
Real Estate
NEW JERSEY
Published by Real Estate Forum Magazine
January/February 2009
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Fighting Recession

Job losses in pharma and financial are the downside, but New Jersey's economic maturity and resiliency could help

By Joe Cavaluzzi
Contributing Editor

More pain than other places? That's a possibility for New Jersey's commercial real estate markets as the national recession deepens. For one, the state's exposure to the staggering national job losses is heightened by the strong presence of financial and pharmaceutical sectors, both of which are seeing an outsized share of those losses, and that could leave some scars.

On the plus side, however, New Jersey has a mature, sophisticated economy that has shown a tendency toward resiliency in the past. That resiliency could be a plus this time around.

As far as real estate, office building owners were already feeling the slowdown in leasing when the depth of the financial crisis began to really sink in back in October. According to industry reports, they had already been through 627,000 square feet of negative absorption during the first nine months of last year, according to industry statistics. More than two-thirds of that came in Q3, during which nearly 30.6 million square feet of direct and sublease space was being marketed.

New Jersey investment sales, too, were off substantially by the time the financial markets collapsed. Office building investment sales, which increased fivefold from 2002 to 2007, were off 60% to 75% in Northern New Jersey during the first nine months. Stymied by high seller expectations and financing—when available—at significantly lower loan-to-value ratios, the market has seen few major sales. Fifty-five percent of office sales in North Jersey in 2008 were deals of $25 million or less.

While multifamily properties remain strong with only about 3% vacancy statewide, the CMBS market that provided much of the money for commercial acquisitions is gone and unlikely to return in the year ahead. About one million square feet of new office space was under construction in Q3, and that was split between just three submarkets. So it seems unlikely that developers will be starting new projects this year.

All of this will likely make business tough in the year ahead, and commercial real estate firms will focus on harvesting additional service work from existing clients. Some of the specifics:

The Economy

New Jersey is going to mirror the nation in job losses this year, according to economist James Hughes of Rutgers University. The country began losing jobs in October 2007 and continued to lose them for 12 straight months. Of the 2.1 million jobs that have been lost, nearly 1.3 million disappeared from September to November 2008, with 540,000 jobs lost in November alone.

"This is the start of an extended employment meltdown that is going to dominate 2009," Hughes says. "The national job losses are the predominant force that is affecting every state. New Jersey has above-average exposure to contractions in financial activities as well as in the pharmaceutical industry. Both sectors have had a string of layoff announcements that have not occurred yet. That certainly doesn't indicate any growth of demand for office space."

The deteriorating labor markets are contributing to a second major downward force: Consumer retrenchment.

"Households have had a zero savings rate for the past two years. Their homes have been losing value, and their nest eggs have a lot of cracks in them," says Hughes, noting that consumer retrenchment is going to impact warehousing and distribution as well as the softening retail markets. "There's no real way to sugarcoat any of this."

"Households have had a zero savings rate for two years. Homes have lost value and nest eggs have a lot of cracks in them."

JAMES HUGHES
Rutgers University

The one sector of the economy that has kept growing both in employment and facilities use is healthcare, and Hughes predicts that will continue. The other bright spots in the state's immediate economic future are investment in state plans to make infrastructure improvements and the fall of oil prices.

"Lower oil prices should help counterbalance things," Hughes says. "Cheaper transportation costs affect every corporation. The removal, at least temporarily, of those punishing energy costs is a positive."

Finance

The sources of finance for commercial real estate likely will remain limited in the year ahead. As 2008 came to an end, the federal government's bailout money had not shown an impact.

Jon Mikula, senior managing director of Holliday Fenoglio Fowler in Florham Park, says the lack of real estate finance is in large part the result of institutional investors' liquidity problems. But an even bigger problem is determining how to price risk.

"If you're a lender managing fixed-risk investments, why make a real estate loan at 400 basis points over Treasuries?"

JON MIKULA
Holliday Fenoglio Fowler

"If you're a lender and you're managing your fixed-risk investments, why make a real estate loan at 400 basis points over Treasuries?" Mikula asks. "The risk-returns aren't there for investments. Some lenders are still suffering from subprime loans they made. But the biggest problem is pricing capital."

Banks, primarily the regionals and locals, as well as the insurance companies, are likely to be the main sources of issuing debt in 2009, although Mikula anticipates that insurance company volume will drop by 20% to 30% from 2008, when it already was down from the previous year.

"They are going to look at cash flow for the future and for best-of-class because they can," Mikula says. "A lot of the local and regional banks that didn't go for the riskier deals that were in vogue are being presented with great opportunities to which they normally wouldn't have access."

Maturity defaults will be a big factor this year because a significant number of loans, many of them on value-added properties that were highly leveraged, are coming due over the next 12 months. When those borrowers ask for extensions this year they may find lenders unable to help because of their own liquidity problems.

"Not being able to find replacement debt is going to be a real problem, Mikula says. "We are involved in many of those scenarios today."

Some lenders have been taking a proactive approach, sitting down last year with borrowers to work out terms for loans that come due this year, offering to let borrowers pay off the loan at par value or laying off part of the refinancing to a mezzanine lender.

Investment Sales

Palisades Financial of Fort Lee started its first investment fund of about $200 million in 2002, and it has produced returns of about 15% a year. Even last year it managed to produce returns around 7%. But when the opportunistic financer started a second fund in 2008, it was able to generate only $75 million, far short of the $200 million it hoped to raise.

"Fortunately, we're sitting on cash right now. We have no leverage at all. That's the reason we're in the black."

JACK CHIMENTO
Palisades Financial

"The thing that is very fortunate for us is that we're sitting on cash right now," says Palisades principal Jack Chimento. "We have no leverage at all. That's the reason we're in the black.

"The only thing that's going to solve this crisis is time," he says. "Once all of the loans originated from 2004 through 2007 finally hit their stride in terms of what the total foreclosures are going to be, that's when it's going to stop."

In 2009, Chimento says, Palisades will seek only completed projects or those near completion. He anticipates finding some opportunities in condominiums because of lender fatigue of first-mortgage issuers and mezzanine lenders that are looking to get out because they are past their time horizons.

"So, you can get some good values," he says. "A year ago, you could get 80% loan-to-value. Now lenders are giving first mortgages at 55% to 60% loan-to-value. That's what we're focused on—getting pretty well secured in this market."

Caution will be the rule for investment sales in 2009, Chimento says, because things change quickly and a property with anything less than very solid tenants could lose value fast if one of them moves out.

Consider this example: A property with a net operating income of $10 million and a 5% cap rate has a value of $200 million. But if the NOI goes down to $8 million and the cap rate goes to 7%, the value drops to about $114 million, a 43% decline.

"You have to be really careful right now because things got so frothy over the past several years," Chimento says. "But if you have the money you can pick and choose."

While investment sales were down 70% last year, Mikula says, there still are people in the market who are taking advantage of the opportunities that are out there.

"Those who can look at this as a great opportunity to buy property at a discount—and they're out there—are buying property and buying loans at discounts," Mikula says.

Michael Fasano, regional manager of Marcus & Millichap in Elmwood Park, notes that the down economy has lessened the gap between sellers and buyers. There is more pressure on pricing for office, retail, industrial and hotel properties than for multifamily.

Indeed, vacancy for multifamily is only 3% to 3.6% across the state, so owners can still achieve reasonable increases in rents, and that continues to make apartments the favored investments.

"On the office and industrial sides, the players this year are going to be people who are well healed and probably sat on the sidelines in the boom years because of the high prices," Fasano says. "They will be able to capture this new level of pricing. I also expect that contrarians who believe this is a strong time to enter the market will be active. Many people who purchased in the late 1980s to 1992 are in a strong position today."

"With all the pressure, you'll see more people on the regulatory side looking much more favorably on clean ratables."

MICHAEL SEEVE
Mountain Development

The financing crisis is generating demand for apartments and likely will help keep that demand strong in the year ahead, says Kenneth Uranowitz, managing director of Gebroe-Hammer Associates in Livingston. His company acquired apartment buildings last year in North Jersey's Bergen, Essex Hudson and Union counties.

"Those counties have the highest foreclosure rates, Uranowitz says. "We closed 14 deals in those counties totaling 586 units valued at more than $68 million last year. In 2004 and 2005, when housing was at its peak and money was being given away at the corner candy store, people were fleeing apartments to take the cash and buy a house. Some of those people are finding they can't afford the house they bought, and they are becoming renters again."

Development

With 20% vacancy at the end of the Q3 and one million square feet of office space under construction, it's unlikely that any new office projects will come out of the ground in 2009. Data centers may provide some opportunity as they did last year, however.

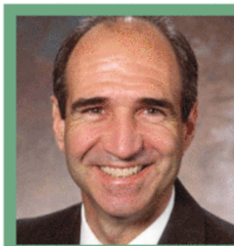
"New Jersey is a critical market for connectivity and data center services," says Michael Seeve, president of Mountain Development Corp. in Clifton, which built Mountain Technology Center there and leased space last year to Telx and Automated Logic Corp., a division of United Technologies.

Goldman Sachs, meanwhile, is building two data centers totaling 300,000 square feet in Bridgewater, while Digital Realty Trust, which already has one million square feet of data center space in New Jersey, is building a 450,000-square-foot center in Franklin Twp. Barclay's, the bank that acquired Lehman Brothers last year, recently completed two data centers totaling approximately 500,000 square feet.

"We did one data center deal and two office deals at Mountain Technology Center," Seeve says. "It wasn't just trading space. Those are bigger uses where radically smaller or no uses existed before."

While Mountain Development doesn't have any new projects on the board for 2009 so far, Seeve hopes to find opportunities as the year goes on. He is also hopeful that the recession will create pressure in Trenton to streamline the regulatory process of development.

"There still is a need for traditional value-added real estate development," Seeve says. "With all of the pressure being brought to bear on local governments and on the state, I think you're going to see a lot more people on the regulatory side looking much more favorably on clean ratables such as office buildings, warehouses and flex product that don't consume a lot of municipal services."



"When you look at markets with availability rates staying where they are, a lot of what we do is help tenants renew."

RICK MARCHISIO
Grubb & Ellis

Brokerage

The successful office and industrial real estate brokers in this year's market will be the ones who find ways of providing a greater level of client services.

"The interesting thing is that in the midst of everything that is going on, America isn't going out of business," says Rick Marchisio, managing director of Grubb & Ellis in Fairfield. "Companies still need to occupy space. They

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