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From the Los Angeles Times

REAL ESTATE

The chill spreads to commercial real estate

Credit market turmoil has slowed sales and softened prices for office buildings in Southern California.

By Roger Vincent

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The global credit crunch that took hold of financial markets in the summer is now taking the steam out of commercial real estate.

Office buildings, warehouses and shopping centers looked like a safer haven for big investors wary of falling prices for houses and condominiums. But now, the commercial side is feeling the pinch.

Even Southern California, which has been one of the country's favored markets for investment in recent years, has seen sales cool off and prices paid for business properties decline. Some owners are holding onto their buildings and waiting for the market to improve.

But with a falling stock market, a shrinking dollar and widespread concern about recession, real estate deals are getting dicier.

"The biggest issue on both sides -- seller and buyer -- is that no one wants to pay or sell at a bad price," said real estate analyst Raymond Torto. "They are all searching for 'the market.'"

One of Southern California's largest office landlords, Arden Realty Inc., recently put six buildings on the block and then yanked most of them off. Two were in Los Angeles County, two in Orange County and two in San Diego.

Arden valued the properties at more than \$200 million but didn't like the offers it received.

"We're moving forward on one sale in West L.A. and pulling back on the other five," said Robert Peddicord, Arden's chief operating officer.

"We think we will get better values next year."

The underpinnings of most of Southern California's office markets are still strong, though, Peddicord said. The economy has been growing for the last few years, so many businesses have expanded and rented more space.

As a result, offices are harder to find and landlords have been able to raise rents, especially on the

west side of Los Angeles County, where rents are hitting record levels. There has been little office construction since the early 1990s, so property owners have little new competition to contend with.

Offices are the largest category in the commercial real estate field, but empty warehouses and other industrial buildings are hard to find in the region. Most apartments have tenants and average rents are rising. The shopping center industry is also healthy.

So while many investors are having trouble finding money to invest in big buildings, the commercial property business is more stable than the troubled single-family home market, which has seen sales volume drop to 20-year lows, with prices edging down as well.

"Although commercial real estate and residential real estate have the same last names, they are not related," said analyst Torto, a founder of Boston-based CBRE Torto Wheaton Research. "Commercial is not overbuilt. Residential is."

But although the fundamental supports of commercial property such as occupancy and rent levels are still strong, sellers can't reap as much as they could a few months ago. Torto estimated that the price of an office building has fallen an average of 10% since they peaked in July, with the best buildings in desirable neighborhoods often suffering no depreciation.

Meanwhile, many lesser-quality properties away from big business centers have dropped about 15% in value.

Even though building prices are falling, there's no cause for alarm yet, he said. Most owners who have had their properties for at least a few years are still in a position to profit from a sale. Average prices are back to January levels, Torto said, and if they fall 5% more they will match the levels of the third quarter of last year.

"So if you bought a building from 2003 to 2005, you still have a lot of unrealized value," he said.

Some of these owners are willing to sell their buildings and, for example, might make a profit of 25% instead of the 30% they could have made in July. Others are keeping their properties off the market and waiting to see if they can get that higher payoff later.

The dearth of motivated sellers means there aren't a lot of bargains for vulture investors to snatch up, Torto said.

"A lot of people are going looking for where there is blood in the water, but they are having a hard time finding what I would call a seller in distress."

The commercial real estate investment market was due to cool off a bit after more than five years of hefty annual appreciation, industry observers said.

Overall values were driven up in part by expensive office portfolio sales, most notably Blackstone Group's \$23-billion acquisition of Equity Office Properties Trust in February. The transaction "lifted values in spring, but now we've taken that increase back," said Wayne M. Brandt, managing director of commercial lender RBS Greenwich Capital.

The main factor in falling prices is turmoil in the credit markets that supply a lot of the money to buy real estate, experts say.

A slowdown in price appreciation of single-family homes last year led to a downturn in many markets this year. That has been accompanied by a larger-than-expected number of delinquencies in mortgages to buyers with flawed credit histories.

Many lenders lost trust that they would achieve their expected returns and stopped making as many risky, complicated loans. Buyers have been required to increase the size of their down payments, or equity, another hindrance to a healthy flow of deals.

"Global capital markets are extremely unsettled right now," Brandt said. "Losses haven't fully been contained."

And commercial real estate is a lagging indicator, economist Jack Kyser of the Los Angeles County Economic Development Corp. said last week. Local businesses aren't expanding as fast as they were a year ago, and landlords shouldn't count on demand continuing to grow in the months ahead.

"We are in a period of slower growth in Southern California," Kyser said, aggravated by the housing slowdown and the strike rattling the entertainment industry.

Much of the inexpensive credit for investing during the recent price run-up came from commercial mortgage-backed securities, which are pools of loans secured with commercial properties. They are traded like stocks, providing liquidity and diversification to investors and access to capital for lenders.

The commercial securities market "was the source of all that loose credit coming into commercial real estate," Torto said. It funded about 35% of purchases during the peak this year.

Their decline in popularity has created opportunities for traditional real estate investors such as insurance companies and pension funds, which had lost out to hedge funds and other Wall Street players.

Several major pension funds and other institutional investors say they are underinvested in real estate and are looking to buy, Torto said.

The California State Teachers' Retirement System only recently achieved its real estate investment quota but will continue to buy and sell properties strategically.

Also expected to keep the investment market in motion are foreigners keen on taking advantage of the weak dollar. Torto said he had noticed growing interest from buyers in Europe and Australia.

This year, British developers paid \$500 million for the former Robinsons-May department store in Beverly Hills, one of the priciest property sales ever in Southern California. Plans call for the site to be redeveloped into condominiums and stores.

Most observers expect to see calm return and commercial real estate prices to rise again some time in 2008.

Notwithstanding how bad it looks now, commercial real estate will improve in the first to second quarter of next year, real estate attorney Michael Hamilton of DLA Piper believes.

"Smarter, more prudent lending practices will be implemented," he said, "but the market will continue to develop and grow."

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