



# TRIUMPH NEWS

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## BRASS TACKS

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- DEVELOPMENT
- INVESTMENT
- BROKERAGE
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Much has happened since the last newsletter (see "Sudden Clarity" in the Newsletters section of the Triumph website, [www.triumphrealestate.com](http://www.triumphrealestate.com)). Shortly thereafter we heard the economy receive its official obituary from the National Bureau of Economic Research (NBER), who said in November that the nation's economy has been in recession since March. Recently, a rash of economic data suggest things are getting better, and that growth is on the horizon. As the great seer and always-jovial Alan Greenspan testified on January 23rd: "there have been signs recently that some of the forces that have been restraining the economy over the past year are starting to diminish and that activity is beginning to firm". Yee-Ha. With unemployment falling, the ICM index higher than it has been since August, 2000, and the index of leading indicators up for a third straight month, most analysts predict a recovery by the second quarter of this year.

But before we get too tingly about the next boom, Greenspan continued: The "impetus to activity will be short-lived unless sustained growth of final demand kicks in" before the positive effects of the inventory draw-down dissipate. The recovery is likely to be "tepid," he said. "The markets have been assuming a far more rapid snapback than I have".

### RECOVERY IS NOT UNIFORM

It is also important to be aware that because of the regional concentration of many industries, recovery from this recession will not impact everyone at the same time. "The recession will end when the Midwest and industrial South stop hemorrhaging jobs" sometime this spring, says Mark Zandi, Chief Economist at Economy.com in a recent Wall Street Journal article. But beyond that, it could be Summer before tourist destinations...begin to recover, followed by technology centers like San Jose and Austin in the fall, then financial centers late this year or early next, he continued. Finally, he differentiated between types of centers, saying that tech centers that are P.C. or semiconductor oriented will come back first, while "regions making telecommunications gear, such as the Dallas and Denver areas, may not begin to bounce back until next year". Uh-oh.

Analyzing the industries and regions that will lead recovery is important when discussing real estate, mainly because prolonging the downturn in an area increases the severity of the impact on commercial space, and makes it harder to know

**TIME(tim) n. 1.a. A nonspatial continuum in which events occur in apparently irreversible succession from the past through the present to the future.**

*-American Heritage Dictionary*

### FEATURED PROPERTY

#### THE STEEL FLOORS BUILDING

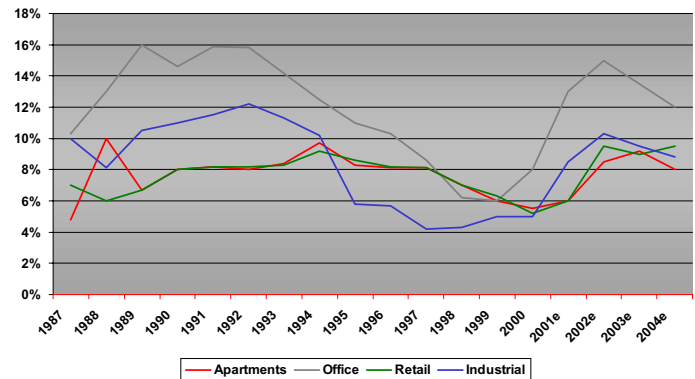


The Steel Floors building, a state-of-the-art, 88,000 square foot industrial building on 12.5 acres in the northeast portion of metropolitan Denver, is being offered for sale by Triumph Real Estate. The proposed deal structure is a sale leaseback, with a ten-year lease from Steel Floors, LLC at a market rental rate or the property could be made available to users. The price is \$5,650,000, which represents a 9.5% capitalization rate on proposed Net Operating Income. This facility sits prominently at the intersection of US 85 and E. 104th Avenue in Commerce City, near both I-76 and E-470, just north of DIA, clearly one of the most desirable locations in the market.

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how to manage investments. When Greenspan determines that the US economy is recovered, Fed bias shifts to inflationary concerns and interest rates begin to rise, Denver may still have several months to go before it's ready for recovery. There is a vacancy problem in the office and flex markets now, and there is a lag between recovery and the resumption of demand for space that needs to be accounted for, which when coupled with a delayed return to growth does not bode well for those owners. In the same Journal article, Rick Pederson, President of Foundation Properties and Ross Consulting here in Denver and forecaster extraordinaire quantifies these issues, predicting it will take until 2005 to lower the overall office vacancy rate in Denver back down to 12% from its current 19%.

**US PROPERTY VACANCY  
By Property Type**



Sources: NCREIF; Foundation Properties Inc.; NAIOP

Vacancy, how long it will last, and how to either handle it or take advantage of it is what's on everyone's mind right now, so its time to get down to the brass tacks. The highest vacancy rates of any product type- industrial, office, retail or multi-family - belong to the office market (see chart) and its industrial hybrid cousin, "flex", so we'll focus on those for the balance of this issue.

## OFFICE MARKET SHIFTING

The timing of a recovery in Denver could be less or more than these forecasts. But once overall economic recovery does begin to take hold, companies must first return to sustainable profitability and solidify their core businesses. Then, at some unspecified time thereafter, hiring will resume, and the under-utilized office space (currently still leased but void of people and not on the market for lease or sublease) will begin to re-fill. It's not until that plays out that the real vacancy rates can start to decline. Between now and then, there will be some interesting things happening. While many office-building owners are already hurting, they have been granted a stay from panic both in the form of 40-year lows in interest rates that provided breathing room through refinancing, and from the companies still paying rent on vacant but for-sublease space. Further, many office owners with direct vacancy are hoping to catch someone from the (ever shallower) pool of user-buyers in the market before cash runs out, because user-buyers essentially pay them for their vacancy, sparing them the pain of writing down the empty space enough to sell to an investor. The problem is that due to the recession companies and their owners are hoarding cash and cutting costs... users aren't buying buildings right now, and they probably won't be again until late in the next expansion. Regardless, prices for properties, even with substantial vacancy, have not come down meaningfully.

## CAPITULATION

If too much time passes before demand for new space (positive absorption) returns, the time that was borrowed through re-financing will run out for many as vacancy continues to fester, subleases run out and user-buyers fail to materialize. Also, since much of the vacancy is in class-A properties, rental rate reductions and leasing incentives in those buildings will begin to pull tenants out of class-B properties (call it the "trickle-up" theory), which will create enough pressure on them that prices will have to start to fall. At a recent forecast sponsored by NAIOP, Mr. Pederson agreed: "2/3 of the negative absorption (in 2001) was class-A, setting up the B to A movement we saw 8-10 years ago." Therefore it follows that A-building values will decrease with lower rents, but those that sell will most likely do so with stabilized occupancy, while the bid-ask spread currently stalling transactions in the B and C market will have to crumble in favor of the buyers eventually.

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What does that mean for investment? Should we expect cascading prices and a meaningful buyer's market? "No", according to Peter Culshaw, all-around good guy and venerable head of the Denver Technological Center, which operates its namesake business park as well as the 1,500 acre Meridian International Business Center in the southeast metro area. Peter, of course, deals with Class-A suburban offices primarily, but points out that there is too much pent-up money out there, which having seen what happened in the early 90's, is waiting for those great buying opportunities to appear. That will, in fact, prevent those great buys from happening in the first place; prices will be fair, but not opportunistic or distressed. He also reminded me not to underestimate the impact of cheap money. The cost of money is so low, he says, that he can hold vacancy for 18 months and still be on pro-forma. Wow.

However, these arguments do not apply so convincingly to smaller B and C class properties that generally fall under the radar screen of all that pent-up money. And with the trickle-up theory as noted above swinging into gear, I would still think there should be some opportunistic buys in that arena over the next few years.

## DEMAND IS THE KEY

But who is going to fill all the vacant space up? Since the oil and gas industry drove demand in the 70's and 80's, and telecommunications drove demand in the 90's, what industry is going to step up and be the big machine in Denver now that telecom is dead? "An eclectic mix of high-tech businesses taking advantage of the demographics" of highly educated, young workers, says Mr. Culshaw.

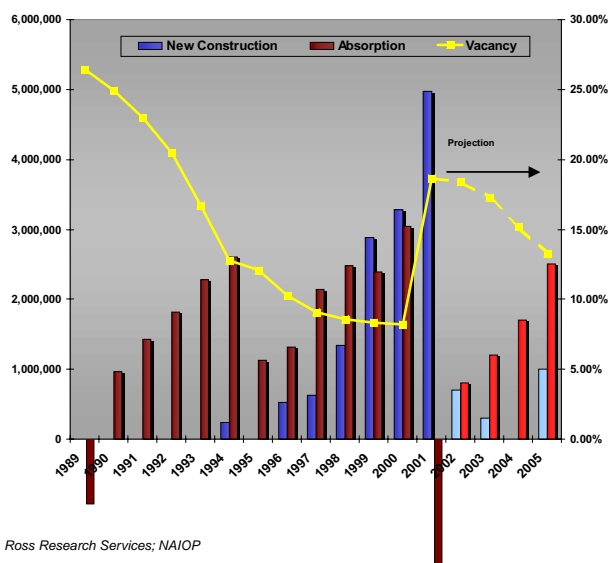
"Ok, but with one caveat", adds Steve Buretz, a developer with excellent vision and an ability to make big money on everyone else's throw-a-ways. "Denver has to become an affordable place to live again to attract new companies to move here", which means a dramatic reduction in housing costs will have to occur for that demand to be realized. Good point; In the past six years, Denver has lost its position as one of the best mixes of educated workforce, quality of life, and affordability in the country. Two out of three ain't bad, but it may be the affordability factor that stalls our overall recovery if businesses aren't moving here. I wonder how much time it will take for that to correct itself?

## A FEW REMARKS ABOUT FLEX

Also crucial to the supply and demand picture in Denver is the market for single story office and office-warehouse properties, a.k.a. "flex" space. Its low profile keeps it largely hidden to the main thoroughfares but driving around the concentrations of this product in Centennial, Inverness and Interlocken gives one the same reaction as we had when "see-through" office buildings dotted the highway in the early 90's: There is a major vacancy problem in flex. It's a little bewildering too, because this stuff took the longest to recover coming out of the last downturn, yet still commanded an inordinate amount of developer attention this time around. I believe the office stock developed between 1995 and 2000 squarely met the growth in demand, and the data for that period backs me up (see chart). I believe flex, on the other hand, was over-built.

Right now there is approximately 6 million square feet of flex space available in the overall market, out of a total stock of 32 million square feet (19%), which is in-line with the office vacancy here. However, of that total, over 9 million square feet (28%) was constructed between 1995 and

DENER OFFICE MARKET BALANCE



Sources: Ross Research Services; NAIOP

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2002, and carries a vacancy rate of nearly 30%. So the first big question is: Why was so much flex built? Well, developers anticipated higher demand in part because rising rents for traditional office buildings were causing some users to consider the less expensive flex alternative. Also, the late 1990's corporate culture was shunning the mahogany and marble for a more austere image. But mostly its because flex is cheap to build, and you get near-office rents for it, so the profit margin is huge. The second big question is, since flex is in so much trouble, should we be out bargain hunting for it? That depends on whether someone will lease it, of course.

And that, according to Mr. Culshaw, is the problem with flex. Despite the cultural shift to a lean-and-mean image, ultimately "the corporate mindset cannot go into single story stuff, so its survival will depend on ancillary businesses", who, by the way, happen to be busy taking advantage of the free rent at the traditional office buildings at the moment, thank you. The up-shot is that this product will take the longest to recover during this downturn as well.

## PREPARATION AND RISK

My crystal ball, for what its worth, tells me that we should be on the lookout for good acquisition opportunities in 2002, but be aware of demand at the same time, which may be tricky.

Despite my occasional enjoyment of teasing economists, I do have a degree in the subject of economics and actually am guilty of spending a great deal of time poring over charts, data, and news. The reason I do it is not purely for entertainment, but rather to gain a better awareness of both supply and demand issues in the market so that I may better assess risk and be more valuable to my partners and clients.

By correctly anticipating demand for space by geography and industry, we can manage investments appropriately and avoid the costliest of mistakes. Similarly, it becomes possible to turn a distressed property acquisition into a solid money making opportunity and decrease risk. Waiting for demand to become evident is waiting too long, because by then it will already be over-serviced and risk goes up. The problem is, it's harder to do deals on the front end, because lenders, who are generally looking backward at data to assess their own risk, have red flags on everything from absorption to rental rate trends when the best opportunities to buy start to appear.

Because of these underwriting practices, the best deals will go to those with cash in hand, ready to buy with 30-50% equity, and the balance sheet to back it up. Right now we are beginning to see opportunities appear to buy real estate at very reasonable values, mainly due to vacancy problems. The challenge going forward will be to accurately gauge the return of demand by industry, market, sub-market, and product type, and then have the resources in place to act quickly. So it is time for investors to be patient and alert, as we may be entering an excellent period in which to acquire real estate.

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