

## **Commercial real estate (CRE) market – next meltdown or recovery on the way?**

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### **ABSTRACT**

Based on industry data and that from other sources such as Federal Reserve Board testimony and publications, this paper provides a review of continuing commercial real estate market stresses and analysis of implications for stakeholders and the U.S. economy as a whole from numerous vantage points. It includes perspectives drawn from lenders, government officials at local, state and federal levels, tenants (including small businesses), developers, as well as those who may be concerned with the U.S. economy in light of numerous opportunities and threats. During the period from 2004 to 2007 developers overbuilt for both the U.S. housing and commercial real estate markets. Their ability to do so was in many ways directly related to “easy credit” made possible as lenders developed vehicles such as CDO’s (Collateralized Debt Obligations), which were sold in secondary markets (and freed up capital such that lending processes could be repeated). Subsequently, defaults brought foreclosures and price declines in the housing market, losses and uncertainty regarding the value of assets of any kind, a retraction of credit availability to consumers and businesses—adversely impacting entrepreneurial growth and development, and finally employment. This analysis suggests that there are differences between commercial real estate and residential real estate serves to stabilize the CRE market. The existence of capital to buy distressed real estate, the potential for converting properties to other uses, and the relative sophistication of players (e.g., professional investors, lenders and commercial real estate developers as parties to transactions) all contribute to long term strategies that allow for greater flexibility in commercial real estate transactions. The size of real estate developments increases the stakes for related parties and incentivizes creative solutions to maximize utilization of properties. Nevertheless new economic stresses such as possible long-term increases in oil prices, inflation, the devaluation of U.S. currency, and rising debt levels are now reverberating through the economy, could overwhelm the commercial real estate industry.

**Keywords:** Commercial Real Estate (CRE), Market Stresses, Leasing, Entrepreneurship, Economic Recession

## INTRODUCTION

While some economists contend that the economic recession (Macroeconomic Outlook, 2009; Mansour, 2009; Rosen, 2008) which began in 2007 is showing signs of recovery, there is still considerable angst and foreboding concerning the commercial real estate market. Commercial real estate performance during an economic decline generally results in reduction of asking rents (Pothering, 2010), increases in vacancy rates (Gibson, 2009), and concessions in the face of defaults (Hard times give tenants a way out of lease agreements, 2010). However, this present recession is exacerbated by foreclosures and price declines in the housing market, losses and uncertainty regarding the value of assets of any kind, and thus constraints on the ability of small businesses to obtain financing for start-ups or ongoing operations (Kowitt, 2008; Martin, 2009; Petrecca, 2009). These constraints impact the ability of commercial real estate developers and managers to do likewise (Coggan, 2009), and this is another area of stress facing commercial mortgage lenders and investors (Woodwell, 2009).

The reason for the aforementioned foreboding is that while the recession was originally attributable to the implosion of residential housing markets, overall economic activity has subsided as consumers tightened their spending fearing loss of employment (United States Unemployment Rate 2010) and a host of other consequences (Shinkle, 2010). Many others feared losing the homes they purchased during a real estate boom that foresaw seemingly no end to ever higher housing prices. Many of these homes were purchased with almost no down payments or income verification documenting the qualifications of purchasers (a.k.a. “liar loans”) using financing such as ARMs that provided low “teaser” variable rates subject to refinancing should the owner expect to hold the property over the long run under terms and conditions that might be considered reasonable at the time of purchase. When adjustable rates began to reset at higher interest rates, delinquencies in these types of home mortgages soared.

As a result, the real estate bubble popped (Why the Fed Can't Fix it Now, 2007) and these highly leveraged homeowners discovered that the value of their homes was less than the debt owed, many simply walked out of their obligations leaving neighborhoods or entire communities blemished with foreclosures and short sales that exerted a downward pull on the value of surrounding properties. When other families discovered they could rent for substantially less than their previous monthly payments, they had financial incentive to walk away from their debt (Bengtson, 2010; Olhasso, 2009; Shinkle, 2010). Unfortunately, many Americans also lost their income and were unable to maintain payments, resulting in even more foreclosures. As general consumer confidence dropped in the 2007 - 2008 era, the recession was not limited to residential housing industry but to the financial services sector and consumer discretionary spending. What began as a real estate bubble that burst ended up dramatically reducing consumer confidence and reduced consumer spending. According to a January 2011 report released by The Financial Crisis Inquiry Commission:

More than two years after the worst of the financial crisis, our economy, as well as communities and families across the country, continues to experience the after-shocks. Millions of Americans have lost their jobs and their homes, and the economy is still struggling to rebound. (The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, 2011).

As the snowball has continued to roll downhill and gather both mass and momentum, Americans are now seeing state and local governments contend with severe budget shortfalls threatening even more layoffs that will reverberate to the private sector. Recent highly publicized conflicts such as those involving teachers (and their union representatives as well as peers in other states) versus the governor and legislators in the state of Wisconsin are symptomatic of deeper issues and yet-to-be-resolved consequences. These conditions have created a near “perfect storm” and downward economic cycle in the U.S., a recovery from which could be described as tenuous at best given that even when the economic news is good for a change, oil prices (Rosen, 2008) and inflationary fears rise, stories of increased global competition for resources abound, and a sentiment that nothing is really getting any better persists (Chan, 2010; Politi, 2010). Further, some pessimism may well be justified due to long-term problems on the horizon for the financing of homes (given that this was where the recession began):

Even though the Federal Reserve has announced a \$600 billion purchase program of bonds, which is supposed to lower yields and ultimately keep interest rates low, consumers sooner or later will face the prospect of rising rates to combat inflation as the economy recovers. (Clark III, 2011)

When homeowners who took advantage of easy-to-get mortgage money to purchase homes prior to 2004 woke up in 2007 to find that their homes were worth less than their debt, they invented such an array of methods for dealing with this that the term “strategic defaults” became a new real estate financing term while the strategies themselves encouraged behavior that was in the aggregate, a further drag on an economic recovery. A similar scenario as that described above confronts those who borrowed (Meeks, 2008) to build commercial real estate as well as others who are involved with property management and associated activities. Thus, the commercial real estate (CRE) industry continues to be threatened by market stresses (The Outlook for Commercial Real Estate - Federal Reserve testimony to the Congressional Oversight Panel, 2011) in an economic recession (Clark III, 2011; Guernsey, 2010; Ryan, 2010; Viva El Cycle, 2011). Accordingly, based on industry data and that from other sources such as Federal Reserve Board testimony and publications, this paper provides a review of continuing commercial real estate market stresses and analysis of implications for stakeholders and the economy as a whole from numerous vantage points.

### **Commercial Real Estate - Next Crisis/Opportunity?**

According to Bloomberg, “approximately \$2.2 trillion of US commercial properties bought or refinanced since 2004 are now worth less than the original price”(Clark III, 2011). Bart Steinfeld, managing director of Jones Lang LaSalle, a real estate investment bank, has stated that “with more than \$1trillion worth of commercial real estate loans expected to mature between 2010 and 2013, it is no surprise that a majority of borrowers are placing significant importance on restructuring those loans” (Clark III, 2011). One potential solution is that lenders may grant extensions of up to 24 months to allow real estate firms an opportunity to restructure or refinance their real estate development loans (Corcoran, 2009; Heaberlin, 2009).

The challenge for these firms is whether they will be able to refinance before dramatic rises in interest rates. While the Federal Reserve Bank has been buying back federal

indebtedness to keep interest rates low, this strategy creates more money supply and the potential for future inflation, and later on, significantly higher interest rates. “The Mortgage Bankers Association (MBA) forecast calls for 30 year fixed-rate home mortgages to average 4.9 percent in 2011 and 5.5 percent in 2012” (Clark III, 2011). The problem facing the commercial real estate industry is that the condition of the financial services industry has been seriously weakened (Meeks, 2008; Peyton, 2009), thus threatening its ability to provide critical financing for commercial real estate.

Adding to concerns over the commercial real estate market is the overall demand for such properties is soft. “At the core of all these economic woes are lost jobs—nearly 8 million of them since the recession started. Household unemployment remains at 10 percent, the highest level since the 1982 recession. And while optimists see job losses ending soon, a hoped-for return to sturdy employment growth is already taking longer than many expected, thanks to enduring tightness in credit markets and fears of a double-dip recession” (Shinkle, 2010). If the recent turmoil in the Middle East coupled with escalating oil prices continues (resulting in pressures on consumers, small businesses, municipalities, school systems, and myriad other affected parties), one might predict with some degree of confidence that the U.S. economy will indeed continue to languish.

On the “opportunity side” of this discussion, just as buying low-cost short sales and foreclosures have been a boon to investors and individuals in the housing market (relative to those who remain in a position to purchase at bargain basement prices) and resulted in a transference of assets and wealth for individuals who have purchasing power, in the CRE market there are signs of at least some pockets of activity where some stability is to be had (Gregor, 2010) or at least deal-making for reasons of opportunism (Olhasso, 2009) or survival is occurring. For instance, *Chain Store Age* reported that “Retailers and developers talk a lot more these days. The recession-driven business of shedding stores and adjusting leases is throwing landlords and tenants together, forcing them to sit eye ball to eyeball (or at least e-mail to e-mail) to hash out real estate strategies that both parties can hopefully live with” (Field, 2009).

Similarly, a recent article published in *Advertising Age* suggested “retailers are expecting to obtain favorable lease terms in shopping centers and malls due to the many vacancies created by the recession. They hope to take the market share of former rivals who have suffered business failure” (Zmuda, 2010). It has long been known that in recessionary times, opportunities for taking market share from weaker competitors and innovation (i.e., by virtue of necessity) represent a “silver lining” (Madsen, 2009) to businesses that have the wherewithal and/or foresight to do so. For example, in the retail CRE sector, “Kohl’s snapped up a number of Mervyn’s locations after Mervyn’s went bankrupt, solidifying its presence on the West Coast. Target and Nordstrom have also moved to take advantage of distressed retail real estate” (Zmuda, 2010).

### **Unique Dynamics of Financing in the Commercial Real Estate Market**

In order to appreciate the unique dynamics and need for capital in the commercial real estate market, a description of the structure and practices of the industry may be helpful. Commercial real estate describes different types of real estate activities. These include: financing and building of hotels and motels; the construction of large apartment complexes; the construction of shopping malls and retail strip developments (strip centers usually do not have a large “anchor” store as compared with traditional malls that include larger “anchor” stores with

many smaller retail units); commercial office complexes; and, industrial parks. Each of these segments is vulnerable to economic conditions, both short-term fluctuations and long-term structural changes.

For example, the hotel/motel industry is impacted by business travelers (Bankruptcy is Sought by Hotelier, 2009). When economic activity is robust, the hotel/motel industry tends to thrive. However, when the economy softens, business travel budgets are reduced thus increasing vacancy rates in the industry. Structural changes also impact this industry: improved Web-based meeting technologies are arising, with purveyors touting the benefits of saving money, hassle, and time, as compared to traveling for face-to-face meetings, for instance. Videoconferencing and Webinars offer many of the benefits of in-person meetings without the expense of travel so providers would claim; thus, these types of technologies may constitute a substitute product in the travel market, especially if oil prices (Macroeconomic Outlook, 2009) and consequently air travel costs rise.

Retail malls and strip shopping center occupancy rates are directly impacted by short-term variations in consumer spending patterns (Paul, 2010). During the recession vacancy rates increased as consumers reduced per capita expenditures for discretionary purchases. A longer term structural change that is negatively impacting retailing is the explosion of retail sales over the Internet brought about by improved technology to display products (including the ability to actually demonstrate products in use with video technologies; this power of demonstration has previously been available only to firms with budgets that are large enough to support advertising through TV commercials as a medium). Internet sales have dramatically increased during the past ten years. Even office rentals are seriously impacted in the short-term by the failures of a number of financial services institutions. Longer term structural influences include the ability to create a virtual office at home to offer professional services such as investment services, etc. Los Angeles-based CB Richard Ellis Group, Inc. estimates an average national office vacancy rate of 16.6 percent for the third quarter of 2010—the first decline since the second half of 2007 (Clark III, 2011).

Another factor that impacts commercial real estate is the variation of demand for different commercial uses of properties. For example, many old downtown multistory factories and warehouses have been converted to loft apartments and multiuse buildings. Changing demographics significantly impact the valuation and use of real estate. For example, in the mid-1990's downtown office buildings that were once Class A developments were abandoned by banks, law firms, insurance firms and other professionals who left for suburban high-rise developments that provided free parking and were located much closer to residential subdivisions and their amenities (with benefits such as being closer to schools, where the children of some of those professionals who moved were enrolled). Many of these once prestigious glass and concrete office buildings were converted to residential units. That type of conversion requires significant alterations to the structure to install more plumbing, wiring, and kitchens; meaning extensive refinancing was necessary.

The structure of the industry and the manner in which commercial real estate development occurs involves a series of financing efforts at each stage of the life of the development. In a typical scenario, the life cycle of most large commercial real estate projects starts with a promoter who forms a limited partnership. With relatively little in the way of capital as a percentage of the total funding required to build out the project, the promoter secures an option to buy land. Using appraisals based on comparables of developed properties and with capital raised from limited partners, the real estate developer obtains interim financing to begin

construction of the development. During the construction phase, the promoter is lining up longer term financing based on projections of future cash flows from the project.

The promoter may also be seeking the possible sale of the project to an institution seeking a long-term investment with solid cash flows. These institutions may be other limited partnerships, real estate investment trusts (REITS), or insurance companies looking for both cash flows and future capital appreciation (NREI By the Decades, 2008). Regardless, all those purchases are leveraged through debt, including CDO's (Collateralized Debt Obligations) which essentially are aggregations of different types of debt put together as a package and resold. "CDO's help banks to make loans bundle them together and sell them to investors. This arrangement frees up more capital for the bank to invest by making more loans" (Der Hovanesian, Foust, & Cady, 2009; Raju & Maniam, 2009).

Holding periods vary depending on the CRE project and the capital needs of the investors. While commercial real estate appears as relatively permanent buildings, the economic reality is that there are typically periods of extensive refinancing and appraisals, renovations and restructurings of facilities themselves and the paper associated with these during the life of commercial properties. Commercial real estate investors tend to hold their properties from as short as one year to up to forty years.

The length of the holding period depends on the stage of development, the type of commercial project and the need for capital to pay for renovations. For instance, hotels, resorts and motels require significant injections of capital for renovation every three to five years. Carpeting and bathrooms need updating every three to five years. New technology such as flat screen TVs and Internet hookups are other improvements that usually cannot be financed out of cash flows. In the hotel/motel industry, changing the lobby and upgrading other amenities to remain competitive requires large sums of money. These improvements are capital improvements that have a three to five year life requiring terms of financing that are timed accordingly.

Apartment complexes similarly require new roofs, new asphalt, new swimming pool equipment including liners or patching and painting the walls and floors of the pools, and new water heaters and heating, ventilation, and air-conditioning (HVAC) units approximately every seven to ten years; yet "the sector's sales volume dropped from \$4.7 billion to \$1.5 billion. In October 2008, more than \$1 billion worth of garden apartments were sold, a month-to-month reduction of 49 percent and a year-over-year decrease of 66 percent" (Commercial Property News, 2009). The amount of capital required and the duration of this capital investment again calls for refinancing, but with weak sales and declining valuations the justification for such investment is a difficult case to make in commercial properties of any type.

### **Current Potential Crisis for the Commercial Real Estate Market**

Business reporters have noted that while the recession has reduced activity for most lawyers, those involved in commercial real estate law have remained very busy handling foreclosures and refinancing (Ryan, 2010). While some investors decide to cash out or "flip" their properties before having to seek financing for renovations, the sale of the property is nonetheless going to involve financing. The current potential crisis for the commercial real estate market is based on the following:

1. The industry norm requires extensive amount of debt financing/refinancing at all phases of the real estate cycle.

2. The economic recession has reduced occupancy rates and cash flow to support payments to lenders by owners of commercial real estate projects.

3. Banks and other financial institutions must maintain a portfolio of assets (meaning the loans they make) supported by valuations (Lennhoff, 2009) sufficiently high to meet the regulatory requirements.

4. Banks and other financial institutions are already facing regulatory scrutiny and an angry public for making “bad” loans, and the affect of new regulations have resulted in banks erring on the side of declining loans and instead taking the “safer” route of buying federal bonds and notes (in effect lending to government).

5. Many commercial real estate developments have faced increases in vacancies, increases in tenants that are unable to make lease payments, or a reduction of occupancies. With the increase of residential homes on the market and a scarcity of buyers, many institutions or homeowners unable to sell their residential properties have made them available for rent. Increasing the supply of single family homes, town homes and more desirable properties at lower prices as rentals has depressed pricing for apartments.

6. The economic recession has reduced overall demand for commercial real estate developments (The Outlook for Commercial Real Estate - Federal Reserve testimony to the Congressional Oversight Panel, 2011) and as a consequence market value of many real estate properties has dropped resulting in some properties carrying a debt load that currently exceeds the market value of the properties.

7. Commercial real estate properties for the reasons stated above require relatively frequent refinancing to facilitate changes of ownership but also to fund needed renovations and updating. When additional financing is needed, there is a certainty that new appraisals will be required thus complicating the ability of commercial real estate projects to obtain capital.

8. Future economic developments such as inflation which may stall true increases in retail activity; rising oil prices—which are very likely to increase prices for numerous consumer goods including necessities such as groceries and therefore reduce consumer discretionary spending—and unemployment figures, all have potential harmful impact on both the cash flows of commercial real estate projects but also on their economic viability as they attempt refinancing of their operations.

In the end, there are multiple perspectives concerning commercial real estate. Among these are from the standpoint of those in the industry who own or manage commercial properties, those who underwrite loans and provide financing, and another is from the standpoint of the tenant/lessee. Then there are the “suppliers,” in effect—those who design, construct, and provide the necessary materials, labor and other resources to develop properties in the first place (or renovate/reconfigure existing properties). Finally, governments that approve zoning and collect taxes, as well as other parties such as occupants of buildings and stakeholders in the economy at large are either a part of, or impacted by such a potential crisis should conditions not improve.

### **Implications for Owners/Real Estate Developers**

During 2009, according to the research firm Real Capital Analytics, about \$83 billion of office, retail, industrial and apartment properties fell into default, foreclosure or bankruptcy reflecting an increase in the default rate for commercial mortgages increasing from 1.62% to 2.25% (Paul, 2009). Given the uncertain state of the economy, there is definitely the potential

for a “bubble burst” (Corcoran, 2009) in the commercial real estate market. Mitigating the possibility of a collapse of the commercial real estate market are several factors. First, there is a substantial amount of capital that has been aggregated for the purpose of buying commercial properties as distressed properties. So much capital has been raised for this purpose that there is the possibility of competitive bidding for either providing capital for refinancing or for outright purchase. According to Norm Miller, Vice President of Analytics for CoSar:

Prices are higher than expected at this point in the cycle, which is largely due to the flood of capital that is chasing these deals. There was more than \$200 billion of opportunity funds raised in anticipation of tsunami of distress, with another \$150 billion expected over the next 12 to 24 months. The funds were raised in anticipation of a 1992-style flood and investors have been shocked by the level of competition and pricing, with so much capital chasing such a limited supply. (Pothering, 2010)

“More than two years into the economic downturn, commercial real estate executives have yet to experience the kind of the distressed environment seen during the late 1980s and early 1990s” (Pothering, 2010).

On February 4, 2001 Patrick M. Parkinson, Director, Division of Banking Supervision and Regulation with the Federal Reserve Board, delivered testimony before the Congressional Oversight Panel, Washington, D.C., addressing the current state of commercial real estate finance, including its relationship to the stability of the financial system overall. That testimony was strongly suggestive of FED policies aimed at encouraging lenders to work through troubled loans: “Loan restructuring can reduce the ultimate losses to the banking system. In addition, proper restructuring can reduce the damage done to businesses and the economy by limiting the forced liquidation of commercial properties that would further depress prices,” he said (Parkinson, 2011). Thus, as compared to the distressed environment seen during the 1980s and early 1990s mentioned above it seems to be the case that “fewer banks are under the same pressure, whether from their regulators, accountants, or stockholders, to recognize losses based on artificially low values calculated at the bottom of the commercial real estate cycle” (Burr, 2010). “Lenders and special servicers, with the blessing of the Federal Reserve, have pushed back the maturity dates on commercial real estate loans to defer the realization of loan losses” (Clark III, 2011).

According to Howard Roth, a director at Ernst & Young, “an asset is only distressed when [parties] are forced to sell. Otherwise it’s just under water. The policy now is the opposite of ‘force to sell.’ It’s ‘encourage to hold,’ which means there’s not a lot of distressed activity” (as quoted in Pothering, 2010). Upon careful examination of a loan a “lender may determine that the best step is to waive existing defaults and restructure the existing indebtedness” (Heaberlin, 2009). “This patience is arguably a good thing. It allows financial institutions and borrowers to stay in business in the expectation that conditions will improve” (Burr, 2010; Corcoran, 2009; Federal Reserve Says Commercial Loans not Threat to Big Banks, 2011; Guernsey, 2010). Thus, while there have been some distressed sales of commercial properties, “there has not been the volume that market players expected, said Spencer Garfield, managing director at New York-based investment manager Hudson Realty Capital” (Pothering, 2010).

Another mitigating factor that may be helping to prevent a complete collapse of the commercial real estate industry is that conditions vary considerably in different regions of the country and are a highly localized. For example, on the negative side Clark notes that:

With 180 commercial properties valued at \$3.185 billion that are delinquent, in default, bankrupt, foreclosed or otherwise owned by lenders, [the commercial real estate market condition in Las Vegas] is dragging down the region. More than 28 percent of the city's 37.5 million square feet of office space can be described as distressed. The third-quarter 2010 office vacancy rate was 23.9 percent, with 1,102,874 square feet of negative absorption reported during the first three quarters of 2010, according to GB Richard Ellis. Las Vegas' office market is significantly overbuilt, and no new office buildings are currently under construction or planned, reports GB Richard Ellis. (Clark III, 2011)

In contrast to Las Vegas, Clark also observed that Chicago's Class A market is rather healthy when compared with other parts of the country because there was no overbuilding (Clark III, 2011). Other observers of the commercial real estate market are even more optimistic in predicting an orderly and efficient unwinding of the problems within the CRE industry (Guernsey, 2010). Another example of a strong localized real estate market is found in the warehouses of Long Island:

With a 4.5 percent vacancy rate that is the lowest of any industrial market in the country, Long Island's 6,200 warehouses appear to be weathering the recession handily. Industrial space tends to have a reputation for stability; while unemployed people may not use office space, they still tend to consume. But the strength of Long Island's market has surprised even its longtime real estate watchers. (Gregor, 2010)

Besides markets segmented by geography, there are other pockets showing resiliency—if not growth prospects—including “green” (Heisterkamp, 2009) buildings and developments. “Green buildings may cost more up front, but they deliver high returns over the long term” (Apgar, 2009). Another market segment that remains strong among specific types of commercial property investments is based on “industry,” where due to the financial wherewithal of tenants, “banks have been eager to provide financing to doctors to enable them to purchase [medical] office space” (Gregor, 2009). Doctors also demonstrate a tendency for longevity in a given location, maintaining leases of “eight years on average, compared with terms of three to five years on typical nonmedical lease” (Gregor, 2009).

Notwithstanding the potential for optimism expressed above, the analysis precedes the recent dramatic jumps in gasoline prices (occurring as this present paper is being finalized), which if they continue could place a real damper on discretionary spending as American consumers would be redirecting their family budgets to purchase gasoline just to get to work rather than towards potential retail spending. Prior to these recent jumps in crude oil prices and increases in gasoline prices, national chain stores were looking at rosier prospects for retail spending (Paul, 2010), anticipating an opportunity to expand their retail outlets to capture increased consumer spending.

For instance, Charles Wetzel, president-chief operating officer of Buxton, a market-planning firm predicted that “there's going to be a lot of opportunity out there....[Companies] are not as aggressive as they might have been in years prior, but, having said that, they're not being conservative either” (Zmuda, 2010). Bill Dreher, a senior retail analyst at Deutsche Bank has concluded that “prime real-estate and the ability to negotiate lease rates are attracting both

national chains and smaller upstarts betting that better times are ahead. Kohl's, for one, is the 'poster child' for gaining market share in the recession" (Zmuda, 2010).

Further complicating the issue of adjusting rents and changing terms of a lease to reflect economic reality is the fact that the owners or investors of commercial properties are usually large institutions. These large institutional investors such as pension funds and insurance companies don't usually manage their own holdings (Clark III, 2011). Rather, they employ property management firms which act as leasing agents, rent collectors and disbursing agents to pay utility companies, repair services, and taxes on the properties they manage. The larger the commercial property, the more bureaucracy there is layered between the tenants and the owners, further complicating the ability to communicate or negotiate changes to existing leases.

### **Implications for Tenants/Lessees**

The degree of overcapacity of real estate is highly inconsistent depending on the region and type of commercial real property (Leon, 2010). This means that the implications for tenants may vary considerably in markets throughout the country. The following discussion illustrates some of the opportunities and challenges facing tenants regardless of whether they are retailers, service providers, wholesalers, manufacturers, or other users of commercial property.

The lack of demand for certain types of commercial real estate has resulted in some discounting of lease fees. "Some sectors are seeing higher per-square-foot discounts, primarily troubled multifamily and hospitality properties, are experiencing average discounts of 40.3% and 31%, respectively, when compared to similar non-troubled assets. Markets most affected by distressed office buildings include Jacksonville, Fla., Sacramento, Calif., Las Vegas, Phoenix and particularly Atlanta" (Pothering, 2010). Even with discounts and other concessions, a word to the wise would express that business owners should have an exit strategy even at the early stages of forming a business. The same is true relative to an exit strategy for real estate transactions, in the event that concessions are still not enough to ensure the survival of the business (Apgar, 2009; Crosby, Hughes, & Murdoch, 2006a; Weiss, 2009).

One of the impacts of a softening commercial retail market for space is that there has been a shift in negotiating power from the landlords to retail tenants. In Great Britain, for example, retailers facing hard times have begun to demand and more importantly to receive "turnover deals" as opposed to fixed rents (Kolakovic, 2009; Wheaton, 2000). The advantage to turnover rents is that they offer security in a downturn. Open market, fixed rental fees have become untenable with the drop in sales revenues of many retailers. Basing rents on sales dollars (Wheaton, 2000) definitely has the potential to reduce the income stream to the landlord, but it may also cushion a mall's landlord from having empty retail space. Vacant space or voids can give shoppers a bad impression of the mall and further reduce the sales potential for existing retailers (Kolakovic, 2009), and emptiness is certainly a sure-fire tip-off for prospective tenants to negotiate aggressively.

"Mark Ridley, commercial chairman and chief executive of Savills, says: "Turnover rents do disguise falls in rental value, so they can be positive for landlords. It is much better in the current market to agree a turnover deal with a tenant than to offer highly discounted rents. It is also more difficult to use turnover information against a landlord when it comes to review" (Kolakovic, 2009). The other potential value of basing rent on total sales volume is that the landlord gains insights about which stores are doing well and which ones are not before the retailer goes into default. Certainly turnover-based rentals are more labor intensive to administer

than fixed rentals but armed with that information, the landlord may be able to solicit a different type of retailer than would overall contribute to a more popular mall from a shopper's perspective (Kolakovic, 2009).

More sophisticated retailers and small business owners have approached their landlords with their five year leases signed during boom times and have simply sought to renegotiate terms of the lease. If they catch the landlord during a time when renovations are scheduled, they may be able to negotiate for some assistance in leasehold improvements that might help the retailer draw more customers. If the mall does not have a strong cooperative advertising program, the retailers may demand more management involvement to promote such strategies that tend to benefit all the mall's retail tenants.

Another strategy that some small businesses use is to sublet a portion of their commercial space whether it is retail or office space (Crosby, Hughes, & Murdoch, 2006b; Forshaw, 2009; Understanding Commercial Leases, 2011). By bringing in a tenant, the small business owner can offset some of their fixed overhead during lean times. The benefit to the smaller tenants is that they are getting a smaller footprint than what otherwise might be available. Not all malls agree to such arrangements, but commercial real estate owners who have retail or office space in smaller towns may find this to be a better alternative than losing their primary tenant.

In the context of professionals like lawyers, accountants and architects, not only does office sharing reduce per capita expenses, but office sharing can lead to more revenues for the parties. For example, many solo law practitioners deliberately share office space with other attorneys for the reason that if they lack the expertise in a particular matter, they will refer clients to their office mates. When they are pressed with too many court appearances, they will refer potential clients to the attorneys in the same suite. Sometimes a potential case requires more than one attorney to efficiently handle the client's needs and the attorneys will subcontract certain portions of the case. Increasing a professional's network through office sharing is a sound strategy (Rhys, 2005). Bartering and sharing space, services and other resources has also long been recognized as an effective strategy by "entrepreneurial bootstrappers" (Arora, 2002; Lahm, 2005).

Family owned retail stores sometimes find it beneficial to sublet a portion of their space to another firm. This practice is not uncommon in the antique business where the primary tenant will find it worthwhile to collect a small monthly fee for a certain amount of "additional" inventory. While technically, the "sub" tenant is competing for business, increasing the apparent level of inventory from the point of view of customers in an antique store, for instance, may actually produce more clientele, thereby expanding the total size of the pie. Some dealers even rotate the responsibility for maintaining the cash register among subtenants to reduce the cost of operating their respective stores. This is not the same as contingent sales because the other dealers are paying a monthly fee usually based on the square footage utilized.

Notwithstanding the desire to negotiate in a down market, tenants/lessees may also have to recognize that from a property management firm's point of view countering a prospective tenant's demands for lower rents may present a problematic situation. This is because many properties are highly leveraged—meaning that the landlord or their representative (the property management companies) —may not have much room for negotiations because their loan covenants may constrict their ability to reduce rents or change the basic terms of the lease without permission of the lenders. Meanwhile, the lenders are under the watchful eye of government regulators who may take regulatory actions against a lender that gives in to demands that decrease the value of their portfolios with respect to loan to value ratios.

Thus, while it may seem intuitive that in dealing with a real estate firm that has a half-empty building, it could well be the case that they have less of a bargaining position than a landlord that is in better financial health (simply because of the loan covenants they have with their lenders). Thus, as previously noted, the other reality for tenants is that they are usually dealing with a property management firm whose negotiating authority may be limited and may require dealing with layers of bureaucracy. Clearly the earlier one begins renegotiation in a tight financial situation, the better. Waiting until monthly payments are in default seriously reduces a tenant's leverage in negotiations.

Using an attorney who routinely negotiates with commercial landlords is also very advantageous. It may be possible to inquire of the property management firm or of other tenants for a reference in finding attorneys who are already familiar with the property management firm and the owners of the complex (Rhys, 2005). That will also save time and money for legal fees. Developing good communications with the leasing agent or property management firm is vital.

Finally, opportunities abound for tenants to consider becoming owners and landlords. Over the long run, entrepreneurs whose choice is to rent may fail to leverage the benefits that may be only be available to owners versus renters:

Many entrepreneurs have proven that owning the real estate used by their closely held businesses can provide them the advantages of stable rents for their businesses and appreciation for themselves. Many other benefits accrue to the owner of single-tenant commercial real estate, including the ability to employ advantageous tax strategies, an income stream in perpetuity, asset diversification, and control of the property's tenancy. (Owner-Occupied Commercial Real Estate for the Entrepreneur, 2009)

As was mentioned above, certain types of industries and properties have tended to remain attractive even during the recession. For example, as Gregor (2009) observed "Dr. Francis Martinis, who practices at North Shore Urology, a division of Integrated Medical Professionals, formed a real estate development company with his medical partners and built two medical offices, both about 3,000 square feet, in Port Jefferson and Northport, N.Y."

## **Conclusion**

The landscape of the commercial real estate industry reveals a potential for yet another economic meltdown. There are ominous political and economic developments that could lead to another (double-dip) recession. A global economic collapse resulting from huge increases in prices of oil and commodities due to a natural disaster in Japan and conflicts in the Middle East could trigger new stresses in not only the commercial real estate market but more bank failures as well. Notwithstanding recent events, there are signs of improvement in the overall economy. Slight increases in consumer confidence related to some decline in the overall number of new applications for unemployment assistance and robust corporate profits reflect a potential improvement in economic activity. Any heightened economic activity generally increases occupancy rates, lease prices and commercial real estate values.

Even with the potential of continued macro-economic stress, one of the mitigating factors in the commercial real estate industry is that most of the key players are professionals who have a long-term approach to the challenges facing the industry. Whereas a single homeowner facing a default has little negotiating power with large financial institutions, the sheer magnitude of

commercial developments makes financial institutions leery of pushing for foreclosures. This may be especially true when corporations are tenants, no personal guarantees have been made, and there is little hope of successfully piercing the corporate veil based upon an established legal basis for doing so (Lahm & Geho, 2007).

While this paper has not sought to review every nuance of a plethora of new financial regulations and laws aimed at stabilizing commercial real estate, its authors have surveyed opinions of key commentators and financial regulators and commercial real estate experts to describe the condition of the industry in the United States and presented diverse perspectives on the condition of the industry. Readers may also concur that the situation is not entirely hopeless for the reasons stated above. If one thing is abundantly clear, now is a time to innovate, negotiate, and communicate.

The structure of the CRE industry and the relatively frequent need for capital even in good economic times suggests that there is a mutuality of interests between financial institutions and their commercial borrowers to avoid foreclosure for all but the most desperate developments. The most severely depressed developments may require additional capital to convert them to some other use in order to realize a sufficient cash flow to support existing loans. Because commercial real estate is considered a long-term investment by professionally managed institutions such as pension funds, insurance companies, REITs, and philanthropic endowments, the comparison with the residential real estate industry where loans were made to millions of less sophisticated borrowers (or at least borrowers with less leverage given the relative size of their individual loans as compared to typical commercial loans) complicates the severity for those homeowners.

The tenants in commercial real estate developments, whether retailers, financial institutions, occupants of office complexes or wholesalers (to name few), simply present situations where the stakes may be far higher than they are with borrowers who obtained home loans. This does not mean that commercial real estate tenants are not suffering financially from a soft economy, but it does mean that they are more likely to have the opportunity to work towards terms that may allow the owners to avoid foreclosure while reducing their overhead. Our research has revealed some of the strategies that such tenants might consider in renegotiating the terms of their commercial leases while also exposing the pressures on their property management firms and owners of their facilities.

From this effort, we conclude that academic scholars should conduct additional research to better describe the tension between governmental policy, the law of unintended consequences, the condition of the financial institutions and the implications of public policy and regulatory actions in both financial services and real estate industry. Further research on the types of concessions that are reasonable pertaining to specific geographic locations, industries, and to types of commercial properties can also be of great benefit to those involved in seeking to best manage the commercial real estate industry's impact on their particular situation.

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