GARSON LAW

# Commercial Real Estate in 2014

## Taking Down the Cranes

By Jack Garson

Don't let all of those cranes fool you. There may be a lot of construction going on now and plans for even more in the DC area. But this year, supply is likely to far exceed the demand. The rising buildings, barricades, and detours have a lot of folks convinced we're in the middle of the next boom—haven't those cranes always symbolized thriving times? But the reality is more like a movie set, where there is nothing behind the storefronts but weeds and broken bottles. And whether you're a developer or buyer, landlord or tenant, you need to take action in the near future where the DMV is overbuilt and under-occupied. Just because you build it, does not mean they will come—think "Intercounty Connector."

To be fair, there are some bright spots. Several submarkets in DC have been redeveloped and are booming. Indeed, tens of thousands of new residents have moved to the city in the last decade, driving the need for housing, retail and restaurants and filling office space. Close-in submarkets, like the Rosslyn-Ballston corridor, are thriving because they have the right blend of residents and jobs, including plenty of successful millennials who have sparked a thriving night-life. Well-located retail properties, especially shopping centers anchored by national credit tenants, continue to trade at crazy high prices—driven by low interest rates and buyers' desire to invest somewhere other than near-zero bonds and an increasingly pricey stock market. There are other positives. The recently approved MGM casino at National Harbor will be a gem in itself and will also attract other businesses and development.

But, the big picture locally isn't so bright. In the wake of the Great Recession, plenty of commercial real estate projects were approved out of a desire for growth, not because of demand. Government officials took out the crash cart and tried to jolt the economy back to life. In fact, one former high-level planner told me that the worst projects always get approved in the worst of times—when everyone is desperate for development. Indeed, Fairfax and Montgomery Counties just approved millions of square feet of new projects near Metro stations, including the new Silver Line in Tysons Corner. Yet several of these developments already are being "mothballed" until demand returns.

### Enough Already With The Office Buildings

In the office market, a big slice of local industry—government contractors and the businesses that feed off them— have been whacked by reduced military spending, sequestration and the late 2013 government shutdown. The weakest companies are giving up space as they go out of business; those “barely hanging on” are cutting costs by subletting, and the sturdy ones are seizing opportunities to save costs by signing up for less space when they renew their leases. In fact, plenty of tenants just need less space. Businesses are shrinking or eliminating in-house server rooms as they float data to the cloud. Law firms are eliminating once sizable law libraries. Government and business offices alike are implementing office-sharing and telecommuting. It’s so slow in the office market that some brokers I have talked to are considering career changes.

### Waiting For The Residential Avalanche

In the residential market, we have just experienced a boom in new construction. The entire DMV, especially markets in and near DC, saw a burst of construction during the past couple of years. As Bernanke would say, “They was partying like 2005.” In fact, last year I spoke to one large general contractor who wished for a slow-down if only to get pricing from subcontractors under control. But even this residential real estate party—the strongest local sector in recent years—peaked in 2013. Now everyone is afraid of the avalanche of new rental units in the next couple of years. Buyers are pulling out of deals. Lenders are getting really tough—their terms are starting to make loan sharks look like non-profits. And all but the best deals are being abandoned until the market absorbs the upcoming supply that should surge around 2015. For at least a few years, this party is over.

### Panning For Gold In Retail

What can you say about retail? Great properties still fly off the sales shelf. Even mediocre properties sell. Heck, given all of the investors with pockets full of cash, the bad retail also sells— not that I would advise buying. But it’s the leases, not the bricks, that count. And some retail tenants are just not in as good a shape as they were before the Great Recession. Take Best Buy. Shoppers look and learn at Best Buy and then go to the Internet for the “best buy.” And those Internet competitors aren’t paying for showrooms or sales assistants—so the big box retailer may not be an enduring business model. Further, successful retailers are swarmed by copycats that pick off customers and squeeze margins. Certainly, there are 800-pound gorillas like Walmart that attract crowds of customers—especially in previously underserved markets in DC. But for each new Walmart, there are dozens of stores and their landlords wondering if they will survive with their new neighbor around. Overall, most retailers have been under stress for years and the demand for new retail space has been relatively minimal.

### The New Rules

Certainly, things will improve. The DMV presents countless attractions and amenities. The government won’t always be on a diet. But in 2014–maybe even 2015–you’ll profit from accepting the fact that overall demand is soft and new rules apply:

For credit-worthy tenants, you’re in the driver’s seat. You have plenty of bargaining power if you follow a few basic instructions. Start early. Get a good broker, shop around and have alternatives. And, no, leases are not standard— one-sided: yes, standard: no. Understand the lease and bargain for fair provisions.

Landlords, you need a more tenant friendly process. You're starting to edge out the airline industry in customer service—but not in a good way. Some leases have grown to one hundred pages and are filled with draconian provisions and overkill remedies that—ironically—are rarely used. Take your form leases, pare down the length and make them reasonable. Also, be responsive to tenant needs and fix building problems. You're more likely to attract and retain tenants if it's easier for them to sign up and they never have a reason to leave.

Buyers need to increase their due diligence. Don't get caught up with the herd, eager to buy anything with a monument sign and tenants. When current leases expire, many of those tenants are going to leave, reduce their square footage or bargain hard—see above—for rent reductions. In fact, go through this exercise: pretend the property is vacant. How hard would it be to lease and what rents would you get?

Developers are in a particularly difficult situation. This may be one of the best times to get projects approved by local officials (although sometimes with burdensome proffers). Yet loan terms are getting worse and demand is drying up. Some developers may be faced with bailing out of purchase contracts or carrying loans on raw land. Those who still are in a position to make a decision need to consider this new reality: There is more supply of commercial development opportunities than there has been recently in plenty of markets. But there is not an equal amount of user demand. Caution is warranted and the best move may be the lowest cost, wait-it-out strategy—whether tying up projects with a contract or option to purchase, sitting on land you already own, slowly moving through the entitlement process or holding on to your cash and waiting for that right balance of supply and demand before you purchase or develop. So, don't let the cranes fool you. They're taking them down soon.

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