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REDNews
reprint from February 2009 Issue of REDNews Magazine

Houston Industrial Overview

Financing Affects Industrial Buyers & Tenants

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It's no secret that the real estate community across the country is bracing for challenging times in 2009. In the Houston Industrial market, we have been somewhat insulated, but certainly not immune to the challenges affecting the rest of the country. In this overview of the Houston Industrial market, we will discuss how changing financial terms affect buyers and tenants in a market well stocked with new product, but short of quality second-generation real estate.

Finance

As a result of the credit crisis sweeping the worldwide financial markets, most purchasers of real estate have seen dramatic changes in lending standards over the last 9 months. Many lenders have increased credit rating and equity requirements, with down payments generally in the range of 25% to 40%. Additionally, interest rates have topped 7% in many cases, and lenders have shortened amortization schedules and loan terms to the point that many buyers can no longer obtain acceptable financing for real estate projects. In this environment, there have been few investment transactions, so market capitalization rates on investment deals are difficult to determine. This adds additional uncertainty for potential transactions even if the buyer is bringing all cash or if financing is not a problem. We have also seen disparity in property valuation. Some lenders are appraising property at below contract pricing, even in design build and new construction circumstances, which effectively raises the equity requirements further for buyers. One area where banks have been more ready to lend money is for owner occupied properties. Whether seeking SBA or conventional loans, many small business owners have been able to secure acceptable financing for real estate purchases, if they can find suitable property for their needs and they are willing to meet the equity requirements.

Product

As businesses search for property based on their needs and the financing terms they have achieved, they are finding that available properties that suit their business objectives and budget are few and far between. Although there has been a significant amount of speculative new construction over the past several years in Houston, many buyers and lenders are balking at the price tag. If business owners are unwilling to pay for new construction, they find few high quality second generation buildings available for purchase. The list grows even shorter if the buyer requires special features like cranes, excess land for parking or outside storage, or has very specific geographic parameters. For smaller users (10,000 to 30,000 sf), there are literally dozens of new buildings available within small parks that have been built in the last 3 years, but there are a couple of challenges with many of these projects. The high cost of construction and materials has elevated the sales price, and the high cost of land has led developers to put as much building as possible on the sites, thus limiting parking or outside storage. For larger users (100,000+ sf), the situation is even more challenging. There are very few existing buildings available for purchase and little speculative development of buildings for sale in that size range. If buyers cannot find a building to buy, most resort to leasing. In 2008 alone, new construction has added nearly 10,000,000 new square feet of space to the Houston market. Over 6,000,000 sf of that space is bulk distribution lease space over 100,000 square feet, which is regionally focused in North Houston around Bush Intercontinental Airport and in Southeast Houston near the Barbour's Cut and Bayport container terminals. As with the building purchase scenario, although there is much availability (as much as 50% vacancy in new construction by some estimates), the rental prices are high compared to second and third generation buildings. The high cost to build out office space within the warehouse along with other amenities like warehouse lighting is making an already expensive building even pricier. In many cases, build out costs often far exceed the allotted tenant improvement allowance. Most of these bulk distribution facilities were not built with the small tenant in mind. Many of these facilities will not accommodate requirements much less than 50,000 sf, which leaves many smaller tenants without many suitable alternatives in the market. Although some companies are willing to pay for new construction, many others are left searching for lower rates in older buildings. This scenario has created demand for established properties with lower rent factors, resulting in occupancy levels of 93.8% at the end of 2008, according to Costar. Many tenants are finding it difficult to identify space that works for them within their financial means.

Conclusion

Real Estate is a trailing economic indicator. Tenants and owners don't generally have to take immediate action to change their real estate position until after an economic downturn is in full swing. In Houston, we have yet to see the full extent of the impact of this latest economic downturn within our market. As a result of the challenging financial environment, many owners have forgone plans for new building and tenants are executing short term renewals in their existing space to ride out the current economic cycle in hopes that availability will increase in the future, or their financial means will increase to pay for higher priced product. Not everyone will survive the storm. 93.8% is still historically a very strong occupancy rate, but it represents a slight decrease from last year, and we can expect that trend to continue and potentially accelerate.

But there is a silver lining. For those buyers and tenants that are in the market today, the next 12 months will see a "loosening" of the market as vacancy increases. This will provide more options and leverage for buyers and tenants who have cash or credit. There will be opportunities to buy and lease quality real estate at a discount to current pricing in the coming 12-24 months; just be sure to bring cash.

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