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OP-ED: Converging conditions good for commercial real estate

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The many considerations that affect valuation and pricing of commercial real estate have now aligned to create a near ideal environment for borrowers. It's been a long time since so many broad-based economic factors have conspired so favorably. Indeed, it's unusual to see such typically divergent factors team together:

1. Surge in capital

• The market is overflowing with foreign and domestic capital, including both debt and equity from institutional and private sources.

• Investors, both buyers and lenders, are flush with money.

2. Historically low Treasury yields

• At the end of August 2014, U.S. Treasury yields were below 2.35 percent – the lowest in over a year! As the index used to price commercial mortgages, we're seeing simultaneous low interest rates.

• So, why are U.S Treasuries attractive now? The simple answer is geo-political risk. In essence, we're experiencing the infancy, or arguably the adolescence, of a truly global economy. Concerns about overseas conflict in the Middle East and Russia as well as financial distress in Europe and South America are driving global investors to seek the relative safety of the world's surest investment: U.S. Treasurys.

• This investment demand drives down yields, and by extension, commercial property mortgage rates. For example, well-positioned, modest-leveraged, quality real estate have been getting longer-term fixed rates in the mid-3 percent range.

• Normally, low Treasury yields are a symptom of a tanking economy. Yet the U.S. economy is experiencing widespread recovery.

3. Solid economic recovery supports fundamentals

• A strong economic recovery now translates to robust commercial real estate fundamentals. Supply and demand has substantially regained balance across all property types.

• Real GDP growth was revised up to 4.2 percent in the second quarter of 2014.

• Consumer confidence is on the rise and employment gains, though modest, have remained consistent.

• Perhaps most surprising is the fact that we're simultaneously experiencing both a bull market in equities (rising stocks) and historic lows in Treasury yields (bonds).

• Though the course to recovery has been choppy, the likelihood of another collapse is less probable.

Of course, the various property types perform differently in the market. Since my job is to help commercial property owners obtain financing, I can provide insight into how lenders evaluate the different property types as ranked by their current market strength: apartments, industrial, retail and office.

The apartment market continues to exhibit substantial surges in renters, rental growth and subsequent proliferation of new units. The bulk of this activity is fueled by millennials and baby boomers competing over the same product.

Both major demographics are vying for similar lifestyles of greater efficiency, though motivations may be different.

In consideration of these social and economic factors, lenders will underwrite and price apartments most aggressively. In the Portland-metro area there is a bit of concern about the volume of new construction, especially since it's concentrated largely at the same demographic with higher-end urban infill locations. Yet the apartment boom has been sorely needed as judged by the city's consistent low vacancy rates.

The next hottest property type is bulk industrial, which is generally a straightforward assessment. If the property is clean, well-located and maintained, then it's both leasable and desirable as collateral for a loan. Industrial rents don't fluctuate too dramatically, and landlords face less onerous re-tenanting costs on turnover. As such, lenders favor industrial and will continue to seek this property type in Portland.

As for retail properties, credit is generally the attraction for lenders. But in terms of performance, the market is bifurcated. The market has fared well at the two ends of the spectrum with both luxury retail and value discounters swimming in profit while the middle market treads for survival. Lenders will often underwrite, size the loan and price the rate based on these evaluations. Portland is considered an 'under retailed' market, so more supply could be absorbed.

From a lending standpoint, office properties are categorized as either urban or suburban. This may be a common distinction, but is representative of a range in risk for lenders. In general, urban office properties are less risky. After all, downtown Portland remains a hot commodity with low vacancies, rising rents and high demands. On the contrary, suburban office properties are more risky depending upon their location. Location is critical, and value is based on proximity to transportation and employment centers.

During the market downturn, too many tenants downsized, leaving landlords with big re-tenanting costs with zero to little prospective replacement options. Today, lenders prefer suburban business parks with rents that are at current market rate or lower, and with a diversified rent roll. Even then, lenders exercise caution with a typical max loan of 65 percent or less (versus standard 70 to maybe 75 percent) of perceived value.

Though each property type is assessed differently by lenders, the overall conditions are pretty fantastic. Again, the main tenets supporting this idyllic environment are all working together. With a surge in capital, low U.S. Treasury yields and low interest rates, and a steady economic recovery fueling strong commercial real estate fundamentals, borrowers can enjoy this panacea… for now.

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