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Denver office recovery: The question remains when

An article on the Denver office market out of necessity requires a review of the economy, and any discussion of the economy requires a review of the political climate. So, off we go.

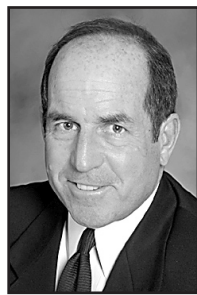
In early 2008, I suggested the winds of change had reached hurricane force and prudent students of economics and real estate should batten down the hatches. In early 2009 Barack Obama rode into the White House promising exactly such earth-shattering changes.

In just a short time, three words rarely – if ever – evoked by governments became household phrases. Bailouts, subsidies and trillions became the euphuisms for an administration that promised no one would fail. The auto industry, Wall Street, banks, credit card holders, homeowners and the jobless were told not to worry. The government was there to take care of everyone. No problem was so great that the president, the speaker of the House and the Democratic Party wouldn't be able to grant unimaginable sums to solve every problem.

The only difficulty was who was going to pay for all this. The answer always boiled down to the taxpayer. The difficulty was that falling tax revenues only allowed the government to come up with the money if it decided either to borrow or print more dollars. In any event, either choice only can lead to massive inflation.

Not content with these giant intrusions into the home of every taxpayer, more is to follow. Coming soon to your neighborhood manufacturer is cap-and-trade legislation that will drive more jobs out of the country and further harm the economy. Also heading down the pike is a health insurance plan to expand the Medicare/Medicaid plan already in existence, which by every measuring stick along with Social Security cannot meet its obligations just a few years from now.

Despite historical proof a country cannot spend its way out of a recession, the U.S. government is determined to watch history repeat itself. Last month, Vice President Joe Biden announced the Obama Administration had underestimated the problem and is expected to request another stimulus package to add billions more to a



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bill the taxpayers cannot possibly pay for without even greater massive tax increases.

Most economists anticipate continued job losses both nationally and locally for the next two years. Regardless of the causes of the recession, taxpayer-funded bailouts of specific industries simply become a statement that those who work hard, work smart and work to success will be expected to pay for the lives of those who failed to do the same. Thomas Jefferson once said, "A government big enough to give you everything you want is strong enough to take everything you have."

Now, with that big picture established, let's move to the local picture of Denver office market trends. Vacancies at the end of the second quarter were up approximately 1.5 percent from the end of 2008. Almost every submarket suffered from negative absorption and building owners carefully watched the market conditions and competed strenuously in an effort to retain their current tenant roster and to attract new tenants from other buildings.

Office building occupancies increase as jobs are created. A few announcements headlined the recent business news, such as Ascent Solar in Thornton anticipating adding 200 new jobs in the next two years, and DaVita announced a corporate relocation to Denver. As would be expected, the government sector is the healthiest of all industries and represented two of the top 20 deals signed thus far in 2009. There also have been some bright signs in the legal, technology, and oil and gas sectors. Venture capital invested in Colorado companies is largely dedicated to the medical equipment industry, including a \$15 million investment in CeraPedics Inc.

National reports that compare Colorado with all the other states consistently name Colorado as one of the brightest stars in the economic sky. Denver was named America's No. 1 city on the verge of recovery from the residential real estate slump on NBC's "Today" show. The ranking was based on eight factors, including job growth potential, a well-educated population and lack of overbuilding.

Commercial real estate is a business sector that requires the availability of lender funds to survive. These funds are necessary for the development, acquisition and tenancing of buildings. When funds are no longer available in the normal course of business operations, the industry slowly grinds to a halt. Existing owners of office buildings find the requests for the renewal or refinancing of their current mortgages being rejected. Funds for the remodeling of vacant space are not available. And a reduction in value begins. Attempts to sell these buildings become difficult as the values drop below the balance of the existing mortgage or the existing owners refuse to accept a price so far below the buildings' previous investment values.

As the market grinds to a halt, investors anticipate opportunity. Those who have kept their "powder dry" are setting aside large amounts of cash to buy these properties at prices that are reminiscent of the pricing that occurred in the 1990s. At that time, the Resolution Trust Corp. was created to dispose of real estate portfolios held by savings and loans that had gone bankrupt. Active investors of that era found opportunities in real estate properties that generated tremendous profits over the next 10 years. Many of those same investors are standing on the sidelines hoping for similar opportunities to appear in this market. There are marked differences in the conditions today and those of the 1990s. However, there also are many similarities.

In 2009, a large gap seems to exist between the asking price for income properties and the amount a buyer

is prepared to pay. This bid-ask gap has resulted in an almost complete shutdown of the markets nationwide. Mortgage lenders now have been reduced to banks and life insurance companies. While both groups are conservative by nature, they are even more so at this time. Banks get mixed messages from the federal government. They are told to stimulate business and investment by putting more funds to work, but at the same time they are held to even stricter standards of how much they must hold in cash reserves. In times like these, the phrase "cash is king" is heard over and over again.

If the upward spiral of inflation occurs, it can solve many problems. Fixed mortgage debt becomes cheap when the value of a property is measured in future inflationary dollars. Inflation is the rising sea that serves to raise the value of otherwise depressed office buildings.

Finally, a look at the crystal ball. Office market occupancies are expected to fall some more. Lease rates and concessions will continue to adjust with the conditions. Well-capitalized building owners will anticipate these conditions and weather the storm. Building owners not prepared to meet the demands of the coming years either must recapitalize or sell the properties at a price attractive in the current market. If neither choice is an option, a property is likely to go through foreclosure and future resale to the deep-pocketed investors waiting on the sidelines.

Some 40 years of Denver commercial real estate experience has offered me the opportunity to study seven economic downturns and recoveries. While all of these cycles are different in some measure, one thing is certain: This office market will recover. The hard question to answer is "when." I am not sure, but I anticipate the winds of change will continue to blow and to bring this office market recovery along with other changes.▲