Ron Kleinberg

Get "Real" Estate: Time To Buy on LI?

Remember when Charlie Brown asked Lucy what she wanted for Christmas and Lucy replied, "real estate?" I always imagined Lucy would break open her piggy bank and focus her real estate lust on the target-rich assets of Long Island's Gold Coast, Hamptons and Five Towns.

Charles Schultz, the creator of *Peanuts*, is no longer with us, but if he was, Lucy might elect to ride out the last legs of this seller's market on the sidelines. It's a defensive strategy momentum buyers might be wise to emulate, as the word on the street littered with "For Rent" signs is that it's now a buyer's market.

Impatient buyers may be getting ahead of themselves. We're still six months away from a downdraft in valuations.

A windshield wiper analysis will confirm what real estate experts agree is happening island-wide–fluorescent flags of surrender are popping up in the most unlikely places. That is, in modern shopping centers and class A rental apartment buildings that historically enjoyed a waiting list of prospective tenants.

Last year, hesitant buyers were asking us, "Is this market softening?" Today those same buyers are affirming it.

Over the din of tighter underwriting criteria in the debt market, are reports of the demise of this seller's market exaggerated? The party is over. Elvis has left the building and so have the syndicators, flippers and interval buyers with their irrational capital.

Nevertheless, impatient buyers might be getting ahead of themselves. I think we are still six months away from a downdraft in pricing valuations as real estate fundamentals continue to weaken and erode confidence on the buy side.

Well-heeled investors are no longer wearing out their shoe leather chasing this year's assets at last year's high multiples. Instead, they are circling the wagons, preserving capital and protecting assets as they wait out underperforming owners with overleveraged debt (to date, auctions, fire sales and bank REO properties are virtually non-existent).

Owners in the office sector prepare to batten down the hatches as business tenants are balking at taking more space. Leasing agents detect a slight uptick in subletting, which is typically a harbinger of rising vacancies (the vacancy factor for Nassau and Suffolk counties has hovered around 10% for the past two quarters).

In the last quarter of 2007, 2,500 people lost their jobs in the financial sector, primarily from the bankruptcies of American Home Mortgage and Delta Financial. Expect office owners–who recently purchased their buildings by mixing a cocktail of a short-term, interest-only loan with short-term lease rollover–to sober up, reducing their pricing expectations as rent growth flattens.

Time-constrained 1031 buyers continue to pay up in a supply-constrained environment for blue-chip assets in niche markets. With the media amplification of a recession, sellers of triple-net properties paint a far rosier picture of cap rates remaining steadfast, and single-tenant properties become the asset of choice for the passive investor. Backed by leases guaranteed from investment grade corporations, the risk-averse investor gives up possible higher trading profits for a predictable revenue stream (typically 6% to 6.5%).

"Sales velocity slows as retail buyers of strip centers see an inverse relation of more inventory coming to market with fewer transactions closing, usually a hint of market psychology shifting and cap rates rising," says Dale Staudigel, partner of Tri-State Properties.

Inexperienced investors that purchased older strips last year on overly optimistic pro formas that utilized projections are going to get hurt. Investors will have to recalibrate their calculators and realize they are not going to receive the rents they require to support their purchases. Nor will they have the ability to sell their problems to the next guy in line.

I rememberSam Zell, the billionaire real estate mogul, telling a joke about the previous real estate bubble that illustrates this point. The joke was about the sale of a can of sardines. As the can is sold from buyer to buyer, the price escalates wildly: $1, $2, $5, $10 and finally $25. The final buyer opens the can and takes a bite. He spits out one of the sardines and screams, "This is terrible!" and is told by the seller, "Hey, what are you doing–those sardines aren't for eating, those are for trading!" —RENY

The views expressed here are those of the author and not Real Estate Media or its publications.

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Real Estate

Ron Kleinberg

All Quiet on the Eastern Front

Four months ago I went out on a limb (maybe it was a twig) when I predicted Long Island was teetering on the last legs of a sellers' market. Specializing in the brokerage of investment properties with my partner Dale Staudigel, it wasn't hard to read the writing on the wall that said, "For Rent" on vacant storefronts and office suites island wide. The print in Newsday was black and white. Citing the economic meltdown, Circuit City, Fortunoff, Linens & Things, and Eckerds all filed for bankruptcy. National Wholesale Liquidators itself was in danger of being liquidated. Supposedly solid retailers were swimming in a sea of debt. Tenants were sitting ducks; calm on the surface but underneath paddling to stay afloat.

The misery on Main Street was compounded by a stricture of liquidity in the credit markets. Happy go lucky financial institutions that once injected the veins of investors with leverage were seizing up. The umbilical cord between borrower and lender was fraying.

On Wall Street the Dow wasn't fraying but unraveling. The bears had the bulls by the horns. Cash positions were quickly turning into fetal positions. Losses on the big board were easy to quantify if one had the testicular fortitude to open monthly financial statements. The economic news piling up in the fourth quarter of '08 was so grim, one felt less like a viewer and more like an eyewitness.

Today in the investment arena, the buzz is off the phones. Sales velocity has slowed. The ship has sailed. Reluctant sellers can only wave goodbye to the unrealistic and unsustainable prices that got away. Mispriced assets have lost traction and bidding wars merely skirmishes.

Well allocated owners that make up the core of our buying database are being distracted from the negotiating table, preoccupied with shoring up their assets (filling vacancies, pruning expenses, tenant retention etc.). Starry-eyed first time buyers have pumped the brakes as well. Suffering from depressed stocks and crumbling home equity (negative wealth effect), the neophyte buyer's confidence, like James Bond's drink, has been shaken not stirred.

While some sellers are still in denial hoping for a lucky strike from a 1031 exchange, non-contingent cash buyers are beginning to approach endangered species status. There is a lot less country club equity (and if dues keep rising, a few less country clubs) looking to bid unless sellers reduce expectations and asking prices. While non-motivated sellers have typically tested the waters by pricing today's assets at tomorrow's prices, the majority of experienced operators have taken their priced to negotiate properties off the market. Motivated sellers still exist through estates sales, partnerships dissolving, and divorce, surprisingly these owners that are compelled to sell are having difficulty making it to the alter. Sellers often holstering recent appraisals are facing off with buyers armed with bank commitments that require lower LTV's and higher debt coverage ratios, resulting in diminished cash on cash yields for purchasers.

Cap rate compression turns into cap rate depression for sellers unable to offer either an assumable mortgage in place or unwilling to hold a private money mortgage. Buyers celebrate the New Year reviewing "for sale listings" that have become "on sale" listings with capitalization rates flirting between 7.75% - 8.25% (B & C assets). Regardless of cap rates heading north, forward thinking buyers are not rising to the bait. Buyers want to be compensated for having the decreased upside potential associated with a softening market. Pessimism is being priced into pro-formas. The going in rate of return is downplayed by value added buyers who recognize above market income streams can turn to a trickle as short term leases burn off.

Real estate professionals agree the best time to sell a property is when you don't have to, but the tide might be too strong for some landlords to sit out this down cycle. If commercial properties remain under leased and expenses continue to rise, Long Island might see the first ripple of distressed owners who will be forced to go deep into their pockets when its time to refinance. Opportunistic buyers with capital capacity must practice patience, as the window to take advantage of market dynamics might be just around the corner.

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Why is there a canary on this page?

NET LEASE TRENDS

Triple-Net Leases Provide Safety

Mention you're a physician to anyone within earshot and you will be barraged with a slew of health-related questions. Mention you're a commercial real estate broker and only one question comes to mind: How is the market?

That is a question whose roots date back to the first time the Garden of Eden was sold. The question is similar to asking a chess grandmaster: "What's the best move on a chessboard?" It's a shifting transactional marketplace. Over the years, each asset class—retail, office and multifamily outperform each other, only to fall out of favor, then back in vogue on investor's radar screens.

In the early 1990s when builders were constructing strip centers on every corner, one out of eight retail stores became vacant in Suffolk County. Then came the proliferation of the big box category killers, such as BJ's, Costco and Target, which competed in central business district areas with the local neighborhood stores by offering one-stop convenience. Today, the regional mall is evolving into the new

"Triple-net leases allow the investor to COMPUTE WITH CONFIDENCE a more PREDICTABLE RATE OF RETURN."

CBD---offering entertainment, banking, restaurants, etc., all under one roof. Intense competition still exists in the suburbs between outlets, strips and chain stores, but the greatest challenge facing retailers is not the billion-dollar super stores, but the growth of the Internet shopper. In 1999, there were 83 million Internet users in the US and that number is expected to rise to 165 million by 2003.

Even office buildings have lost some of their cachet due to sector consolidation, corporate downsizing, continuing tax hikes, skyrocketing insurance costs and rising electricity costs. One example is Cablevision, which is marketing 300,000 sf of class A office space for sublease in Jericho, NY. With operating expenses now topping $12 a foot in some parts of Nassau County significantly reducing the bottom line, an increasing number of high net-worth individuals, pension fund advisors and REITs have been searching for greater portfolio diversification.

Conditions that following September 11 and the subsequent stock market meltdown have created a new conservative breed of risk-averse investors looking to alter their multi-tenant operations, resulting in heightened interest from investors on a 'flight to quality' to the safety of an absolute triple-net leased property, guaranteed by investment-grade corporations. A definition of a 'rated' tenant might be one whose credit has been verified as excellent, in other words, rated AAA by credit-rating agencies such as Standard & Poor's. Typically, in a triple-net lease transaction, the tenant or lessee is responsible for the direct care of a property and also must pay all of the expenses related to building operations. It's also the most secure lease structure for a passive or absentee landlord, as the tenant takes over all management responsibilities. Pricing on net-leased projects is based primarily on the lessee's credit, lease term and the desirability of location, or in other words, a property's demographics.

Ronald Kleinberg

For example, take the sales of two net-leased drug stores on Long Island—one located on the North Shore and the second located in Hicksville, with an aggregate price of $6.7 million. Both properties traded at above market yields, due to the abbreviated lease terms (under 10 years on the primary). Today's prototypical new drug stores are free-standing with drive-through windows, 20-year lease terms, offering convenience to families, seniors and other residents.

Another instance of a safe investment that earned excellent yields and proved successful for both the buyer and the seller involved a national daycare center. The firm desired to consummate sale/leaseback transactions for a number of their properties on Long Island. The asking price had been established utilizing a cap rate of 8%, with 8% increases every five years during the primary term of 15 years.

While demand continues to exceed supply in all asset classes, in a volatile market, triple-net leases are becoming more popular with lease durations of 20 years or more, bridging economic cycles and allowing the conservative investor to compute with confidence a more predictable rate of return. ◆

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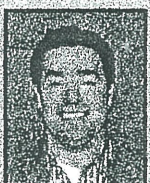
brokerage

Long Island real estate - The waiting game is taking its toll on investors and brokers

Ron Kleinberg



Tri-State Properties LLC

Dale Staudigel

Tri-State Properties LLC

Chiropractors must be crying – homeowners are no longer straining their necks staring at the super bubble in the grayer economic sky. Triggered by the kryptonite of 1 trillion dollars of adjustable rate loans that reset in 2007 combined with shoddy underwriting, the housing bubble of unrealistic and unsustainable prices finally burst.

Specializing in the brokerage of income producing properties with my partner, Dale Staudigel, we are often asked by dorsal finned buyers with a keen sense of smell – "where are the foreclosures and fire sales?" "Surprisingly, the helium in the commercial bubble has actually gained altitude in upper tiered assets," said Ron Kleinberg. "Buyers appear to be in denial. They just don't believe that regardless of the turmoil in the residential market, (foreclosure filings were up 20% in N.Y), owners of commercial blue chip assets continue to trade at historic high multiples (15-16 times the net operating income for irreplaceable properties).

While buyers circle far and few between fiscally and physically distressed properties, would-be sellers of class B and C non-core assets are suffering intellectual gridlock, unsure if they would still be riding the tail wind of unprecedented higher multiples or selling into the headwind of re-trading and re-pricing uncertainty.

This waiting game is not only taking its toll on investors but on brokers. Fueled in part by stubborn owners that have encoded in their DNA never to sell. Brokers are stepping up their efforts to convince reluctant sellers that while there might be a slight uptick in buyer yield expectations, cap rates flirt with 7% for office and unanchored retail in tertiary locations.

The reality is this overstated rate of return exists only on paper. Incestuous owners and brokers persist in exercising selective amnesia neglecting to include fundamental expenses (i.e., management, vacancy, reserves, etc.) on pro formas in an attempt to inflate the bottom line by distorting fiscal reality.

Transactional velocity slows on off-market transactions and for-sale inventory as constraints on capital (debt more than equity) reduces the volume and speed of sales.

Committed for-sale owners display less conviction in their voices and swagger in their steps as they head for the exit doors trying to unload this year's assets at last year's prices. Owner/users and endorphin high 1031 buyers with cross-over capital are the usual suspects that continue to elevate pricing valuations. Luxury rental apartment buildings, due to their durability, as well as single tenant triple net properties are two asset classes that the risk adverse investors continue to pay up for, based on their predictable rate of return. While demand continues to exceed a critical under-supply of product in all asset classes, in a volatile market, triple net leases with lease durations of 20 years or more have the ability to bridge economic cycles. Nationwide Walgreens are the most popular asset in this property sector with the medium price rising 10% over the past year to $393 per s/f.

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"Right now the commercial market reminds me of a game of chess between a buyer and a seller that could end in stalemate," said Kleinberg. Visualize two players staring at a board and after a lengthy period of time looking up simultaneously and exclaiming – "it's your move." The purchaser has the material advantage of liquidity (buying power), while the seller has the positional advantage. The clock is ticking but only time will tell if it was better to be a speculator or a spectator in the real estate end game of 2007.

Ron Kleinberg and Dale Staudigel are the co-presidents of Tri-State Properties LLC, Dix Hills, N.Y.