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FINANCE AND COMMERCE

Commercial real estate still looks like a winner to investors

Even the revival of stocks and bonds this year hasn't dampened investor enthusiasm for commercial real estate properties. Industry experts say that trend isn't likely to change soon.

By Mark Anderson/F&C Finance Writer
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Real estate investors may be earning less than they've grown accustomed to in recent years, but they're still eager to spend more of their money buying and financing commercial properties in the Twin Cities.

Investors have been pouring their dollars into the relative safety of real estate for the last two years, cycling out of a stock and bond market that had punished them recently.

But even with stock and bond performance rebounding, the investment surge in commercial real estate still goes on, and real estate executives say a considerable portion of that shift might very well become permanent.

It's not easy to measure the size of that investor expansion, but commercial mortgage and investment executives don't leave any doubt that it's real and having a market impact.

"Whenever we go to raise equity on our buildings, we're oversubscribed," said Peter Austin, a senior vice president at Welsh Capital in Bloomington.

He said the main contributors are high net-worth individuals — investors who are looking for concrete asset value in the wake of the accounting debacles and high-tech misjudgments that blasted their stock portfolios during the last three years.

The long period of exceptionally low interest rates was another driver in the investor boom, enabling those private investors to leverage their savings and join partnerships that helped them buy into large multi-tenant property markets that had been closed to them in the past.

"Private investors have been king" in this market environment, said Scott Pollock, a senior vice president in investment sales at United Properties in Bloomington. Their entry in such large numbers created "an incredible demand for buildings."

Or, as another mortgage pro who asked not to be named put it, there was always somebody willing to spend more for a building than it was worth.

Some of that rush of investment will eventually migrate back to other investments, especially as interest rates make bonds more lucrative and debt harder to afford.

But shifts in a handful of fundamental factors are probably going to keep many investors and a larger portion of their assets in commercial real estate, the experts said.

One of those fundamentals is the age of the baby boomers, who by now are all thinking about retirement, said Beth Timm, an attorney and real estate specialist with Winthrop and Weinstine.

"Those investors are in a more conservative mood" after watching their parents retire and promptly lose one-third of their savings to the stock market collapse. "They continue to view real estate as a stabilizing investment."

The development of the tenancy-in-common (TIC) partnerships is another factor

That investment tool makes real property ownership more practical, by enabling private investors to turn most management duties over to the TIC sponsor. The size of the TIC investment pool also gives individual owners access to a much broader commercial market — from small freestanding buildings to many large multi-tenant projects.

Banks are also rapidly gaining comfort with TICs as borrowers and are streamlining their processes for lending to the syndications, Timm said.

The pace at which those are being created provides a good measure of scale of the investor boom, Pollock said. "Although we haven't seen a great impact on the local sale market from TICs yet, we're hearing about the creation of new groups all the time."

That private market demand combined with growing investments by institutional investors had the classic effect on commercial real estate pricing, driving up the costs of profitable properties and marginal properties alike.

That, in turn, drove down the returns to investors, but that hasn't dampened the investor market.

"Those returns are still very good compared to what people have gotten in their 401(k)'s, and investors still see that real estate continues to build up principal value," Timm said.

Returns are off by at least 100 basis points to about 9 percent internal rate of return on average commercial real estate investments, according to Pollock. Premium prices drove returns even lower for retail properties, which have generally been regarded as the safest class of property investments.

But given the new liquidity in the market because of the increased investor pool, and the growing discipline in the buyer market combined with more transparency in both building and geographic market performance, investors say the reduced rewards are offset by lower risk.

Many of the same factors have been at work in the lending market, too, which benefited by new investment from overseas — driven in part by a very favorable exchange rate — and by growing contributions from traditional commercial real estate lenders.

"More institutions — insurers and pension funds — are putting their marginal dollars into real estate," said Wayne Streck, head of commercial mortgage lending at Thrivent Financial for Lutherans. "But when a lot of people put their marginal investments in the same place, that ends up being a big change."

The result was a competitive lending market that narrowed spreads, making borrowing even more attractive.

As summer begins, it’s clear that some of the basic economic factors are already shifting. Mortgage rates have climbed by 100 basis points in the last two months, although Pollock said that modest increase shouldn’t diminish private activity by much through the end of the year.

The result should be a lot of buying and selling as investors and sellers begin to see improvement in the Twin Cities economy in the second half of the year, and an improving story on many high vacancy buildings.

“Every building has its own story; it may be location or it may be a developing market,” Austin said. “We’re looking at buildings with 60 percent vacancies, and we see opportunities there. We can wait when we believe in the story.”

Pollock agreed. “Investors believe the market has turned, and they’re more willing to take a risk. They think we’ve seen the bottom of this market.”