

## **Commercial real estate forecast for Dane County warm to partly cloudy**

By Tony Larson, Matt Karnick

*As published by WisOpinion.com on 6/4/08*

*The column below reflects the views of the author, and these opinions are neither endorsed nor supported by WisOpinion.com.*

This year's news headlines paint a cloudy picture for real estate in general. In fact, the residential real estate market across the country has seen some significant price declines. This is complicated by the sub-prime credit mess and a slowing economy. A quick recovery is unlikely.

What few people recognize is that the forecast for commercial real estate is not quite as cloudy. Commercial real estate includes office buildings, warehouse and manufacturing facilities and retail space. Commercial markets are not facing the selling pressure of residential markets. With the exception of some retail spaces, most commercial markets are in equilibrium with vacancies running about 10 percent. When vacancies rise above 10 percent, owners are forced to give rent concessions. When they fall below 10 percent, demand exceeds supply leading to more building.

The strongest commercial properties are in the office building, warehouse and manufacturing facilities. Lease rates are stable and growing modestly. Landlords should be able to increase rents in line with inflation. And unlike residential properties, values of commercial properties in these markets have not fallen.

On the other hand, retail spaces are facing some challenges due to a declining economy and falling consumer spending. The residential refinancing boom of a few years ago, fueled by rising residential real estate prices, fed a lot of consumer spending. Decreased home equity is now having the opposite effect. This puts pressure on retailers causing some to put expansion plans on hold, or worse, to close up altogether. As a result, we forecast fewer new retail leases and project that some existing leases may lapse.

Fortunately, Dane County continues to have a stable real estate market overall. The region has had a strong and growing economy. But a few years ago, we thought Madison real estate showed signs of being overpriced with building owners commanding prices that weren't supported by the cash flow, especially in the residential rental markets. Today, the overall market is more fairly priced. Commercial real estate prices in our market are rising at a slow but steady rate.

Commercial real estate investors may be surprised by the impact, or actually the lack of impact, of declining interest rates. While the Federal Reserve has dramatically reduced short-term interest rates, this has actually "reshaped" the yield curve into a more traditional upward slope with lower rates for short-term debt and higher rates for longer maturities. Prior to this year, the yield curve was actually inverted with some shorter-maturity debt commanding higher rates. For most commercial borrowers, this has meant mortgage rates have not declined, and in some cases, have even risen.

Going forward, with a few caveats such as the uncertainty in retail markets, we should continue to see a relatively healthy commercial real estate market. Prices should rise gradually, in line with inflation. If you are considering purchasing or refinancing commercial real estate, keep in mind the following tips:

1. Carefully consider whether you finance your purchase with fixed or variable rate debt. Fixed rate debt allows you to lock in an interest rate and create a predictable expense and more predictable cash flow, especially if you have strong tenants. On the flip side, some floating rate debt holders have benefited of late as interest rates have come back down. Choosing variable rate debt can be risky, but if rates stay low it may be a way to save on interest expense. Some businesses chose a combination of both fixed and floating debt.
2. Do a thorough analysis of your tenant mix and the underlying financial strength of your tenants. A tenant in default and vacancies are property owners' worst enemies. The foregone rent can never be replaced.
3. Cash is king. It is important to point out to a lender that you or your business has strong cash reserves allowing you as an owner to carry the property in troubled economic times.
4. If you don't have cash or the ability to come up with a 20 percent down payment, it does not mean you are out of luck. There are a number of local and national organizations who will provide financing to small businesses. An example locally is the Dane County Development Corporation. For a listing of development organizations in Dane County communities, visit: <http://www.commerce.state.wi.us/BD/BD-EC-dane.html>.

While the current credit environment may make finding financing on some projects challenging, we believe lenders and borrowers alike are being prudent in today's economy. This is healthy for everyone.

*-- Larson and Karnick both work for First Business Bank, Larson as a senior vice president and Karnick as an assistant vice president. For more information on various commercial lending strategies, visit [www.firstbusiness.com](http://www.firstbusiness.com).*