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Investing in suburban markets during this economic downturn


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In this current distressed economic climate, investing in suburban markets tends to present investors with a number of obstacles and opportunities. With the market changing daily, developers and investors are beginning to experience a rapidly increasing weakness throughout all sectors of commercial real estate. Projected increases in unemployment and the resulting market contraction are now upon us.

In the suburban NYC markets, numerous commercial loans have gone into default or may soon be in trouble. Recently funded deals were traded at exorbitant valuations and predicated on leasing rates, occupancies and financing assumptions that are now unachievable. The repercussion from the financial crisis has quickly degraded the performance of the market in general, and the near-term prognosis going forward is only expected to get worse.

Businesses and consumers alike are cutting unnecessary spending, conserving cash and reducing costs on all levels. All real estate sectors are going to face a slump, though in certain areas it will be of more substantial proportions. One segment that is already facing tremendous obstacles is the retail sector. Small, medium and large-sized retailers are experiencing a substantial decline in sales, and are seeking to cut costs by delaying new store openings, closing marginal stores, and asking for concessions on renewing leases. In addition, the current lack of available credit is making it almost impossible for many small- to mid-sized retailers to continue financing their operations or fund expansion.

This combined effect of poor sales and frozen credit has retailers going out-of-business overnight, leaving vacancies in places once populated with booming stores. You can walk through almost any downtown mall or shopping center and see closed stores for which there are no replacement tenants. Adding to the vacancy woes is the ongoing bank consolidation that is leaving many vacant retail branch locations in its wake. Overall, the vacancy rate has rapidly climbed and is expected to continue for the near future.

Although this recent economic downturn has impacted the retail sector very rapidly, the spillover effect is starting to have similar impact on the office and industrial sectors as well. Those sectors will also see a similar contraction in demand and corresponding higher vacancy and lower rental rate.

The rental apartment segment is currently the brightest star on the market and is expected to out-perform all other sectors. With the housing mortgage crisis, we see people who are unable to purchase homes or who can no longer afford their mortgages moving into more affordable rental apartments. Long-standing apartment projects where the owner has low-cost basis will be able to outperform the newer, more expensive competition by offering reduced rents.

One potential damper to the apartment sector in certain suburban areas is the competition now coming from foreclosed homes and failed condominium projects that are now being listed for rent. Although both homes and condominiums are hamstrung by typically seeking higher rents due to their larger size and cost. It is uncertain how much this additional supply from these two sources will dampen the traditional rental market.

This economic slump will not be bad news for everyone, as during the last major downturn we saw the low-cost alternative product prevail in all sectors. Suddenly B and C class space, be it retail, office or industrial, were in vogue as cost efficient alternatives to the more expensive "luxury" class A product. With a focus on the bottom line, companies won't need costly, unessential amenities such as a fancy address, building lobby or view. Owners with a low cost base will be able to cut rents, increase occupancy, and still make a profit while the newer, high-cost properties will face losses in order to remain price-competitive.

On the lending side, one positive in the suburban market is that community mid-sized banks are well capitalized and still lending money. These community banks are conservative lenders, thus potential transaction must offer high loan to value and debt service coverage ratios. In addition, these lenders tend to lend up to $20 million, therefore the larger projects will not be able to attract this type of financing. However, qualifying projects can still obtain financing in this credit-frozen environment.

Palisades Financial, being a private equity fund, does have capital to invest and has been actively pursuing a variety of investment opportunities in the local tri-state area. As an opportunity fund, we continue to strategically invest in transactions that will provide both a very good return combined with a lower loan-to-value. With the current credit crisis and traditional lenders now on the sidelines, we are receiving funding requests from a higher quality of borrower and deal than traditionally would have used our type of financing. We recently financed the remaining unsold units of a successful condominium project where a majority of units had been sold and closed. Our cost basis in the project is very low, thus affording us the option to either rent the units or sell the units at a big discount to market and still achieve the targeted returns.

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