Lowenstein Sandler's Real Estate Podcast: Terra Firma

Episode 3:
Waiting Out the Market: How Real Estate Buyers, Sellers, and Investors Are Managing Current Conditions

By John Stolz, Stacey Tyler, and Stephen Tanico

SEPTEMBER 2023

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Stacey Tyler: Welcome to Terra Firma, conversations on commercial real estate. I'm Stacey Tyler.

Stephen Tanico: And I'm Stephen Tanico. Stacy and I are real estate attorneys at Lowenstein Sandler. On today's episode, we'll be talking about general real estate market trends. I think Stacy, I would not be underselling to say it is with the greatest honor to introduce the strongest, smartest ....

Stacey Tyler: Handsomest.

Stephen Tanico: By far the handsomest attorney we have ever met. And we're not just saying that because he's our boss, John Stolz, Chair of the Lowenstein Real Estate Group.

Stacey Tyler: Thanks for joining us.

John Stolz: I'm trying to pick up a shovel so I get that stuff out of the way so we can actually talk. What a very flowery introduction. I appreciate it. Nice seeing both of you today. That's the first time I've been called to any of those things, and I'm sure probably the last as well.

Stacey Tyler: So John, dear leader, paint us a picture. What do you see happening in the real estate market generally right now?

John Stolz: Well, I guess I could look backwards because that's always easier than trying to prognosticate as what's become down the road. I mean, anyone has a crystal ball, everyone's visions of what the future may have been this year are largely wrong. But looking back, you can sort of piece together as to why we're here today. I think the big term of the market right now is we're in a credit crunch, right? You have the beginning of the year starting with series of recent bank failures, Silicon Valley Bank, Signature Bank, First Republic. The impacts that had in the marketplace is just sort of like the leading edge of what is to come and what has happened and what is happening today. So the impact on commercial real estate, you have deteriorating fundamentals, you have rising interest rates, you have declining values, you have all those things leading to market uncertainty.

In the world we're in now and the things we're seeing with our clients today is just inertia. You have this prolonged price discovery. Sellers don't want to be the last ones to the party. Buyers think the party isn't over yet. So it's one of those things where you're having deals not happen because sellers are trying to get too much, buyers think the prices should be lower and you just have this massive bid ask spread, which is actually becoming more of a gulf. Certain asset classes are performing better than others. Industrial, for example, has been the market darling pretty much since COVID. And again, macroeconomic factors drove that. You had everyone running indoors, stores getting shut down, e-commerce booms, the need for more warehouse takes off and the need of an asset class that is just sort of exploding. That asset class is held up in this economy largely because the rents that are driving it support the values that you're seeing in those assets.

Less true in other asset classes. We can talk about office later. Retail, not so great, but certain categories of retail doing better than others. Hospitality of course, again hit very hard during COVID and the other asset classes that sort of fall out of there are not doing as well. So you end up having this situation where for the most part, our clients are just sitting on the sidelines sort of waiting for the next shoe to drop because no one wants to be the one catching a falling knife.

Stacey Tyler: Right. Unless they have a refinanced deadline or some other reason that they have to get it done.

John Stolz: Well, it is great that you actually pivot to that because that's sort of the next major thing in the marketplace that's affecting us today is that refinance pressure. Whether you're looking at the office market where the industry knows that between 2023 and 2025, you're going to have trillions of market debt coming to the maturity and largely in the office market, again with lesser degree in retail and hospitality in the other asset classes, you have a scenario where you have declining value in those assets, largely driven by ... Look at our own building in New York City, it's partially vacant.

Stacey Tyler: Right.

John Stolz: Not saying our particular space, but we're in a million square foot building that is not...

Stacey Tyler: Yeah, across from Rockefeller Center.

John Stolz: And it is not full. So by and large, by definition, that building is worth less today than what it was when the debt was put on it years ago. So as that debt comes due, you're trying to refinance it out with less revenue and at a lesser price point, but you still have a loan to take out that is at a higher value.

So what does that mean for the market? You have to find ways to either add equity, you have to find ways to either hold on as best you can if you're in distress. Then you're unfortunately in that scenario where you're trying to either exit as cleanly as you can. Some cases you've seen even the most well-healed, well-established developers in the market handing back keys. I mean, just a few weeks ago, Brookfield handed back the keys to the Brill building in Lower Manhattan. So those are the types of things that you're starting to see sort of trickle out through the market. And it's just sort of all borne out at a really high level, been living through a world of inflation, unprecedented inflation. It's still not checked. It's still not gotten under control. We know the Fed's fiscal policy has largely been to ratchet rates, which again is putting pressure on borrowing. And at the same time, it's sort of making it difficult for our clients to find parity in the market as it relates to valuations of assets.

Stacey Tyler: You mentioned the industrial boom. We were really seeing in that immediate aftermath of COVID, are you seeing that kind of boom and development cooling off as well?

John Stolz: So the supply chain in the deliveries of new assets in the industrial space is slowing down. So supply, I'm not saying has met demand, but the gap is closing. We're also seeing slower leasing activity. Between 2020 and 2022, it was a fight and people were outbidding each other dollars per square foot over even the height the market was years before. So you're in a situation where you could not get space fast enough, you could not pay enough money to get space. That changed in 2022 when Amazon came out and said, "Oops, we overbuilt"

Stacey Tyler: Yeah.

John Stolz: "We took up too much space in the marketplace, so we're going to have to turn back millions of square feet and either ..." They did a combination of things, right? They stopped development that was early stage. They canceled commitments that were able to be canceled and they sublet the rest. So they got rid of, and I can't remember the number at this point, but I think it was on a magnitude of like 30 million square feet that were coming off the marketplace, that were under Amazon's umbrella.

That sort of rippled through the marketplace as those opportunities get absorbed, but also you get to a point where how much further can you drive rents? So again, that asset class is still holding on because the rents have driven so high and it does sustain the value. Although everyone has seen through the first quarter and second quarter of this year, demand is softening a little bit. Those prices are starting to flatten. Of course, there's outliers. You always hear about Inland Empire in California, our own backyard in Jersey in the Meadowlands district, the port area. Those areas are pushing rents in the mid to upper twenties.

Stacey Tyler: Yeah. We've even seen top dollar on parking lots in Newark. Yeah, just to park your tractor trailer trucks.

John Stolz: To park your Amazon sprinter banks. And at one point, I don't think the market is exists now, but about a year and a half, two years ago, you're somewhere near 25 to $30,000 an acre just for parking. So that started, of course, then impacting what people were building. If people were getting into speculative plays in the market to build new assets, they were looking at parking as not just, "Okay, you need to park a truck, but that's a real asset. If I have more of it, I can attract higher rent for my asset from my property."

Stephen Tanico: Now, you mentioned the credit crunch at the beginning of this episode, but do you think a part of this kind of whiplash in the cyclical market is having an impact on what we're seeing today? Or is it less so just it happens to be a condensed cycle comparatively to past cycles?

John Stolz: I think this market has been one ...

Stacey Tyler: You don't know everything?

John Stolz: I'm going to admit to those that are listening today, which are probably two people, but I will admit that I do not know most anything that's

Stephen Tanico: I feel better you know more than us since we're the ones asking the questions and my answer would be, "Stephen knows that."

John Stolz: It's been a market of extremes ever since the pandemic, which was just throwing the world at the chaos that we'd never experienced before, and then the overreactions that created shutting down industry by everyone running indoors, then okay, now we're all buying things online. Now I can't get warehouses fast enough now. I want things not yesterday or two days with Amazon Prime, and I needed one or two hours from a local hub. So that requires backfilling more into that marketplace. Multifamily, that is another asset class that has historically performed extraordinarily well, especially since the great financial crisis of '08 and '09. And it continued to hold on throughout all that time. It's starting to now soften a little bit. Same kind of pressures that you're seeing with other asset classes with loan maturities coming due, flattening rents, slower renewals. But ultimately the high rate of mortgages and home mortgages is what I'm talking about, is keeping people out of particularly first time home buyers, keeping them out of the market, forcing them back into the multifamily space. So the fundamentals for that market still are strong. Varies by metro, but it's still a strong asset class.

Stacey Tyler: And speaking of multifamily, I know during the immediate aftermath of COVID, we were seeing such huge supply chain delays that you really had a .... It became a huge challenge for construction and new assets. Are you seeing that easing at all? Is construction happening a little more easily now?

John Stolz: It definitely is. I mean, going back in COVID days, two, three years ago, there were certain commodities that were known in the marketplace you couldn't get, you needed a rooftop air conditioning unit, you needed a roofing insulation, God forbid, you need an electrical panel. Those were things that we weren't talking about a couple of weeks of a lead time, you're talking, the best I can guess is 16 to 32 weeks, maybe a year is what you were hearing. And those assets were literally just stuck in ports in China and other parts of the world and not making their way here. So it was something that we as lawyers were trying to be thoughtful about when you started drafting these leases or drafting contracts, having flexibility on timing. The word force majeure is something no one gave a about.

Stacey Tyler: Those provisions are three times as long as the used to be.

John Stolz: It was like active God wars. No one really cared what that meant. Now, it's one of those things that it's heavily negotiated along with just about everything else, but those pressures have considerably softened. China's zero COVID policy slowed that down and continues to slow it down, but you're not seeing delays that are 6, 8, 10 months out anymore. Things are much more predictable and you can get projects built and constructed in a more reasonable timeframe.

Stephen Tanico: All right, John, I think we've had enough lawyer talk for one day. We want to hear about your thoughts on the market from an investor perspective. I know we've had conversations in private that I'm now going to reveal to the hopefully three people listening. We picked up on ...

John Stolz: That's funny.

Stacey Tyler: Hi dad.

Stephen Tanico: What are you looking at when you're looking at deals from an investing standpoint, personally? You're deploying your own capital versus kind of papering deals for someone else.

John Stolz: I mean, for any income producing asset, it always starts with the rent roll, right? It starts with what rents are you getting? What quality are the tenants and how long are the leases? So how strong is the income coming out of that and how much is it going to cost you to finance that acquisition? And that's the credit crunch problem we're having right now where rates have been pushed up through the Fed's fiscal policy with tightening. You're seeing interest rates that are in the sixes or higher. Multifamily, use an example, the cap rates were historically depending on where your assets were located, upper threes to the mid-fives. Now you're starting to see cap rates sort of ticking up again into higher numbers. So you're looking at a whole bunch of things. You're looking at that rent roll, you're looking at the cost of buying it, and you're looking at trying to read the tea leaves as to what's the future going to hold in terms of the near term fiscal policy, my ability to hold on to tenants and perhaps drive rents even further.

I did an interview last year and one of the comments I made during that interview was, how much further, particularly in an inflationary environment, can you push rents? And I always felt multifamily had been one of those where the drivers behind those valuations were just pushing rents, pushing rents, pushing rents higher and higher and higher. And ultimately people do need a place to live, right? The question is something has to give at some point. It hasn't quite given yet. But again, we're starting to see some edges of flattening demand and softening in the rent increases. But as long as people are willing to still spend top dollar on homes, notwithstanding the fact that they're maybe getting a 6 or 7% mortgage, that tension is still there and their people will still find their way into apartments.

Stephen Tanico: There's a funny perspective aspect. When rates were 3%, 6% seems ungodly. Yet rates going from 7 to 6%, you're seeing people flood back into the market because what a deal you're getting now that if they've come down even just a little bit.

John Stolz: You're seeing some of that. I mean, I think this is probably more in the residential side than I've seen in the commercial side, but it was surprising to me, particularly earlier this year, when the Fed was doing more of the half point increases and mortgage rates were really getting into the sixes and sevens. And in certain desirable communities, you're still seeing people getting into pricing wars over homes, overpaying well above ask.

Stacey Tyler: In cash.

John Stolz: in cash, waiving inspections, waiving contingencies. I'll waive the appraisal, I'll just close my eyes and hope for the best. Then you read articles later about people saying, "Oh God, I wish I didn't do that. What a terrible mistake. I moved in, there was a colony of bats in the attic and no one was looking."

Stacey Tyler: Of bats.

John Stolz: So there was some insanity in the market. It's starting to, again, slow down a little bit, but residential market has a certain emotional aspect to it that you don't see in commercial, at least not with our clients. They take more of a logical edge to these things. And you're looking at assets that can pencil out at the end of the day.

Stacey Tyler: So are you seeing more creative deals happening given all of these different pressures, joint ventures and the like?

John Stolz: It's a great question. I've always viewed joint venture and corollary sale leaseback activity as being countercyclical. We saw a lot of this activity in '08, '09, and '10. The markets dried up for a different reason, but you still couldn't get credit, you couldn't get it affordably. But you are starting to see more joint venture activity and sale leaseback activity trickling through the market. We've done probably a half a dozen JVs in the last few months alone here, and that's a practice that we hadn't touched probably in several years before that. So what JV activity ends up helping people do is find more economical capital, right? It's cheaper money. When you have parties going into a deal hand in hand, one's doing sweat equity, one's putting in cash. So they're both putting in some varying level of cash, but you're taking the bank out of the equation, or at least you're reducing your reliance on the bank and hopefully reducing your reliance on private equity, which is the most expensive money out there next to hard money and lenders.

So we've started seeing a lot more of that activity and helps people get deals done that I'm not saying they couldn't get done, but they didn't really pencil out when you started factoring in the cost of money and the likely refinance out of that money, particularly if you're building an asset. You're looking at usually in the near term, two or three years, you're going to build and then finance out of that to something that's more permanent. These joint ventures enable parties to find creative ways to get deals done without having to get boxed in with bank debt.

Stacey Tyler: So one of our themes in our podcast is that we as transactional real estate attorneys are kind of deal makers. We can help people strategize about their assets and what to do in the long term. So what are you telling your clients now if they're on the more nervous side, doing the wait and see and just kind of sitting on the sideline? What are you advising them? Are you saying "You just keep waiting if you can,"? Or how are you helping them figure out whether it's the right time to act or not?

John Stolz: Regardless of what market you're in, I've always had the view that well located properties will always trade well. So that's irrespective of the market itself. So fortunately, our clients aren't so reliant on debt, so they're actually on the sidelines more because of they're waiting for opportunity. And again, that goes back to the point at the beginning of the cast where we were talking about this bid ask spread. Our clients are mostly buyers and they're looking at assets where they view this in this environment, in an inflationary environment, a rising rate environment where these prices should have come down. The sellers, again, not wanting to be the one left holding the bag, like, "No, this price isn't coming down." So they're just sort of waiting out the market and they don't want to be the ones that are plunging in at a point where I guess there is uncertainty.

So I think what our clients are doing is really trying to get more visibility as to when this bubble will break and when people start getting back heavily into the market. I personally thought it would happen in third quarter or this year. I, like most people, have been wrong. I remain optimistic for the end of the year because at the most point, our clients don't make money unless they buy things, unless they invest their capital. They can collect all the dry powder they want and that's what they're doing. But at some point, they're going to have to reach a decision where they're comfortable enough as to the long-term forecast to deploy that money and start buying again.

Stacey Tyler: So no crystal ball still?

John Stolz: No, I haven't found it. I must have rolled off the table.

Stacey Tyler: Well, we really appreciate your time today. That about wraps it up for us. Thank you, John, for joining us and helping us get a little bit smarter about just market trends generally right now.

Stephen Tanico: And thank you listeners for tuning in today. Be sure to like, subscribe and follow Terra Firma wherever you're listening to this episode. Stacy, and I would love to hear from you. So feel free to reach out to us at TerraFirma@lowenstein.com. Until next time.

Stacey Tyler: Ciao.

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