FEATURED ARTICLE

# IS A DOWNTU

BY STEVE BERGSMAN
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**Real estate cycles seem to churn about every 10 years, which means the current upward momentum could be ready for a downward turn. Most brokers believe the market still has legs – at least through 2018. The new tax bill is a big concern as past tax reform acts caused havoc in real estate markets.**

When it comes to tax reform be careful what you wish for. Tax bills generally are so laden with pork, the American public often doesn't know what it is getting. And sometimes there are triggers in these bills that have unforeseen consequences to the economy and, in particular, to real estate markets.

So, if you're a Republican, take a victory lap.

On the other hand, if you are a student of history, you might remember it was 32 years ago that a Republican president, Ronald Reagan, pushed through the Tax Reform Act of 1986, an attempt to simplify the income tax codes and eliminate tax shelters. Oh, and it so abruptly ended the real estate boom of the mid-1980s that property values sunk like a boulder. Anyone remember the Resolution Trust Corp., which was established to sell off the enormous quantity of bad commercial mortgages from failed financial institutions?

# R N COMING?

This memory-jolt is important because the country has been in a slow, but very long economic upswing with a commercial real estate market that looks unbeatable at the moment. However, real estate is about the cycles and at some point the arrows will start pointing downward instead of upward. The question is will the turn come sooner or later. Or, will something unusual like a new tax reform bill change everything?

John Steinbauer, SIOR, president of Steinbauer Associates Inc., Miami, has been in the commercial real estate business since

1974, which means he has been through a number of real estate cycles. He considers this current one very unusual because of its length, 10 years. The market peaked around 2007, dropped precipitously in 2008 and 2009 and has been moving upward since 2010. As Steinbauer points out, it looks like "we are about at the point where we were in 2007."

Does that mean Steinbauer expects the market to turn downward this year? Not in his Miami area. "We have a few more years of adjusting upward," he says. "The housing market seems to have peaked, especially with expensive homes. The office market lagged up until last year, now a few new projects are going up. As for industrial, we have a few more years of improved prices and usage requirements."

Two things can make a difference in Miami. First, the expanded Panama Canal could mean bigger ships coming into the port of Miami, which will benefit the industrial market. The other issue is the tax bill, which Steinbauer says, "it is still difficult see what the benefits are to real estate."

Another commercial real estate veteran, Arlon Brown, SIOR, a senior vice president with the SVN Parsons Commercial Group, Boston, says the current, commercial real estate market reminds him a lot of 2000 and the dot.com era. Being a high-tech center, the Boston real estate market was at peak in 1999, and then it wasn't. Today, the Boston market is peaking again.

"Demand for industrial space in my area is still climbing and the basic reason is the supply is very limited and the demand is getting greater," Brown reports. "Lease rates on industrial is going up – somewhat. For small scale industrial space, under 20,000 square feet, the market is going crazy. We are into double digits on a triple net basis. Once you get above 20,000 to 25,000 square feet, the rates slide precipitously to $6 or $7 a foot, triple net."

With the Boston market so frothy, Brown believes the cycle is in the "eighth inning of a nine inning game."

He adds, "I'll be starting my 41st year in the industrial market. I've definitely seen the cycles, but the most interesting thing is, you can never accurately predict when cycles are going to end. I said we were in the eighth inning, but I just don't know how long this eighth inning is going to last."

The big question mark for Brown is if the new tax law "will affect real estate like what happened in 1986."

The other thing, he says, to look out for is the stock market. "If company performances start to go lower and workers are laid off, look out, because every office worker takes up 150 to 200 square feet," he explains. "When companies lay off thousands of employees, the extra space starts to add up."

Tim O'Brien, SIOR, president of O'Brien Commercial Real Estate, is fortunate to be in the thriving, Midwest, industrial and distribution market of Indianapolis. Amazon boasts a number of fulfillment centers in the area and distribution is still being built, although vacancies ticked up very slightly toward the end of 2017.

O'Brien is an optimist with limitations. He thinks the industrial market will continue to expand, but there are risks.

He explains: "Often, as vacancy rates fall and the marketplace tightens as a result of job growth, the area sees more construction, whether speculative or build-to-suit. When that occurs, tenants migrate to the new space, vacating older space, and creating a void in second or third generation space. The effect of those tenants in existing properties moving into the new construction creates vacancies in the buildings they are leaving, and those buildings will compete fiercely with both new space and other old space. The landlords (or lenders) for this second generation space often cut rates and get more aggressive in pricing. When this occurs, there is downward pressure on rates and tenant incentives go up. It tugs downward on the all the new construction properties and there's generally a slowdown in new construction because of the increased vacancy (and, thereby, competition)."

O'Brien doesn't anticipate those dynamics to come into play until late 2018 or early 2019. "At that point, I could see us at the start of the downward part of the cycle," he says.

The one thing that worries O'Brien is corporate performance. "We have strong corporate earnings and job growth, but it doesn't take much for it all to reverse," he says. "Many corporations are international and they are affected by events in other parts of the world. Our market in Indianapolis may be completely healthy, but if a handful of companies downsize and shut down an office or distribution center, then you have additional pockets of space, which can really have a big ripple effect."

Probably, one of the most optimistic of SIOR members is John Culberston, a senior vice president with the Brennan Investment Group, Charlotte. If you ask Culberston about the commercial market, well, his response is, we should all by partying like its 1999, which, of course, meant that you partied for the next eight years or until 2007.

Culbertson's current, predictive, time line isn't that far out, but it's close.

"A byproduct of the growth in the residential market is a push for additional warehouse space and this trend will continue for at least another three years and perhaps as long as five," he says. "The improvements in robotics and the streamlining of manufacturing shows there will be continued investment in industrial manufacturing for the next five years. Robust demand in automotive and the changes in demand for infrastructure should continue for the next three to five years."

He adds, "America will continue to be a place where overseas investors will want to be and that's going to mean that cap rates will remain low even as interest rates creep up. Certain submarkets will do better than others. Midwest probably will not do as well as the Southeast and Southwest and Texas. All in all, industrial real estate should remain quite good."

Asked if he had any cautions at all, Culbertson commented, "any of our leaders who have erratic tendencies could get us into trouble.

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# Three Ominous Omens You Didn't See Coming

When asked if there were any disturbances in the force that could change the course of the current economic expansion, Gabriel Silverstein, SIOR, managing director of SVN/Angelic, New York, who is known for his out-the-box economic discussions, listed three potential death stars in the making.

**THE CURSE OF THE MEGADEAL.** The later you get into an expansion the more megadeals you will see. That is a common rule that applies not just to real estate but to the business world in general. The single largest merger in the United States that is going on right now is CVS buying Aetna for $69 billion. Specifically for real estate mergers: Brookfield Property Partners LP bids roughly $15 billion for stake in GGP Inc.; and Unibail-Rodamco to buy Westfield Group. That's two megadeals with top 12 retail owners (two of the top six enclosed mall owners) happening at the same time. It is a very common trait of late expansionary period in the cycle to see the mega-mergers at the entity level as opposed to the property level. Instead of buying a 50-property portfolio, a buyer will purchase the whole company. That is late-cycle behavior.

**ERRATIC ECONOMICS.** The other thing you see in the late innings is data that reverses direction erratically. New York office leasing just set a record, but a couple of quarters ago it was the worst leasing quarter in several years. Erratic trends that don't seem to have consistency are another strange phenomenon of late-cycle behavior. It's hard to explain: are people indecisive then they over-decisive? This happens two times in the cycle, at the very beginning because there is not enough volume to show consistency, and late in the cycle, but as yet it is unexplainable.

**BEWARE THE FED.** There is a school of thought that the Fed actually causes a recession. If you look at the historical data, the argument is, the Fed causes recessions because it raises interest rates too far and the economy can't recover fast enough once the Fed closes the spigot. The average is 41 months from the first interest rate rise to a recession and median is 33 months. The Fed started raising interest rates consistently in 2016 (ignoring the outlier of December 2015) and did three interest rate rises in 2017. The Fed will probably continue raising interest rates every couple of months through 2018 into 2019. From the time the Feds start raising rates, the clock is ticking towards the onset of a recession. This means that we are not in danger of anything in 2018, but it's time to start thinking about 2019. A recession in 2020 almost feels inevitable.