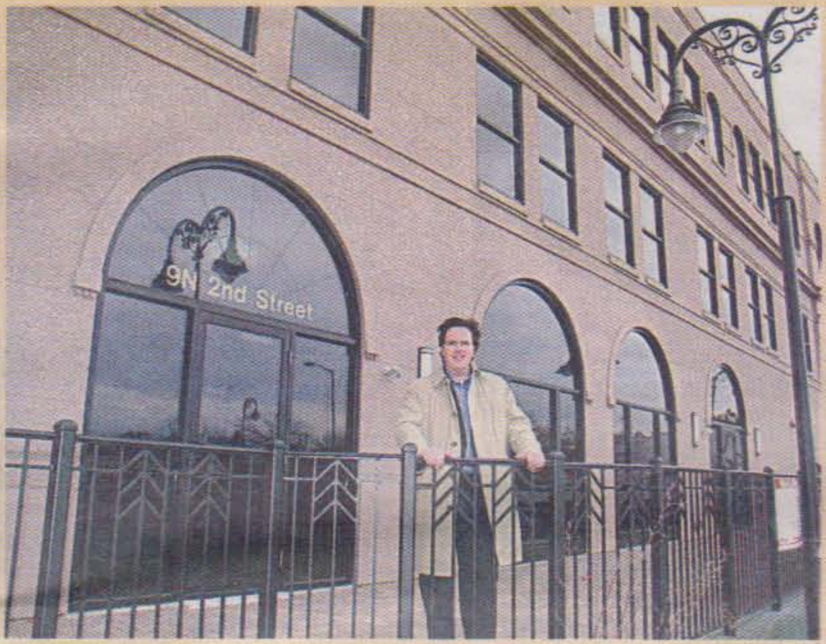

Commercial real estate agent Kevin O'Donnell says locations like this one, at 3 North Second St. in St. Charles, are being sought by liquid investors looking for a bargain. (Photo by Dietrich Wolfframm)

Cash-rich investors dive in as commercial real estate sinks

By John T. Slania
Contributing Writer

The bad news is that the commercial real estate market is expected to hit bottom in 2010.

The good news is that the plunge will offer big bargains to investors and better leasing deals for building tenants.

These are the findings of a new national study, and the views of the landlords, brokers, bankers and investors operating in the local commercial real estate market.

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"This is the toughest market I've seen in my 25 years in the business. But for some, this market offers some real opportunities," said Kevin O'Donnell, president of O'Donnell Commercial Real Estate Inc. in St. Charles.

This outlook is supported by a new report by PricewaterhouseCoopers LLP and the Urban Land Institute. The report predicts that nationally, the commercial real estate market will bottom out by late 2010, as vacancies continue to rise and rents continue to fall.

The situation will leave some owners of shopping centers, office buildings, factories and warehouses unable to pay their loans, leading to fire sales or foreclosures, the report suggests.

Deep-pocketed investors are expected to benefit the most, especially individuals and institutions with cash to buy property from troubled landlords, and banks eager to unload distressed real estate portfolios.

"A sense of nervous euphoria is growing among liquid investors who can make all-cash purchases. Those that are patient, daring and selective could score generational bargains on premium properties," said Stephen Blank, a senior resident fellow at the Urban Land Institute.

Another projected winner will be building tenants who will be able to negotiate better lease deals.

"Those who are looking for new leases, and those who are renegotiating leases will be a good position," said Paul Martis, a broker associate with Coldwell Banker Commercial Real Estate in Oak Brook.

The statistics help tell the story. Vacancy rates are at historic highs, and rents at historic lows, in the retail, office and industrial sectors.

Retail vacancy rates approached 12 percent in the third quarter, the highest level in 15 years, according to a survey by CB Richard Ellis Inc. Leasing rates, meanwhile, are down some 20 percent from their peak in 2007, according to the survey.

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>
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Area office vacancies climbed to 15 percent in the third quarter, up from 12 percent in the same quarter last year, while rents fell 4 percent, according to a report from Chicago-based Transwestern Investment Co.

Industrial space vacancy rose to 11 percent in the third quarter, its highest level in two decades, while rents have fallen 4 percent in the first three quarters, according to a study by Delta Associates.

Fewer tenants and lower rents are a bad combination for landlords, especially those with riskier short-term and interest-only loans. As their revenue streams dry up and their bank loans come due, these landlords have few options.

"People living on the razor's edge and a bank note coming due in 2010 are in a tough spot," said James Valete, president and CEO of First Choice Bank, with locations in Wheaton and Geneva.

"But even someone with a rock-solid loan they've been paying for 5-10 years can get close to the edge if they lose a tenant."

Compounding the problem is increasing pressure from banking regulators to get banks to remove troubled assets from their books, Valete said.

"It makes it more difficult to get refinancing," he said. "Two years ago, you could place five calls and choose from among the best five deals. Today, you might make 25 calls and maybe one person will look at it."

Commercial loan defaults are expected to spike in 2010 and 2011 for two reasons: many short-term loans will come due and banks, having worked through their residential loan problems, will turn more attention to shedding their bad commercial loans, industry insiders say.

"It's like the MASH 4077—like a triage unit. Banks have been dealing with their worse [residential] cases first. They've been carrying the bad commercial loans in the hopes that things will turn around. But they can't do that forever," said Todd Vezza, senior vice president of investments for CenterPoint Properties, an Oak Brook-based industrial property owner and developer.

As a real estate investment firm owned by CalPERS, the nation's largest pension fund, CenterPoint has "hundreds of millions" in cash to invest as the commercial real estate market hits bottom, Vezza said.

"We're well positioned to take advantage of the deals we expect will be out there in the coming years," Vezza said. "In this market, only the strong will survive."

Similarly, Oak Brook based Mid-America Development Partners LLC is in the process of raising $50 million to $100 million in cash in anticipation of finding some great deals in the retail sector.

"We expect the deals to start in 2011," said chairman David Bossy. "In some cases, developers may be selling for 20, 30, 40 cents on the dollar."

Even those without deep pockets could benefit. Tenants interested in leasing retail, office or industrial space will have opportunities to negotiate better leases, said O'Donnell. A landlord worrying about how to pay a bank loan is much more amenable to negotiation, he said.

"For tenants in the marketplace, this is a really good time," O'Donnell said. "We see people doing some very aggressive lease deals. Landlords are willing to do these deals in the hopes of hanging on until things get better."