Rodney’s Take
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Fear the Walking Dead

In the late 2000s, I taught an HS Dent conference we called Demographics School. I know; the title was riveting, but try as I might, I never found a better one. During the two-day program, I’d cover real estate and show a slide of where you could buy a home for less than $5,000: Detroit. The catch was that you had to pay all of the taxes and citations. And, of course, at the end of it you’d be a homeowner in a not-so-nice part of Detroit.

Downtown Manhattan is a million miles from Motor City, but there are some similarities. In the Big Apple, you can buy a share of a high-rise for a dollar, as long as you can cover the fees and the note.

At the end of last year, the Canada Pension Plan Investment Board (CPPIB) sold its share in 360 Park Avenue, New York City. The fund owned almost 30% of the building and sold it, along with all liabilities connected to it, for a buck. It sounds awful, but the Canada Pension Plan (CPP) is worth about $435 billion. Real estate comprises about 8% of the total, and the properties are scattered around the world. The CPPIB could write their real estate holdings to zero and still live to fight another day.

Investors like the CPP aren’t the issue in corporate real estate. The problem is that many building owners borrowed from banks, especially regional banks, to fund their properties with typical, seven-year, interest-only loans. Every month that our seven- to 10-year interest rates stay above 4% is another month that commercial building owners have to make hard choices. It would be easy if tenants who are consolidating were all in one building, but that's not how it goes. Sure, the best buildings will have tenants, but for those not considered the cream of the crop, well, the "for lease" signs will be plastered in the windows.

The building owners with the worst metrics, meaning highest loan-to-value and highest vacancy, will fall, but then better-quality buildings will see their valuations drop. I have no idea if this will cause a bank meltdown, because the central bankers have proven they stand ready to shore up the industry. But I wouldn't want to risk capital in the sector over the next few years for fear this turns into a long game of "extend and pretend." Building owners and banks don't have to go belly-up to be a drag on the economy. If they just turn into zombies, they can weigh down a portfolio.

Unless you want to see "the walking dead" in your portfolio, turn the channel to something else, like energy. These stocks throw off a lot of income and appear resilient.

Rodney

Got a question or comment? You can contact us at info@hsdent.com