Keeping A Keen Eye On Value

Owners and serious buyers of commercial real estate recognize the need know what drives property values. With things changing as fast as they are around the country, that knowledge has become even more important. Perhaps the most significant of these drivers is the rise in demand for industrial space, which has been ongoing since 2010. The resulting imbalance in the supply/demand equation has reached a critical level in many markets throughout the United States. Tight supply has helped some areas recover nearly all the losses in value that resulted from the Great Recession. Sale prices have spiked more than lease rates, mainly due to the availability of 90% financing for owner/users at low fixed rates offered through the Small Business Administration. This has resulted in a bifurcated value structure: one price for owner/user properties, another for leased investment and abundant low cost capital available to investor properties of equal quality.

Vacancy has fallen sharply and lease rates are moving back up as a result, emboldening landlords to offer fewer concessions like free rent and specialized tenant improvements. The days of moving allowances and cash signing bonuses are going by the wayside. The industrial vacancy rate now stands at less than 7% nationally, and acute shortages in some submarkets have become problematic for businesses looking to grow.

Every property owner acquires assets based on market conditions and trends as they exist at the time of acquisition, but also with an investment strategy that reflects the relative importance of cash flow, value appreciation, maintenance cost, functional utility and other priorities. However, markets are dynamic and so are the goals and objectives of the investor or the business owner. So, it is a good idea to regularly measure the performance of every property relative to changes in investment goals and the overall performance of any property as compared to others in the area.

Current investor owners are enjoying the benefits of rising rents and occupancy levels, which have combined to drive cap rates to record lows from coast to coast. In turn, business owners, anxious to avoid those runaway rental increases, are rushing to control their occupancy costs by buying their own facilities using low-cost, fixed-rate SBA loans. However, there just isn't enough product to meet demand and would-be user buyers are forced into paying more to lease the space they would rather own. Add the heavy tax burden of outright sales to the equation and even those owners desiring to sell feel compelled to exchange into the same supply-constrained market and pay a premium for the privalege.

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This double-bind is expected to continue, and only the players who stay in close and constant touch with their local market conditions will fare well under these circumstances. In most markets, the owner/user option for business owners is the clear choice, provided the business can function efficiently in the chosen facility for several years. Making the choice sooner rather than later is also important. It won't be long before our central bankers at the Fed finally follow through on the threat to raise interest rates, which will most certainly result in higher occupancy costs for businesses that purchase their own facilities.

The inevitable rise in the cost of capital is likely to affect cap rates, as well. As the Fed boosts rates, returns on alternative investments will also move up, resulting in a rise in cap rates for industrial real estate. Rents should keep moving up for the foreseeable future, as supplies are expected to remain tight. Only a few markets around the country even have the land to add a significant amount of new inventory, and bulk distribution space makes up the lion's share of the new inventory being constructed on a speculative basis. Smaller industrial users and, in particular manufacturers, are left to pick only from existing inventory, much of which is functionally obsolete with a higher degree of deferred maintenance.

So, keeping a keen eye on value is critical to today's real estate players. Markets are moving fast and choice of assets to choose from whether you are an investor or owner user, are on the wane. Vacancy is likely to continue its decline, and the ranks of markets with vacancy rates under 5% will become more common. That poses a challenge to investors and businesses looking to expand in their own markets. While investor/owners can look to new markets to place their capital, owner/users generally cannot.

If you are looking to acquire or dispose of assets in these changing times, we at Lee & Associates are here to be your boots on the ground, keep you informed and efficiently execute your transactions.