Denver Business Journal
In Depth: Commercial Real Estate
From the November 18, 2005 print edition

Industrial investors should consider selling property

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Have you been reading about the housing bubble lately? It's a pretty pervasive topic and a difficult one to avoid if you're even remotely aware of what's happening in economic circles.

Its precise meaning is subject to some debate, but to me, a bubble emerges when the value of a home exceeds what the market is willing to pay for it. I don't know if there's a housing bubble in Denver or anywhere else in the country. It depends on who you talk to, and when. What I do know is that even the threat of a housing bubble here can profoundly affect what happens to industrial properties, especially for buyers and sellers.

The industrial market metro-wide ended the second quarter with 9.6 percent vacancy, down from 10.2 percent at the end of the first quarter, according to CoStar research services. Average blended rental rates hovered at around $5.95 per square foot, unchanged from the first quarter. Net absorption, however, registered a healthy 1.6 million square feet, and six new buildings were delivered to the market.

Nationally, the U.S. Department of Commerce reported that economic growth ended the third quarter at 3.8 percent, up from 3.3 percent in the previous quarter despite the impact of hurricanes Katrina, Rita and Wilma.

Most local experts agree that these numbers, among others, reaffirm a strengthening economy nationwide and could signal the beginnings of the recovery phase of the Front Range industrial cycle. But I'm not so sure.

This constant chatter of a housing bubble is but one of a number of indicators that all is not well with American consumerism. And when there is uncertainty among consumers, there is uncertainty in commercial real estate.

For starters, the days of cheap money and record-low short-term interest rates are over. The Fed has raised those rates a quarter point 11 straight times since June 2004. Many of the homeowners who took advantage of those all-time-low adjustable rate mortgages and interest-only loans will no longer be able to afford their homes. The consequences of encouraging Americans to borrow more for less will certainly result in a spike of foreclosures and bankruptcies. It's happening already.

So what does all this have to do with industrial properties? Plenty.

American consumers are overextended. Rising interest rates and below-zero personal savings are bound to slow consumer spending. Slower spending means less demand for retail products, which means less overall demand for warehouse space.

There are other factors driving these concerns, as well.

The U.S. is in a significant, even "dangerous" current account deficit, according to a June 2005 Wall Street Journal analysis. The current account deficit is a measure of the shortfall on trade and investment income between the U.S. and other nations of the world. To finance this deficit, the U.S. borrows about $2 billion a day from foreign countries. Think about that one for a minute. The risk here is that foreign investors will eventually demand a higher interest rate or a lower value on the dollar.

Fuel prices are also a hot issue. Although there seems to be some recent stabilization, we are still paying significantly more at the pump than at this time last year. And we have already been warned of a sharp increase in home heating bills, something we in Colorado cannot avoid.

I'm not saying we're on pace for imminent inflation, or worse. But there is evidence that things still have the potential to get worse before they get better. This poses some unique challenges for industrial owner/users.

As in other market sectors, industrial investors have benefited tremendously from low interest rates by snapping up a record number of properties in recent years. This buying frenzy has created a lack of available inventory, which drives up prices. In fact, industrial prices here have been steadily going up for at least 10 years.

But with the convergence of rising interest rates and other conflicting economic conditions, sales activity in the industrial sector is cooling. At the very least, buyers are proceeding with far more caution. Indeed, total year-to-date industrial sales here are down from 2004.

For those owners committed to keeping their buildings, the good news is that lease rates will probably begin to creep up in the next year as vacancy continues to drop and would-be owner/users are driven into the rental market. But investors who are not in it for the long haul should be thinking hard about when, or if, they can turn a profit by selling.

It just stands to reason that rising interest rates which have priced prospective homeowners out of the market will have the same effect on prospective industrial investors. Those rates will continue to go up as the Fed chases down rising inflation, which in turn will push up capitalization rates on investments. To top it off, Colorado's total long-term capital gains tax rates weigh in at 20 percent --15 percent federal and 5 percent state. Those rates will likely never be as low in the future.

The net result will be far fewer buyers in the market a year from now, because ultimately, money will be too expensive to borrow. And with fewer buyers, prices will come down.

These favorable conditions for sellers won't last forever. It's too early to tell where consumer confidence is heading, and whether or not it will be a significant factor in the coming months. Industrial investors would be wise to consider selling now and taking a profit while they still can.

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