

Unlike the up to the minute valuation that the stock market produces for publically traded companies, determining the value of commercial buildings is a more difficult task. In this issue of Chrisland's *Market Perspective*, we share our thoughts on building valuation and what lies ahead in 2010 and beyond.

Rising Vacancy

Commercial real estate vacancy rates and, more specifically, the lease income derived from building occupancy is directly correlated to building valuation. Vacancy rates tend to trail overall economic conditions by six to twelve months (or more) depending primarily upon job growth (or loss) and the time it takes businesses to adjust their real estate strategy accordingly. Rising unemployment rates in 2008 and 2009 have led to an increase in vacancy rates across all commercial property sectors (retail, office, and industrial) in Northern Colorado.

Decreasing Lease Rates

In the first few days of 2010 and despite some positive economic indications that the worst may be behind the broader economy, several Northern Colorado office building owners have responded to rising vacancies by offering significantly reduced lease rates of approximately 30% or more off of the same building's previous peak lease rates. It is likely that many others will follow suit in order to compete for tenants.

Increasing Cap Rates

In addition to the amount of lease income, prevailing market capitalization rates (the unleveraged rate of return that a buyer expects to achieve on a real estate investment) are very important in determining value. Capitalization rates or "cap rates" have an inverse relationship to building valuation. Cap rates have steadily risen since lows in 2007 due to the diminished availability of capital and a greater perceived risk in investing during an uncertain economic environment. According to the December 2009 issue of *Retail Traffic*, "cap rates on retail properties have already moved by 200 basis points to 300 basis points from levels seen in 2007. They should continue to rise in 2010."

Building Valuation

The combination of rising vacancy rates and increasing cap rates have resulted in an estimated reduction in building valuation of as much as 20% to 40%+ (the difference being asset type, location, quality of asset, and strength of tenancy). Properties with a greater than 40% reduction in value are typically largely vacant and face the prospect of lengthy absorption times while facing negative cash flow that can arise from servicing debt, paying property taxes, maintaining the asset, and other common building related expenses.

Outlook

As the economy slowly improves (likely over the course of the next two to three years) and employment begins to increase, demand will gradually increase for commercial real estate. While occupancy will improve and rents will grow as vacancy approaches equilibrium, the effects of dramatically reduced rents will not soon go away as many tenants will sign multi-year leases at today's ultra low lease rates. Furthermore, even as more capital returns to the market to gobble up attractively priced real estate, the threat of rising interest rates will help moderate any notion of cap rates significantly declining. In short, recessions are often called "corrections" for good reason and it will take many years for building valuations to get as "over heated" as they were during the irrational frenzy of 2006 and 2007.

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The two primary groups that stand to benefit greatly from this market correction should come as little surprise: Tenants and Buyers.

Tenants

Tenants who are actively looking for space are now seeing lease rates that are similar to those from over a decade ago (depending upon the type of asset and location). For this reason, if a tenant's lease is coming up within the next 12 months, it is highly recommended that they visit with an expert tenant representative (broker) to determine how you can capitalize on present market conditions. Chrisland Commercial can help in this regard as we offer free initial consultations to tenants. There is also no cost to tenants who engage and work with a tenant representative. While this may sound too good to be true, the reason is straightforward.

Virtually all available spaces are listed with a commercial broker. In cases where a tenant representative is involved, the listing broker's commission is simply split with the tenant representative. Thus, the tenant representative's services come at no additional cost to the tenant.

The services performed by a tenant representative include analyzing a tenant's present situation, researching available alternatives as well as comparable previously completed transactions, narrowing the choices to those that meet the tenant's needs and, in the case of an agency relationship, working diligently to negotiate favorable rates and terms for the tenant. The same services also apply for buyers.

Buyers

Due to the correction in the value of buildings, now is the best time in over a decade to invest in commercial real estate.

It is commonly said that successful real estate investing can be summed up by the phrase "location, location, location." While it is true that a great location is vitally important, it is only when such a location is combined with excellent timing and expert management that results are maximized.

Consulting with an expert such as Chrisland Commercial can help buyers determine the best way to participate in these opportunities.