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Keeping Tenants Happy Cuts Property Returns

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Capital expenditures are taking a bite out of the yields for commercial real estate as the weak economy has tilted the scales in favor of tenants.

That's according to the latest quarterly research report released May 28 by LaSalle Investment Management. The Chicago-based money manager has $18 billion in real-estate assets under management, $6 billion of which is in direct ownership of buildings. LaSalle looks at the 12-month yield for commercial properties each quarter.

The firm cautions investors and owners of commercial real estate to expect yields on their investments to continue to fall because of what it calls "cap-ex leakage." Cap ex is shorthand for capital expenditures, the money landlords spend on building improvements, concessions such as free rent and special needs for tenants. Those rising costs are nibbling away at landlords' income and, ultimately, total returns, which are the yield plus the property's appreciation.

"Cash flow from [commercial] real estate may have further to fall for investors because leasing costs and concessions will need to rise if landlords want to maintain high occupancies," says Jacques Gordon, international director, investment strategy at LaSalle, which is the real-estate investment-management arm of real-estate services firm Jones Lang LaSalle Inc.

Some brokers say buyers are entering the market acutely aware of the weak leasing market and what that means for their income from buildings. "Buyers are paying more attention to the income that a building generates [now] as opposed to what it can potentially generate because we are at a tricky moment in the leasing market," says Woody Heller, executive managing director in the Capital Advisors Group at Insignia/ESG, a New York-based real-estate services firm.

Retail buildings had the highest cap-ex leakage of all commercial property in the first quarter, says Mr. Gordon. Taking that leakage into account lowered the sector's yield by 2.3 percentage points to 6.42% for the 12 months ended March 31, according to LaSalle, from the 8.72% yield reported by the National Council of Real Estate Investment Fiduciaries. NCREIF is a Chicago-based association of institutional real-estate professionals with a database that tracks $124 billion of commercial real estate.

Retail traditionally has had the highest leakage because landlords are sprucing up entryways, common areas, signage and shuffling tenants more frequently than in other sectors.

For the year ahead, Mr. Gordon says LaSalle believes cap-ex leakage will be highest in the office sector, surpassing retail, because of the sorry state of the economy, which has led to larger amounts of vacant space due to lack of demand.

"Tenant improvement costs have already gone up" for office landlords, says Mr. Gordon, "and will continue to rise, especially as leases" expire or roll over. "Landlords will have to keep giving free rent and tenant improvements if they want to keep occupancy high in their buildings."

LaSalle says cap-ex leakage in office buildings took 2.05 percentage points off the sector's 12-month yield, shrinking it to 6.63% from a reported 8.68%.

Higher leakage rates typically apply to top-quality properties in major cities, Mr. Gordon says, adding that "lower-quality properties are more often rented as is." While those assets usually are acquired by big investors, smaller investors who invest in limited partnerships, or private or public real-estate investment trusts that buy top-quality assets would be impacted.

Ultimately, the leakage problem could affect owners' ability to borrow or even sell the properties. "A lot of lenders and buyers look at a building as if they had to lease it today," says John Fowler, executive managing director with Holliday Fenoglio Fowler LP, a Dallas-based real-estate investment banking firm. "The lender will make assumptions on [the property's] income stream for the next five to seven years based on the income in place now" so they would lend less.

Mr. Gordon predicts it will take at least two to three years before vacancy rates come back down and cap-ex leakage is less of a problem.