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Commercial Real Estate

Could U.S. Debt Downgrade Aid Commercial Real Estate?

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The fallout from Standard & Poor's downgrade of Uncle Sam's credit could be a boon or a bust for the commercial real estate market, depending on how events unfold as the market enters uncharted waters.

A lower credit rating usually raises interest rates to reward investors for taking on more risk, but just the opposite happened early this week. Amid global uncertainty and Europe's credit crisis, Treasuries were the prettiest girl at an ugly dance.

Investors dumped stocks — before a midweek rebound — and piled into safe havens like Treasuries, sending their prices soaring as rates fell to new lows. Yields are apt to stay low as the Federal Reserve pledged Tuesday to keep short-term interest rates near zero at least through mid-2013.

Low interest rates for the foreseeable future could whet appetites for buying buildings. Owners could also refinance mortgages to take advantage of lower borrowing costs.

In addition, amidst economic uncertainty, institutional investors may buy commercial real estate as a hard asset leading to greater demand, says Chris Macke, senior strategist for CoStar, a commercial real estate information company.

"It is viewed as a safe haven as a result of its tangible nature and the inability to print more of it," Macke said. There will likely be flight to safety in high-quality, high-occupancy buildings in "gateway" markets such as New York, London, Tokyo, California's Bay Area (San Francisco and Palo Alto in particular), Los Angeles/Orange County, Sydney, Miami, Toronto, Vancouver, Bombay, Rome, Munich, Paris, Moscow, Dubai, Istanbul, Sao Paulo, Shanghai, Singapore and Hong Kong, he added.

One Way Or Another

While paper assets like stocks may continue to sell off, commercial real estate will not fare as poorly because it remains a preferred asset class, CBRE's Asieh Mansour and Raymond Torto wrote in a client note Tuesday.

But many factors could negatively impact demand for commercial real estate. Heightened economic worries may keep buyers and sellers sitting on the sidelines. If firms put expansion and hiring plans on hold, they may not want to lease more office space or relocate. New developments could have more difficulty getting off the ground as a result of stricter underwriting standards or lenders' reluctance to lend.

"If a decline in business and consumer confidence persists for some time, it will delay any meaningful recovery in the U.S. economy and adversely affect the nascent recovery in property market fundamentals," Mansour and Torto wrote. "Leasing volumes are expected to slow and the recent improvement in key performance metrics (absorption, occupancy, rents) should lose the momentum that was evident in the first half of 2011."

The spread that lenders charge above a key U.S. Treasury rate may expand as a result of the increased market uncertainty offsetting those declines — or not, they added.

One early effect in the wake of the U.S. debt downgrade and huge stock market sell-off early this week is that some investors have gone bargain-hunting in real estate investment trusts, or REITs.

Both IBD's 125-company Finance-Property REITs industry group and the 31-company Finance Mortgage/REIT group have jumped in rankings among the 197 groups IBD tracks — the property group to 57th and the mortgage group to 48th.

REITs' Wild Ride

The stock market performance of each slid by double-digit percentages in the two weeks leading up to S&P's U.S. credit downgrade announcement of late last Friday, and slipped another 8% Monday. By Thursday's market close, though, the pair erased the week's losses.

The overall REIT sector's Monday drop — 9% according to SNL Financial's data — was the largest since December 2008, a month in which it saw 19% and 15% one-day drops. Monday also marked the 12th worst day in the history of U.S. REITs. They fell to a discount of 23% to net asset value, SNL says.

During the 2008-09 bear market, prices fell to a 40% discount to net asset value, said Jason Lail, manager of real estate research at SNL.

Company fundamentals have improved dramatically since then.

"Since 2008, REITs have been working diligently to reduce leverage and clean up the books overall," Lail said. "So they're in much better shape to take on another recession. They're much more prepared than they were last time."