession began to be heard, attention turning to both the commercial real estate markets and whether or not we had reached an economic peak that would result in another downturn. The response from many SIORs and other observers seems to be a resounding "No"—or at least, not yet.

"We see continued momentum for users looking to grow and expand their footprint," says Phillip Breidenbach, SIOR, executive vice president, Colliers International. Developers continue to react by introducing new projects and investing in existing opportunities. While some indicators certainly hint at a slowdown, most of the companies we are talking to aren't listening."

"It seems that interest rates are beginning to creep up a bit, but treasuries still seem flat—thoughts are they may stay flat for some time," adds John Culbertson, SIOR, founder and managing partner of Cardinal Partners in Charlotte, N.C. "Cap rates are very low, and at least for industrial, we're not seeing more than just a plateau." He says that transaction volume has been slow and the deals being done tend towards new construction, but "there's a great market developing as there's a rush to new product." Sites, he adds, "are very difficult to come by."

Danny Zelonker, SIOR, of Real Miami Commercial Real Estate, LLC, says that while the economy may have peaked, industrial real estate has not. "My opinion is we'll have a mild recession in 2020, but 2019 will be fine," he says. "We have a 3 percent vacancy rate in Dade and Broward [counties], and we can't get enough warehouses. The Amazons, Wal-Marts—logistics companies are all moving in that direction. We're the fastest growing state, by percentage, after Texas."

However, Joe Pelayo, SIOR, broker/CEO/founder with Total Real Estate Consultants, Inc., in Coral Springs, Fla., sees things differently. "Regarding South Florida, our observation is that the market is starting to slow down very dramatically—specifically, the development of large industrial institutional assets (more than 100,000 square feet)," he asserts. "Regarding office space—except for Class A space—there is an overbuilt in downtown Fort Lauderdale. Class B & C are stable, with low vacancies."

## Impact of Interest Rates

What impacts are higher interest rates having on commercial real estate—and what is the longer-term view? That depends on whom you ask. "Due to the fact that interest rates are rising," says Pelayo, "a lot of assets will be reaching non-conforming financing terms. No affordable housing is one of the biggest problems in our market. Fewer important new developments are taking place due to demographics and tapestry of certain neighborhoods. The exceptions to this are the downtown, oceanfront condos, or luxury rentals."

As usual, he continues, you are seeing over development and lack of the right product needed in the market, like small warehouses, office incubators, affordable housing, and shopping centers. "The impact is being felt as of right now," he insists. "The decision makers are very cautious on the risk involved."

But Debbie Carlson, writing for *U.S. News & World Report*, wrote: "Areas with strong job growth may be able to weather higher mortgage rates, analysts say."

"A look at historical performance shows that the conventional wisdom about commercial real estate—that it takes a big hit when interest rates rise—is simply not true," insists TH Real Estate in a June 2018 article, "Think US: The Impact of Rising Interest Rates on Commercial Real Estate."

"As the data shows," the article continues, "the asset category has actually performed better during periods when rates are increasing (like now) or when rates remain stable and high. For investors thinking about the asset class, it pays to look past the conventional wisdom."

Melissa Reagen, Nuveen's head of research, Americas, opined the following: "Interest rates and capitalization rates are believed to move in lockstep, with higher interest rates quickly translating into higher capitalization rates and lower property values. However, that is not necessarily the case. If interest rates are rising because of stronger economic growth—as is currently the case—real estate demand will also likely be growing."

Brad Kitchen, SIOR, president of Alterra Real Estate Advisors, Columbus, Ohio, agrees. "I don't think there's a strong correlation between increased interest rates and cap rates," he says. "The link is probably stronger with employment."

"If they do rise—although they're actually going down a bit now—it will certainly impact the ability of some of the deals that maybe people were stretching on—the potential to pay top dollar, to generate cash flow," Culbertson notes. "But if it's a typically healthy deal, it will continue to perform well—especially if optimism remains. People are only willing to take more risks and get more speculative if they're optimistic about the economy."

That sentiment covers most of his clients, he says. "Tenants in office and industrial space continue to expand, looking for more plants and warehouses," he shares. "We also see continued office expansion and additional hiring."

## How Long Will It Last?

"Nothing lasts forever," the saying goes. So, how long do those who still see a strong market believe it will remain that way? "I think we'll get another three years out of it," says Kitchen. "I talked with my partner the other day, and he said he read that if e-commerce continues to grow at the current rate, we will need 2 billion square feet of additional distribution space over the next 10 years. Data centers will require 4,000 new facilities, averaging 200,000 square feet each by 2020. There are some really good drivers in the economy for industrial real estate going forward."

For Pelayo, there is little chance of a real estate crash since the fundamentals are in place and foreign money is invested heavily with low cap rates. "This creates high asset values; these investors are only parking their money," he says.

Breidenbach sees a mixed picture ahead. "It's a steadily improving housing market in Phoenix," he says. "There is enough demand for both housing and commercial

> "If interest rates are rising because of stronger economic growth—as is currently the case—real estate demand will also likely be growing."

"Any impact, however, will be muted by continued demand from both tenants and investors, both of which seem to still be interested in growth."

property that these [current] issues are little more than 'speed-bumps.'"

Still, he concedes, multi-family and Class-A office sectors are feeling it now. "We see this impacting all markets for as long as the Fed continues to tinker with rates," he says. "Any impact, however, will be muted by continued demand from both tenants and investors, both of which seem to still be interested in growth."

In addition, he says, changes in taxation and monetary policy "will do exactly what they were designed to do—sustain responsible growth and protect the economy from over-correction or crash."

Market crashes, Breidenbach continues, are typically started "with an over-abundance of irrationality and capitalists making bad decisions with other people's money." However, he is confident that current monetary policy and taxation issues will moderate growth rationally, keeping us out of a crash. "In our market however, we SIORs are concerned, and for the last few quarters we are watching the 'key indicators' (the availability of 'Dumb Money,' questionable developers overpaying for land/bad developments, and brokers buying Bentley's, airplanes, and villas in Tuscany—all signs a crash could be looming)."

## Planning Ahead

So, what is Breidenbach's firm doing to adjust and prepare for a slower market? "As a group of SIOR designees, we are experienced and know markets are cyclical, and we see when markets are overheated," he says. "In our shop, we've already begun monitoring key factors in the health of our market, and preparing to help the banks and special servicers if/when these issues arise. We are counseling our tenants on the real cost, and value of short- and long-term leases, and [advising] our owner-clients to start selling assets and amassing cash for upcoming opportunities.

"In short," he continues, "the best brokers make more after the crash when the market is down than when things are good—like now. Their success is not based on timing the crash, but on showing up in good times and bad, understanding what our clients need to optimize assets, and crafting the best solutions to accomplish their objectives."

For Culbertson, "you look for opportunities that may present themselves. If things do pull back a little bit, there may be some if you see companies who planned on growing and maybe took additional space ahead of their growth; you can help them unload some of that space. Our standpoint, like a lot of SIORs, is to take a longer-term consultative approach with clients and help them get in or out of situations—on the upside or the downside."

"We have to change our way of approaching things," adds Pelayo. "We need to look at each market opportunity for distressed assets, non-performing loans, and educate our institutional investors to listen to the market needs to service our communities properly."

SPONSORED BY SIOR | FOUNDATION

Promoting and sponsoring initiatives that educate, enhance, and expand the commercial real estate community. The SIOR Foundation is a 501(c)(3) not-for-profit organization. All contributions are tax deductible to the extent of the law.

### CONTRIBUTING SIORS

Phillip Breidenbach, SIOR

Joe Pelayo, SIOR

John Culbertson, SIOR

Danny Zelonker, SIOR

Brad Kitchen, SIOR