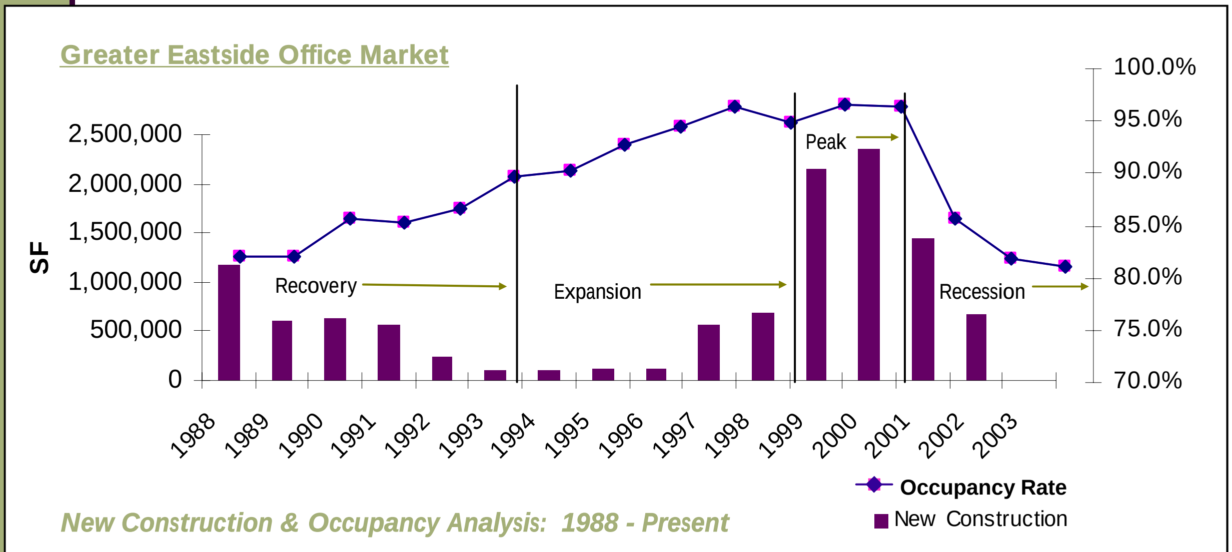
The Ups and Downs of Commercial Real Estate

...and What Your Business Can Do About Them!

By: Eric Postle - Puget Sound Properties



What Goes Up Must Come Down!

Fortunes have been both made and lost at the effect of commercial real estate cycles. Fortunately, commercial real estate cycles are quite predictable. If, for example, you would have bought commercial real estate in the beginning of the decade and sold it at the end of the decade, you would have likely made a profit in every real estate cycle over the past 40 years!

Commercial real estate cycles are governed by three factors:

1. **Job Growth** – Fuels demand for office space.
2. **Construction** – Responds to demand with supply.
3. **Emotion** – Dictates the actions of tenants, developers, and bankers based on perceptions of risk and rewards in the marketplace.

Recovery (Stay alive through 2005): Our market is just now starting to recover from a severe market recession. Job growth is trickling in while construction activity is flat. Early growth tenants in this recovery are the real winners as they can find the highest quality space in the market at bargain rents. As occupancy levels gradually rise, and good quality properties lease, tenant choices will eventually diminish. This shift in the supply/demand balance will signal the market's entry into its next phase – expansion.

Expansion (It's all about job growth): As the job market recovers, office rents and building values will raise. The prevailing emotion in the real estate world will shift from caution to optimism. Technically an expansion occurs when the market's occupancy level climbs past its average rate (equilibrium point) throughout the entire cycle. This is the critical point where demand overtakes supply. This, in turn, provokes new speculative development and expansion of the market's property supply. As tenants lease up space at new property pricing levels, new rental benchmarks are set for existing property to "mark up" to. This leads to an acceleration of lease rates as the market approaches its peak.

Peak (Living large and on borrowed time): The market peaks when job growth is at its highest, construction activity is soaring, rents and values are skyrocketing, demand is at its highest, and new construction is at its highest. But since construction takes 18 to 24 months+, there is an imbalance of demand over supply. This results in rents peaking at values that cannot be supported over time. Very few choices for tenants result in "bidding wars" for the available space. Then, like all things in excess, the bottom drops out and the recession sets in.

Recession (The bottom drops out): The area's last recession is still fresh in most minds. Will it happen again? Hopefully not in severity, but another commercial real estate recession is almost assured if our experience over the last 40 years means anything. When jobs are inevitably cut and office leasing slows, a real estate recession will follow. To compound the problem, the expensive new buildings that begin construction late during the market's peak will arrive as the market is plummeting in its recession. Demand during the recession is at its lowest with lots of empty new space and no takers. Rents eventually bottom out and the few tenants that are in the market have numerous choices.

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What You Can Do About It

Eric Postle

Your company's real estate is a competitive element of its corporate assets. Knowing how to position your lease or company-owned property against the changing local real estate market will both save unwanted costs and add flexibility. With the support of intensive research, aggressive negotiating and superior knowledge of our clients' needs, our focus on cost containment, efficiencies, and appropriate economic structures help our clients to maximize the competitive aspects of their real estate.

If you need more space, less space, or simply want to know that your taking full advantage of the current market conditions, please contact **Eric Postle** at **(425) 586-5646** or **John Werdel** at **(425) 586-5633.**

John Werdel