Worried About the Next Real Estate Downturn?

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As we go longer into the current economic expansion, investors become ever more anxious about the next downturn. After all, the last one in 2008-2009 (known generally as the "Great Financial Crisis" or "GFC") was, to say the least, not much fun.

Though private real estate does not directly correlate with the broader public equity markets, its health is most assuredly dependent upon the strength of the economy. There have been four distinct real estate cycles since 1980 and, the real estate investment team at Bailard has learned that once a downturn begins, price adjustments come so quickly that there is almost no time or ability to make any material portfolio adjustments. Even in good markets, transactions (acquisitions, dispositions and financings) take two to four months to execute. And because it's impossible to "time the market," Bailard believes that the best way to protect against the most damaging effects of a real estate recession is to constantly monitor the markets, make appropriate adjustments in light of market indicators and maintain a well-diversified and defensively-postured portfolio.

As to the next real estate downturn, it is nearly impossible to divine what will trigger it, how deep it will be and/or how long it will last. Regardless, the Bailard real estate team is not overly worried about its impact on the portfolio, except in select instances. Looking at the historical record, another crash on the order of the GFC is highly unlikely; there have been only three in the past hundred years (as Bailard has previously described in some detail*):

- The 2008-2009 downturn was the result of a toxic mix of lax regulatory enforcement, irresponsible lenders, reckless investment bankers, negligent "independent" ratings agencies, over-eager/imprudent borrowers, impulsive/fee-hungry mortgage bankers and delinquent investors... all carelessly participating in the creation and dissemination of complicated financial products with little concern for the consequences of their collective actions.
- The 1988-1992 real estate depression resulted from incomprehensible over-building of all property types (especially office and multifamily) in virtually all markets around the country. Excessive debt availability was fueled by ill-considered (and, in

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** The Long Cycle in Real Estate, Journal of Real Estate Research, Vol. 14, No.3, 1997.*

some cases, criminal) lending practices engaged in by numerous banks and savings and loan companies (S&Ls). At the same time, government tax policy provided incentives for equity investors to do "non-economic" tax-oriented deals that distorted the normal relationship between risk and reward.

- Finally, the very painful and deeply analyzed Great Depression of 1929-1932 was the result, again, of excesses on the part of overhasty banks and exuberant/imprudent investors leading to massive over-building during the roaring 1920s. (For years, the Empire State Building, completed in 1927, was referred to as the "Empty State Building").

Other downturns in the past 50 years were more muted and/or more localized, and did not particularly affect the national data trends. A good example of this was the dot-com/telecom bust of 2000-2002. The real estate downturn in tech/telecom-heavy places like San Francisco, Seattle, Austin, Denver and Boston was severe. Other markets like Los Angeles, Dallas, Houston, Chicago, New York and Washington, DC barely felt a ripple. It may well be that the next pullback in real estate will be local and/or limited.

Given the state of the U.S. economy today, and the reasonably good balance between supply and demand in most markets, the Bailard team sees just a few areas of vulnerability. True, there are some areas of excess reliance on debt—student loans, automobile financing and leveraged corporate loans—but practices in the commercial real estate industry have generally remained fairly prudent. In terms of any looming overbuilding, the most likely pain this time will be in office buildings that, because of their capital intensity, are always more sensitive to broad economic conditions.

Specifically, Bailard is concerned about those markets that in recent years have attracted a disproportionate share of equity and debt capital directed at developing new space at historically-significant levels. While all of the global gateway markets (Boston, New York, Washington DC, Chicago, Seattle, San Francisco and Los Angeles) have enjoyed enviable job and economic growth and commensurate additions to supply, the markets that are most vulnerable are those experiencing construction booms fueled by growth in the technology sector including Seattle, San Francisco and Boston. The table below reflects new office space that has become available since 2013, as well as the square footage (SF) that is currently under construction. Highlighted in tan, the Tech cluster markets are far and away looking at exceptional changes (SF currently available and under construction), notably Seattle with nearly a 23% increase from 2013. Time will tell but, at the risk of generalizing, it seems that Tech has a way of engendering animal spirits and excess.

There's another fascinating trend that's taken hold in this current economic expansion that's both independent of and inextricably linked to the Tech boom, to wit, the explosion of "co-working" alternatives. Though there are many different models, the one that has

Commercial Office Space Increases in Gateway Markets, as of 6/30/2019

	Office Supply as of Q1-2013 (SF, 000s)	Current Office Supply (SF, 000s)	% Change	Current Construction (SF, 000s)	% of Existing Supply	Total Change in Supply (SF, 000s)	Total % Change
New York	571,623	582,052	1.8%	18,507	3.2%	28,936	5.1%
Los Angeles	266,814	269,267	0.9%	5,811	2.2%	8,264	3.1%
Chicago	175,834	180,405	2.6%	7,092	3.9%	11,663	6.6%
Washington, D.C.	172,565	177,855	3.1%	5,958	3.3%	11,248	6.5%
Boston	97,061	103,341	6.5%	5,196	5.0%	11,476	11.8%
Seattle	75,067	88,789	18.3%	3,496	3.9%	17,218	22.9%
San Francisco	56,129	60,990	8.7%	1,250	2.0%	6,111	10.9%
Total	1,415,093	1,462,699	3.4%	47,310	3.3%	94,916	6.7%

Source: CoStar, Bailard Research.

captured the most attention is WeWork. Unfortunately, not only because WeWork is growing at a break-neck pace but also because of WeWork's opacity, it is difficult to get reliable up-to-date statistics on the company. This much is known as of the first quarter, 2019:

1) WeWork was valued at $47 billion.
2) WeWork lost $1.9 billion in 2018 on $1.8 billion of revenue.
3) WeWork lost $264 million on $728 million in revenue in the first quarter of 2019 (better ratios than full-year 2018 thanks, in large part, to several one-time positive items).
4) WeWork is eager to go public to fuel its growth and cash-out its private investors.
5) WeWork's business model generally involves signing long-term (i.e., ten-year) leases and then breaking that space into smaller increments to sub-lease (on a short-term basis) to start-ups, freelancers and even some larger enterprises.
6) WeWork is the largest tenant in Manhattan (the second most expensive office market in the United States)... with approximately 5.4 million square feet of space under lease, surpassing JP Morgan Chase in September, 2018.
7) WeWork claims to have 425 locations and 400,000 members.

Unfortunately for WeWork, the scheme of taking on long-term liabilities and paying for them with short-term assets has been tried many times before... and it generally hasn't ended well. In fact, it hearkens back to the S&L excesses and "mis-matches" that were the proximate cause of the 1988-1992 real estate depression referenced above. Again, time will tell if WeWork's backers (and management) have a chair to sit in when the music stops.

What are some safe strategies to pursue either while waiting for, or in anticipation of, a correction? Some obvious answers come to light:

- Prudently capitalize assets and only utilize modest leverage. It's important to make sure that property debt can be serviced comfortably even if rents drop 25% and occupancy hits 70%.

- Invest in cities where—while there is economic growth—rent levels have not risen to the point that developers can earn ready profits. Outside of the Tech markets, most metros would qualify.

- Source grocery-anchored and "necessity" retail, quality industrial leased to credit tenants and multifamily properties in markets with solid job, population and household formation growth metrics. Each of these should hold up fairly well.

- Finally, refrain from speculative office development where, because of the time involved from conceptualization to lease-up, the investor is in greater peril of being in the wrong place at the wrong time when an economic downturn strikes.

Exposure to private equity real estate is intended to serve as a portfolio diversifier. At Bailard, the belief is that as long one "buys right"—that is, invests in good quality real estate at a fair price in markets with strong fundamentals—then one should be able to weather quite safely all but the most severe economic storms.

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Since 1978, we've held a weekly company-wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05." Just as the 9:05 meeting enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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