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Real Estate Returns to Local Roots

By William Procida,
Chairman and CEO
Palisades Financial, LLC
Englewood Cliffs

In the 1970s and 1980s, the commercial real-estate market had a strong local flavor. The market was comprised primarily of entrepreneurial developers who provided the high-risk seed money and equity for regional projects, as well as local banks that understood their geographic markets. Further, local owners and property managers handled much of the real estate developed before 1990.

But the demise of so many local and regional banks, as well as local real-estate operators in the early '90s gave way to a new, institutionalized real-estate marketplace. His new market was not developed by true real-estate people, but rather by Wall Street players who formed opportunity funds, which ultimately replaced the private entrepreneur and conduits that replaced local and regional financial institutions. Since the cost of entry into the real-estate market at that time was low, these new institutional players achieved significant returns in those subsequent years.

However, the real-estate industry is facing another new reality in 2002. Over the long term, can real estate continue to be operated by corporate entities such as REITs, that posses more finance experience than real-estate acumen? The likelihood is that while some national REITs and conduits will survive, the market will return to its origins to the hands of local and regional owners and lenders.

Today, lenders are seeking local expertise before underwriting a project since they no longer want to rely on third parties for recommendations about projects outside of their area. Even similar properties vary from region to region as influenced by local market conditions. As a result, local insight will once again play a critical role in the underwriting process as the institutional approach to lending makes way for a more focused, personal approach.

The Lessons We've Learned

In addition to a more regionalized approach to lending and developing, the real-estate industry has learned that real estate "know-how" matters. The tech sector fiasco of the last 24 months taught the capital markets a valuable lesson. For example, one should look more closely at the asset's management team and make cost control a priority over cash flow.

REITs, too, will have to divest themselves of their non-core assets and fine tune their focus regionally by more actively promoting their assets rather than holding onto them with unrealized values in their portfolios. With most REITs currently overvalued, investors are going to require that these asset managers reevaluate their portfolios to ensure that they reflect at least current market values. In addition, the REIT industry must include more real-estate people at the table to be able to look at these assets with a more critical eye.

Like REITs, opportunity funds fared extremely well in the 1990s. However, their exposure to the real-estate investment arena has been one sided because of the six- to nine-month lag time that the real-estate market experiences relative to general economic conditions. Simply stated, opportunity funds have yet to experience investing in a soft real estate market. Only those fund managers who truly understand the local real-estate players market dynamics will succeed in a downturn. They, too, will have to adopt a more disciplined approach to their portfolios as real-estate operators versus fund managers, which means promising investors less of a return than in years past.

Where Are We Headed?

Generally speaking, submarkets or tertiary markets hold the greatest promise for profits going forward. With lighter competition for financing needed to build in less congested, smaller cities, these markets still present ample opportunity for development, unlike more saturated primary markets. For example, in Madison, Wisconsin, an undercapitalized developer recently built a $52 million residential high-rise, the city's only such high-rise. The project was 60 percent pre-sold prior to closing, and the preferred equity provider is anticipating a return of 35 percent on an annualized basis. Other submarkets such as Grand Rapids, Michigan, or Jacksonville, Florida, typify markets that offer the greatest potential for profitability.

Inner city areas such as the Bronx, New York, and Paterson, New Jersey, also offer great promise for real-estate investment and development opportunities. Like the tertiary markets, these inner cities are more open to change and progress sparked by real-estate investment because they feature less competition for development dollars and fewer barriers to entry. However, unlike development in major metro areas where lending has returned to local lenders, these markets must look for funding beyond their city boundaries to major money centers where the capital exists. This is true for both equity and mezzanine financing.

The real-estate markets are changing constantly, and for the foreseeable future, this change will generate greater opportunities on a more regionalized basis. Furthermore, those opportunities are not limited to major urban centers.

This new era will have the industry operated once again by people who truly understand the nature of real estate, not the capital markets focused on many of those smaller and sometimes neglected markets of previous real-estate cycles.