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The Rise of Zombie Buildings: *Lack of Capital Creates Eerily Empty Buildings*

By Karl Hanson

Not long ago 90 percent occupancy in quality buildings was the norm. Rental rates were increasing. Property values were soaring. Now, fast forward to today. Markets face occupancy rates around 80 percent, give or take a few points. Rental rates have declined. Property values have dropped significantly. At first glance, it looks like the effects of the inescapable real estate cycle. However, the depth and duration of this downturn has generated a new phenomenon that has caused some property owners to make the conscious decision to allow buildings to remain dark. They are referred to as zombie buildings – physically present but devoid of life.

The table was set at the peak of the market when values were high and cheap credit was readily available. Many commercial real estate owners purchased or refinanced buildings at historically high leverage ratios predicated on inflated values. As the market softened, rental rates declined, cap rates climbed and property values fell. For those owners who were not fortunate enough to maintain their pre-recession occupancy levels, they were faced with a difficult decision – invest additional capital in the building to attract new tenants or let the building go dark? In a normal market, the decision is simple. Investing capital is an essential part of the lease deal to secure a new tenant. The new lease then generates cash flow, which covers debt service and provides a return to the investor. However, in the challenging market that we have experienced over the past few years, market factors complicate the decision. Declines in rental rates combined with increased cap rates have resulted in significantly lower property valuations. Properties that were financed at the market's peak from 2005 to 2007 have loan maturities looming over the next few years. As a result, many owners face the painful situation of trying to refinance properties that are underwater. Further complicating the situation for buildings that have low occupancy is the fact that leasing the space at current market rental rates may not increase the value of the property enough to remedy the problem. And so owners elect not to invest the capital for a new tenant thereby ensuring that the building remains vacant.

With that background, we are left to ask how those buildings will be brought back to life. And what should prospective tenants do to ensure that they do not unknowingly lease space in a building that is not yet a zombie building but is heading down that path?

Zombie buildings will come back to life when their debt structures are resolved. The Wall Street Journal recently reported that of the \$1.4 trillion of commercial real estate loans maturing through 2014, just over 50 percent of that debt is underwater. How will that \$700 billion of debt be refinanced? Some notable owners have elected to simply stop making loan payments to force either a loan restructuring or foreclosure. In some instances, property owners have simply handed over the keys to the lender. But most loans will either be refinanced, albeit with significant additional equity contributions required by the owner, or foreclosed. Either way a new current market value of the property will be established with a debt structure that allows the owners to resume normal market leasing activity.

As for what prospective tenants should do in the way of due diligence to avoid finding themselves in a distressed asset, the simple answer is – there is not a simple answer. But there are several things that a tenant can investigate to ensure that their new landlord will have the capital necessary to meet its lease obligations of providing the tenant improvement buildout bargained for and the ongoing repairs and maintenance needed. The main factors tenants should consider are the owner's reputation and financial standing.

The owner's reputation should be one of the prospective tenant's first considerations when evaluating a property. An owner's past dealings with tenants and track record for maintaining its properties go a long way toward predicting issues that a new tenant can expect to encounter. Experienced brokers in the market are

reliable sources as they deal with the many owners in the market on a daily basis and hear accounts of other tenants' experiences with various owners.

The owner's current financial condition is another key issue. If there is reason to believe that the owner or the particular property the tenant is considering is or may be in financial distress in the near future, the prospective tenant should ask the landlord for a corporate financial statement or other information to substantiate the landlord's ability to meet its lease obligations.

And, finally, look closely at the condition of the building itself. Is it well maintained or are there obvious signs of needed repair? Simple signs that the property manager is cutting corners on the maintenance of the property can be a sign of a lack of funds.

In every economic climate, business owners need office space from which to operate. The challenge in today's market is finding that space from a reputable commercial real estate company that has the standing power and financial wherewithal to make improvements to its properties and maintain an office that meets the needs of its tenants. The best advice is to do your due diligence, research properties and do not be afraid to ask tough financial questions. A reputable commercial real estate firm will not be afraid to answer them.

About the Author

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