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# Experts take market's measure

Premium content from South Florida Business Journal

Date: Monday, November 13, 2006, 12:00am EST

Miami developer Tibor Hollo suggests commercial developers self-insure their buildings to force the hand of premium-boosting insurance carriers.

Solve the region's workforce housing crunch by building high-speed rail and using development subsidies, another developer says.

Don't be surprised if office rents in Miami break the \$50-a-square-foot threshold in the next few years due to land shortages and rising construction costs, one of the region's top brokerage executives says.

These are among the ideas to emerge from the South Florida Business Journal's first real estate roundtable.

In all, 18 of the top real estate executives, lawyers and bankers gathered for the spirited discussion Oct. 12 at Morton's The Steakhouse in Miami.

The quarterly forum will be a hallmark of the new Miami Real Estate News section, debuting Feb. 2 in the Business Journal.

The section's goal is to bring readers the broadest and most balanced view of the trends shaping Miami's cityscape.

"For us, real estate is our No. 1 coverage category, in terms of readers and advertisers, and Miami is our largest city," Business Journal Publisher Gary Press said.

Real Estate Editor Darcie Lunsford moderated the discussion, which delved into such weighty issues as a pending condo glut in downtown Miami, the sudden surge of pricey office condos and the scarcity of industrial space.

Here is an edited transcript of that discussion:

SFBJ: Let's talk about the office market. With office vacancies going down and operating expenses going up, what do you think is going to happen to office rents in the coming year?

Tere Blanca, managing director, Cushman & Wakefield: Well, I don't think it's any secret to

any of us sitting here at the table that we've seen significant rents and appreciation in the last 18 months and significant rent appreciation since the beginning of the year. I think that the bigger question is not whether rents are going up, but whether the profit and the return to the developers and to the owners is going to increase accordingly, given where the operating expenses and taxes and insurance are going. Certainly, you can pass through those increases to the tenant, and so how much can the market bear? I think that, given where we are today in Miami, with employment growth and with population growth, with the dynamics of financial services expanding and the law firms expanding, we are going to be in the \$50 [a square foot] market very soon.

Edgar Jones, VP, Rockefeller Group Development Corp.: Although, I don't think anybody here that's been a developer doesn't agree that just due to the dynamics Tere mentioned that development is a leap of faith. There is a certain leap that, when you finish the construction, the rents will have risen to a level that would justify what you did. I think when you start these things, quite often, it's really on the borderline and, in some cases, maybe even below the borderline. But you believe that the market is so strong or strong enough that the future will be brighter and rents will go up to make the project successful - and it's been the case a lot of times. It's also been the case when it hasn't been that way. We have seen it: too much development has gone on, too many buildings at one time in the market. I think there have been times in the market when construction has been so significant that the market hasn't been able to keep up with that and, therefore, rents have not been enough to justify construction. It happens - we've seen it happen. And I think we're in a point right now, as long as construction doesn't get out of hand, that I really believe a leap of faith would be justified.

Don Cartwright, area director, Trammell Crow Co: I think that's very important. Where we typically quote gross rates, you really need to separate out the operating expense because [of] the answer to your question about rents going up. No question operating expenses are going up. And increasing at a level we have never seen is insurance and taxes on the net rent portion. Net rents have to be dramatically higher than they are today.

Peter Harrison, VP, Transwestern Commercial Services: I was going to ask a question, but Don kind of answered it already. Historically, Broward and Palm Beach counties have leased space on a triple net basis. And with all the uncertainty surrounding operating expenses today, I'm just wondering if Miami is going to be heading to triple net rates.

Blanca: Absolutely.

Alan Ojeda, CEO, Rilea Group: As a developer, starting one office building at 1450 Brickell Ave., I agree that it's a leap of faith. I think the holding position resolve short term-wise doesn't make sense. It's only for long-term players and I'm going to triple it. Because there is no way you want expenses, especially for insurance and taxes, I'm going to triple net.

Patricia Blasi, president, Terranova Corp.: I believe that you're going to see this market convert to triple net rent. We have a couple of office buildings that we are already beginning to convert new tenants to triple net. I think you're going to see everyone jump on that bandwagon as leases roll and they can do it.

SFBJ: What is the office operating expense going to be in the future?

Scott Strickland, senior VP of leasing, Jones Lang LaSalle: Right now, on Brickell Avenue, specifically, and you can throw downtown into the mix, the average is \$15.50 a foot. We have yet to feel the effects of all the insurance increases or the tax increases. We're going to have that issue. So we're projecting next year to be upwards of \$16.

SFBJ: We talked about the amount of money that institutions are paying to own Miami office buildings. How do these institutions justify this and how will it impact Miami in the future?

Raul G. Valdes-Fauli, president for Miami-Dade County, Colonial Bank: We're hearing \$50 a foot rent and that we're the next Chicago or New York. I still think there [will be] some growing pains between now and then. This town is not very good at checking itself. You walk outside and look at all the cranes. The long-term players are going to [be] fine, definitely. There are good fundamentals and good legs to this market.

SFBJ: Are residential properties in downtown Miami going to flip back to office?

Cartwright: Well, I don't know if many people are expecting them to be flipping back. They certainly might. I don't think that there's been that much consideration for condos coming back. The quality of condominiums that are being produced today makes Miami a more attractive market for consumers, given the housing stock. But, assuming the current office development and environment, you know, I think the demand is going to be in check, but we'll wait and see what happens.

Jeremy Larkin, president, NAI Miami: In order to do a master plan change or rezoning and then construction, you're looking potentially at a five-year cycle. The demand is continuing. The supply is stable. Prices will go up dramatically.

Ezra Katz, CEO, Aztec Group: I have a question [for] all these wonderful experts over here. Can anyone tell me the net absorption of space in downtown on Brickell Avenue on an annual basis?

Harrison: 125,000 to 150,000 square feet.

Katz: This is about supply and demand. This is about pure Economics 101. I am simply making a statement that we know that the Miami CBD [central business district] does not absorb a half-million square feet a year. We know that.

Blanca: But there's no products coming on line.

Katz: But we also don't have the corporation tenants. We don't have any large tenants over here. Now on a project like what Alan Ojeda is going to build, it's going to be completely different. It's going to be the named project in Miami. It will be a high-quality project unlike anyone has ever done and that will absorb a different kind of a situation. I also don't see \$50 rents coming around that quickly. We don't have the supply-and-demand dynamics for

that. So I don't want to sit here and get on a conversation about who's right or who's wrong. I'm just a fundamental engineer.

Lucia Dougherty, shareholder, Greenberg Traurig: I have several clients, who had totally approved major use special permits for residential, who cannot either sell it for what it's going to cost to build and/or finance it and are actually going to change it to office and hotels now.

Katz: And I have a response to you, Lucia: Those deals won't make sense. You cannot make an office building make sense in those kinds of locations. I'm saying to you, Lucia, that I appreciate the fact that the residential market is in the toilet, but you're going to pay \$350 to \$400 a square foot to build a new office building? You can't justify it. It simply cannot be. So I don't necessarily agree that that will change the dynamics of supply and demand.

SFBJ: Let's move on to the industrial market. Miami-Dade County has one of the tightest markets in the nation, so there's obviously a need for new warehouse and distribution space. With land and construction costs so high, what will happen to industrial rents in the upcoming year?

Jose Juncadella, president, Fairchild Partners: Class A industrial space is almost 97 percent full in all the different markets. This is a 150 million-square-foot market and the occupancy level is in the upper 90-percent range. Rental rates have gone up almost 20 percent in the last couple of years. Now, we're starting to break a new rental rate, which is \$8 a square foot, gross. A lot of the same things that are happening with the office market, in terms of triple net rent and so forth, are happening with industrial. Rental rates are still quoted on a gross basis, but leases are done on a triple net basis, which is what I think is going to happen in the office market. There is no land available. Land that is available is \$28, \$29, maybe \$30 a foot - if you can find any. So the spec development is nonexistent anymore. I'm presently handling a new development that has 1.6 million square feet available - and that's the former ABC Distributing building in Hialeah. We're seeing activity in several large tenants looking for over 500,000 square feet. But the rental rates will be pretty high. Rental rates in upper \$6 a square foot triple net, I think they're going to go to \$7.50 and up per square foot. I think that's a trend.

SFBJ: Industrial dirt for \$28 a square foot. How do you make that work?

Larkin: I'm not an industrial expert, but I don't see how you can, based on the simple math.

SFBJ: Why would a company pay these high South Florida rents when they can open a distribution center in Tennessee, North Carolina or elsewhere in the nation for much cheaper?

Juncadella: Well, you know, that has been the argument, even when the rental rates were going over \$4 a foot. If you have to be in Miami, you pay the rental rates.

Jones: I think what you see happening has got to be that some of the tenants will be squeezed further away. You're going to get some get squeezed to St. Lucie County or further north to Orlando or some other place completely different. But as the market grows and gets more dynamic, you're going to have people to fill it.

Blanca: I think there are certain fundamentals about this region that will always attract new business. We certainly have a very strong financial services and trade business, and it's always going to continue to be a place of choice for many companies - and they will have to pay the price. And the transportation costs and other costs of business of not being here will definitely outweigh the fact that the real estate is maybe more expensive than what they want to pay.

Larkin: I think we need to take our domestic hat off and look at a global prospective. This is not regional distribution. This is global distribution. And people have to be here because it's perishable products moving in and out between multiple continents. You have 24 hours to 48 hours to move certain products. If you don't get it there, you'll lose your product. So you're going to continue to see a convergence of that type of need and general distribution is going to move to Palm Beach and north.

Blanca: And we have China because they want to do business with Latin America.

Ojeda: They are deepening the Port of Miami to allow for bigger ships precisely for Asia.

Paul Cohen, VP, CB Richard Ellis: This is a global distribution point. This is where Asia meets Latin America. A lot of the freight comes in the body of planes into Miami, where there are more flights to South America than any other city in the Southeast. So the idea that you can go to Houston or even to Tampa or even Atlanta and do the same thing - you just can't do it. Tenants complain. They're tenants. That's what they do. But they will pay what it costs to be here in South Florida.

Dan Carlo, senior managing director, Holliday Fenoglio Fowler: Not to take a political turn here, but there is pending change in Cuba. If there is an opening, then everyone that's in business for the past 40-some-odd years, there is no more logical place [than Miami] for the trans-shipment of goods. Miami is centrally based, so imagine that explosion.

Valdes-Fauli: Latin America is not a big homogeneous lump. When Colombia's economy is down, Argentina's is up. When Argentina is down, Peru is up. I think it's going to keep growing, keep getting better - but not in a uniform trajectory.

SFBJ: How are insurance costs impacting South Florida real estate?

Theodore Carter, senior managing director for South Florida, CB Richard Ellis: I would say two things. One is we're seeing more institutional players come into the marketplace, and that's going to be significant. It's going to change the dynamic of the marketplace. We're grappling with it because we're trying to figure out how we can get our clients into our management portfolio - and so we've had pretty significant growth in terms of the assets that we manage - and that put us initially at a competitive disadvantage with respect to

being able to bring clients in. We think we've solved that problem. This has to be solved. I think the government has to step in. I don't believe that government is the solution for everything, but because of the magnitude of this and the need to create a backstop and a pool that will allow coverage to exist, [it is].

Tibor Hollo, president, Florida East Coast Realty: An interesting concept emerged and we discussed the insurance issue with our lenders and they had a sympathetic ear. The proposal is to evaluate damages of existing buildings. What was the largest claim within the last 10 years and the number of hurricanes that passed us by in the last 10 years? What was the largest claim of a given building? Take that claim, then multiply it by two and the ownership is responsible for that amount, period. Take any kind of state-supported insurance off the top. For instance, you have Citizens for \$1 million per building. Take that \$1 million and let us say you had past damage on the building of \$2 million. You are responsible for \$4 million plus the \$1 million. And that's what our industry is standing on and we are starting to put up a common front. Some of the lenders I talk to are starting to listen to this concept. Now that's really the concept of screw the insurance company, which I'm very willing to do.

Katz: I'm a firm believer that insurance will have a greater impact on ordinary people and their homes than it will on these rich developers. And I think that the impact of increasing insurance on single-family homes, affordable homes, will have greater impact on absorption, on corporate relocation, on affordability and all of those things and it won't matter what the impact will be in commercial real estate. If we see foreclosures going up on residential real estate in the next 24 months, across the board, as a result of increased insurance rates, it will impact this state like no other event has ever impacted us, talking about economically.

Hollo: The fact is that if commercial real estate is willing to look away from insurance companies and become self-insurers, the insurance companies will be crying and will want to capture the marketplace for the residential insurance. So I feel that, as long as our groups can put up a common front, I think that that will take us a long way to help the residential marketplace because there will be no commercial insurance, basically. We all get premiums from commercial insurance.

Katz: It's a brilliant idea, but it will be virtually impossible to implement, in my opinion.

Valdes-Fauli: Lenders and banks, by nature, are not very sympathetic. But bank examiners are being really sympathetic and understanding. They recognize the huge economic impact.

Charles Brecker, real estate lawyer, Stearns Weaver Miller Weissler Alhadeff & Sitterson: I can tell you that one of the segments that's really been hard hit is multi-family and apartments. They cannot pass on these huge increases in insurance to tenants. They'll have empty buildings tomorrow. That's the first problem. The second, I must admit to this group, is the cat that has not been let out of the bag, but we have a disaster in the making that I am personally part of a committee with the Florida Bar, trying to make sure this doesn't happen. I'll tell you what it has to do with. All of the buildings that you see going up in Miami and all over the place that have been, let's assume, filled with purchasers with

binding agreements. They're not. Because in every instance, the developers have to provide notices as an amendment to every purchaser when there is an amendment and one of the amendments are changes in budgets. I can tell you that with communities I'm now handling, and for anybody else who is building residential communities, you're seeing upwards of 150 percent increases from when these building started on Brickell or downtown to when the buildings will be delivered. You're going to potentially have mass terminations of contracts. That is a danger that's lying out there that, again, nobody has really been looking at.

SFBJ: A lack of workforce housing is looming threat to South Florida's economy. The region is losing nurses, teachers and middle managers to less-expensive areas. Based on the region's median income, only 11.6 percent of households can afford to buy a home in Miami. How can we alleviate the housing crunch?

Blanca: I think we all have to accept that we're now becoming a major urban core. We are maturing as a city and it's taken us many, many years to get here and we're still going through the growing pain. But if you visited San Francisco and you visit New York and you visit every other major urban city in the United States - Washington, D.C.; Chicago - a lot of the workforce housing is not in the city. You know, people commute into the city. So, for us, I think, the issue of transportation and workforce housing goes hand in hand. We need to provide the ability for workers to commute into the city. And until we do that, it's going to be real challenge, you know, to solve the problem.

Carter: The other thing that I would just toss out that we haven't talked about, which again goes to the rental rates, is the inflation potential here because wage growth is pretty stagnant. I'm very surprised at how little people are paid in key positions. So, you know, we're already starting to see the velocity of migration to Florida starting to slow. You're starting to see people move to upper Florida, Georgia, et cetera.

Ojeda: Let me throw in a new concept of transportation because we're thinking of new interstates. There's a world out there, a world with high-speed trains. You have had high-speed trains all over Europe for the last 25 years. Somebody at Lake Okeechobee is 20 minutes away at 180 miles an hour in the flattest state in the United States.

SFBJ: Why isn't anybody doing anything about the housing issue?

Ojeda: One plus one is always two. So, if one plus one is always two and someone says, 'Can you do this for one and a half?' No, I can't. So someone from the public sector has to give, for free, the missing half - and that has been invented many years ago in subsidies. There's no other way.

Brecker: Another major drag on the economy of South Florida, and driving some people out of our state, is the disastrous school situation. We're clearly recognizing three issues: transportation, insurance and schools. These are major issues that should not be put on the backs of developers because it should not be their problem. It should be the state's problem.

Blasi: If housing keeps going up and we don't improve the transportation, then we've got to attract a different type of industry. We have to attract those where the salary levels are at a point where they can afford this. You have true urban environment challenges. All of this needs service industry support. There have to be policemen, waiters, nurses and the service economy. So we are going to have to address some sort of transportation and housing solutions or we are going to have a point where we're not going to attract these higher-paying industries because we're not going to have a service economy to support it.

Ojeda: The question is this: Do I have the money to buy where I live right now at today's prices? The second part is the golden prison. If I could afford to buy now, then I couldn't afford the taxes.

Brecker: I think the new terminology is going to be middle-class compression. We're seeing that in South Florida. That's exactly what we're talking about: how people are not going to be able to afford where they're at and their lifestyle simply because wages have not kept up with inflation.

SFBJ: We've seen a tremendous amount of residential construction in downtown Miami. Since 1995, there have been 5,397 units built downtown, including Brickell Avenue. There are 11,364 units now under construction and 17,000 more in the planning stages. Do you think we can absorb all these units?

Hollo: It's not the question of absorption because we did a very strong study. We did a very, very concise study. There are 29 projects that are not going ahead. Four of those 29 are fully sold out. The rest of them [are] 30 to 60 percent sold. There were returned deposits to 8,700 people, so that is absorption. The developer can't build when you compare the sale price to the construction cost, and that's why they returned the deposits. There are people there who want condos.

Ojeda: You have some lawyers here and I think you should ask if lawyers are seeing people closing on these condos.

Brecker: What I'm seeing are, unfortunately, all bad signs.

Hollo: Douglas Elliman Real Estate made a survey of the beach - not the city, they are doing the city now - of all the high-rise buildings. They found that the total inventory not sold is 204 units.

Katz: I don't agree with that.

Valdes-Fauli: I'm moving into a building called Blue. There are 88 units for sale or lease in the building.

Katz: I will tell you there are at least 15,000 listings of condominium units, OK, between Aventura and Coral Gables. And maybe it's higher. So I'm not sure that the statistics of what's available for sale in newly built condominiums or being built is relevant. I think what is relevant is the number of condominium units that are for sale throughout the market,

both being built and existing. I have never seen the number of listings that we currently have in the marketplace, ever, in my 27 years that I've been here.

Jones: The market runs, and you know where everybody is running. They all get in line and run together. A couple years ago, it was run to buy them. Now, it's run to sell them.

Harrison: Being a pragmatist, I think that may be the solution for workforce housing.

SFBJ: There are now about 3.7 million square feet of office condos in Miami-Dade County, 1.5 million square feet on the way and 850,000 square feet in the planning stages. Are these risky investments and will there be a resale market?

Harrison: Well, I think it's very typical of Miami that Cushman & Wakefield successfully markets 1000 Brickell Avenue and all of South Florida jumps on the bandwagon. But I think the glamour is starting to come to an end and we're already starting to hear people talk about converting the buildings back for lease. I just don't see how it makes economic sense. I think these buyers are in for such a shock when they have to close on their units and they're confronted with getting this space built out and \$17 or \$18 a square foot in operating expenses. I think it's going to come to a screeching halt.

Cartwright: The dynamics, though, of the demand of who's buying the units is absolutely the small user that knows what their space requirement is and has the same mentality as buying a home. They're going to have their space requirement for the next 20 years. These are architects, engineers, doctors, lawyers. So it makes perfect sense for them to be building equity, as opposed to paying rent.

Larkin: The basic dynamic of the office condo user is that they have a 20-year hold strategy versus renting. In the 20 years, as a renter, he walks away with zero. As a buyer, he has paid down his mortgage to zero. Even if he sold it for 50 percent less than he bought it for, he's still 50 percent ahead. Basic economics.

Brecker: I've been working on these office condo projects for probably 20 years and the ones that have been successful, I think, are developers who build in those niche markets like little office parks where they can sell to the buyers.

SFBJ: With asking prices of \$300 to \$500 a square foot, are office condos reasonably priced?

Cartwright: If you are the user and you ultimately want to have an asset that's paid off, a condo, in most cases, is a lot less than you're paying per square foot for rent.

Hollo: The purchasers are anywhere between 1,000 and 9,000 square feet, maybe a full floor, if the floor is not so big. They're willing to pay for the location and a good-looking building. I am doing one in Coral Gables now. It is 135,000 square feet and sold out 80 percent. Sales were stopped because I feel that during construction, I can increase the price. I could have sold out the whole thing already. I think they are all users. There is nobody who is an investor in the project.

Larkin: We've been marketing office condos for developers and for ourselves probably since 1998. The first series of sales were \$110 to \$150 a foot. The next round was \$200-\$250 a foot and now we're in the \$300 to \$500 range. So there is an appreciation factor.

Cohen: We did a similar-type study and we found the average price of office condos [is] about \$186 a foot. At that price, it makes sense compared to rents, depending on the market. Typically, we're ticking along - about 200,000 square feet office condos being sold on an annual basis in the last 10 years. All of a sudden, last year we sold almost 1 million square feet. So the demand has gone up.

Strickland: I think, for owner-occupiers, it makes all the sense in the world, but it is the investors who are taking the risk. I think some of the investors getting involved in condos are not savvy office landlords. When you do the numbers and you're getting into \$400 or \$500 a square foot, you can't justify that, based on rents.

SFBJ: Part of the price pressure on commercial rents and residential units is soaring construction costs. Are they going to come down?

Jay Fraser, VP and GM, Turner Construction Co.: Not right away. I think we're starting to see foundation people that are looking for work, but it's going to take 12 months to go all through the division - from foundation to concrete to mechanical and electrical. Right now, everybody tries to understand what costs are. It's useless. Don't waste your time. It has everything to do with the fact that there is not enough labor to build the buildings. And so subcontractors' and vendors' phones are ringing off the hook.

SFBJ: If it cost you \$325 a square foot to build an office high-rise today, what's it going to cost a year from today?

Fraser: I'll go out on a limb and say it may stabilize. It has to. The new construction is not happening. It will correct.

SFBJ: What's happening in the retail market now and what can we expect in the coming year?

Blasi: We're under-retailed heavily in Miami-Dade County. We're at about 11 square feet per person and the national average is 20 square feet. It's a challenge, though, because everyone here has told you we don't have any land. So what are you seeing? You're seeing Midtown Miami. You're seeing Downtown Dadeland. And you're finally seeing development in Homestead, which obviously is all following rooftops. Constraint of the land has caused this vertical development. However, a lot of our planning community all went to the same seminar and learned that it's very important that you should force mixed-use in urban environments. What they didn't learn is that it had to be meaningful. So to force someone, who is building 150 or 200 condos, with 10,000 to 20,000 square feet of shops at the base of their project is senseless because not every condominium building can support its own gourmet market, dry cleaner, whatever you have. You have to have substantive critical mass. The meaningful projects are going to do well because people that have chosen to live in this urban core are desperate for services and retail. If you lived in Miami Beach and

you wanted to go to Target, you had to get in the car and go to Aventura or Kendall. Not now.

Larkin: If you don't have a car, you still have to get there.

SFBJ: What's the impact of insufficient retail in an urban area?

Ojeda: It's almost un-American.

Blasi: We have more traffic. They're going to drive out of that area to get what they need. They're going to get it, one way or the other.