

Tomorrow's New Orleans

BY KENNETH P. RIGGS JR.

The current state of New Orleans' commercial and multifamily property markets is the focus of a recent survey by the Real Estate Research Corporation (RERC). The findings reflect a sense of qualified optimism about the potential for a more vibrant rebuilt city and regional real estate market.

As we pass the one-year anniversary of the hurricanes that devastated the Gulf Coast, the totality of the human and financial toll is just beginning to be put into perspective. One year later, there are some neighborhoods that have been cleaned up, restored and show little residual impact of the storms. But fully one year later, there also are entire neighborhoods and blocks of commercial areas that still look like they did right after the storms—and whose ultimate fate remains in question. ■ As rebuilding continues in earnest, it is important to recognize that the growth phase is yet to come. The core rebuilding will occur as insurance money and an influx of private and public debt and equity funds start to become available and start to pour into the region. ■ There are no quick fixes on the horizon, and there is a long road ahead that, in many cases, still needs to be forged and developed. ■ According to leading sources, one year into the recovery phase the New Orleans metro population is at 70 percent of its pre-Katrina levels. Additionally, 85 percent of the hotels are once again open for business, 50 percent of the hospitals, 33 percent of the restaurants and 29 percent of the schools. While

Figure 1 Survey Respondents' Outlook for New Orleans (Post-Hurricane Katrina)

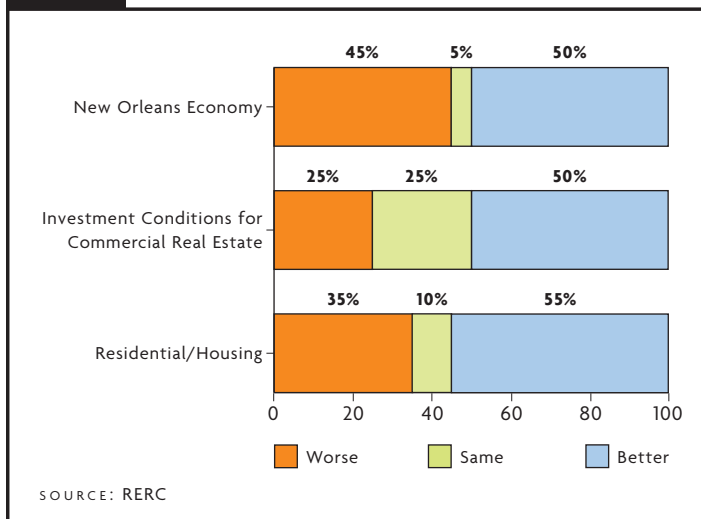


Figure 2 Respondents' View of New Orleans' Current Investment Condition

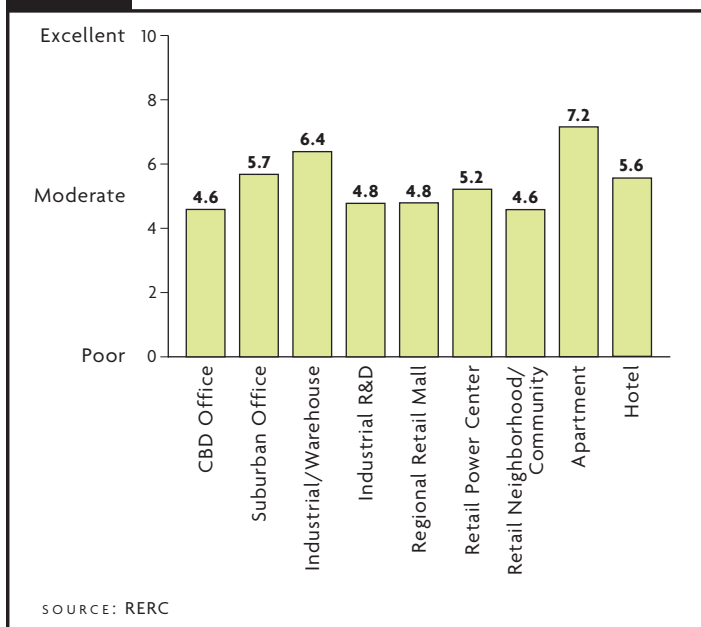
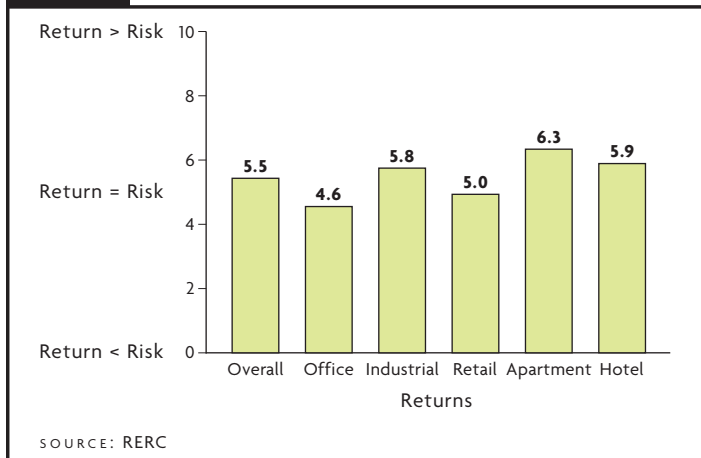


Figure 3 Respondents' View of Return vs. Risk



the city's shipping industry is returning to its prior level of business, small-business activity and basic services are running behind.

The New Orleans convention business began to return in late spring 2006, and the city will host the Chicago-based National Association of Realtors® (NAR's) National Conference & Expo in November. Convention business is absolutely critical to the success of New Orleans, and it will return—but it will take more time to return to its pre-Hurricane Katrina level.

The federal disaster spending for Hurricanes Katrina and Rita will top \$122 billion, which surpasses the federal spending for the Sept. 11, 2001, terrorist attacks by \$100 billion.

It will take at least five years to see a broad-based, meaningful change to this landscape. Growth in the commercial markets could easily go on for a decade or more. It will take courage, patience and conviction to see this region through its rebuilding phase, and there will be winners and losers in the commercial real estate arena.

Of particular irony is the fact that the commercial real estate investment market on a national perspective is viewed as being fully priced and with few investment opportunities. This is especially true for the larger, institutional investors that have too much capital and not enough deal flow to fill their needs. The national commercial real estate market has reached and earned a respectable level of maturity, which brings with it fewer high-return investment opportunities.

As noted in many commercial real estate publications, investors are in search of higher returns but want a lower level of relative risk. The financial world refers to this as the "search for alpha." Most would argue that in an efficient investment market, higher returns with lower relative risk cannot exist, as investors will simply bid away the higher return opportunity with higher prices until the relative return matches the relative risk.

This is the investment backdrop for the New Orleans commercial real estate market. Real Estate Research Corporation's (RERC's) view is that in the coming years, New Orleans will be viewed as an attractive place for debt and equity investors to search for and find alpha; but for now, the New Orleans market is dominated by regional, smaller equity investors. However, for some larger debt players willing to take the time to understand this smaller investment universe, taking on more uncertainty may ultimately pay handsome rewards—but it will take the courage of one's convictions to see it through.

Mixed messages from investors, but bullish undertones

Researchers and analysts do not follow the New Orleans commercial real estate investment market like they do some of the other major markets such as Houston, Dallas and Miami. Therefore, data are not readily available to allow an investor or lender to gain a proper perspective of investment conditions. This becomes exponentially more difficult when you throw in the dynamics of back-to-back hurricanes that together are being viewed as among the worst and most costly natural disasters in the history of this country.

To gain some perspective on the situation, RERC conducted a special survey in summer 2006 among RERC institutional and regional survey respondents and Chicago-based CCIM Institute designees located in Louisiana, Mississippi and Texas. The survey covered commercial real estate investment expectation topics

and opportunities for the New Orleans region.

RERC's survey respondents rated the New Orleans economy at 4.3 on a scale of 1 to 10, with 1 indicating a very weak economy and 10 indicating very strong characteristics. This is a relative weak rating in comparison with the national economy, which is rated at 6.9 on the same scale.

However, this conclusion needs to be put into context relative to other findings and conclusions from the survey. First, 50 percent of the respondents now view the general economic outlook for New Orleans as better than the pre-Katrina outlook. Second, and probably most important for investors, is that 75 percent of the survey respondents viewed investment conditions in the New Orleans commercial real estate market as better or the same relative to pre-Hurricane Katrina conditions (see Figure 1).

This suggests investors feel that while tragic in many ways, Hurricane Katrina may provide the shot in the arm to make New Orleans a better city than it was before, from both an economic and commercial real estate perspective. So with tragedy comes opportunity to reshape and rebuild a great region of the United States.

Clearly, there are no examples to guide us in navigating the opportunities that may or may not exist in the rebirth of a city and a region. Most debt and equity commercial real estate players are searching for evidence that there is ample opportunity to invest in New Orleans commercial real estate from a risk-and-return perspective.

No one is arguing there won't be a tremendous construction boom across all sectors. But the question centers on which sectors to develop, and whether it is better to lead or to follow.

For many, the excitement of being a part of the long-term vision of the area and part of the rebuilding of an entire city is motivation enough.

The reality is that most commercial real estate sectors are perceived as potentially more profitable now simply due to the fact Katrina wiped out a large portion of the supply. Certain areas of the metro region that saw little or no damage have seen a tremendous surge in the demand for space. This is especially true of the Baton Rouge area, situated 60 miles from New Orleans, which fortunately escaped paralyzing damage to existing real estate stock.

Office outlook

In RERC's search to gather insights on this market, we polled investors about which property types held the best and worst prospects. According to respondents, the investment conditions for the New Orleans central business district (CBD) office sector are still below average, garnering a rating of 4.6 on a scale of 1 to 10, with 1 being poor and 10 being excellent (see Figure 2). Further, office properties are viewed as the riskiest of all the property sectors, with a rating slightly below a fair rating of return equaling risk (see Figure 3).

The CBD office sector is also viewed as being priced slightly above value (see Figure 4), and the sector is expected to see a 4 percent decline in value (see Figure 5) and a 0.8 percent decline in effective rent (see Figure 6) over the next year.

Despite the negative responses, there is underlying hope for the New Orleans office market to turn around. Suburban office properties will do better than their CBD counterparts, and are expected to increase in value by 1.6 percent and have a positive

Figure 4 Respondents' View of Price vs. Value

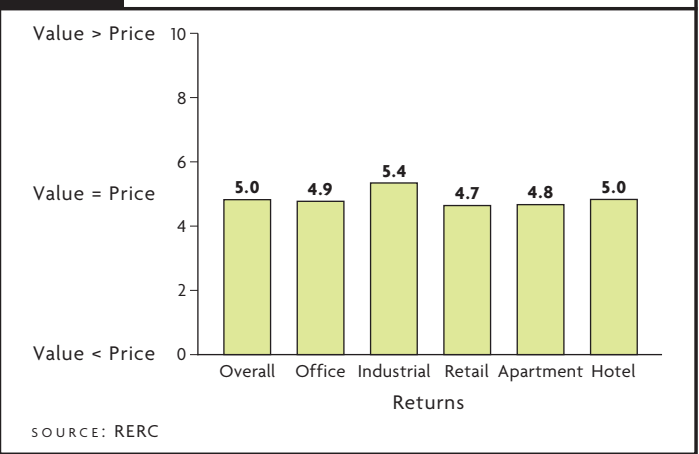


Figure 5 Respondents' View of New Orleans' Value Change

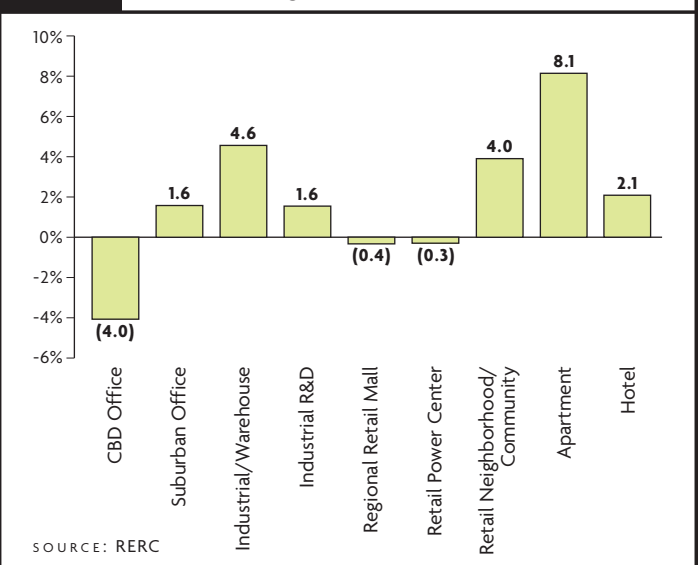
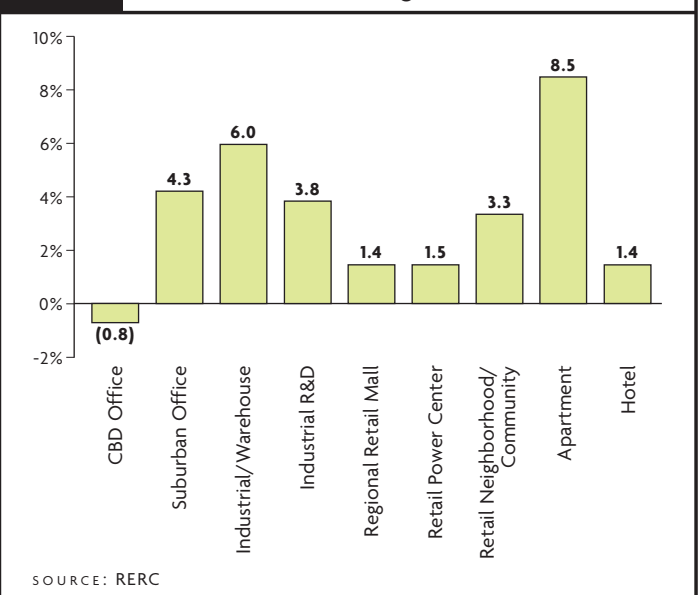


Figure 6 Respondents' View of New Orleans' Effective Rent Change



4.3 percent change in effective rent.

Also, several real estate experts put the vacancy rate for New Orleans downtown class-A space between 8 percent and 12 percent, which is significantly better than that for most southern cities. As stated by one of the survey respondents, "Office space in the Big Easy is getting harder and harder to find."

Many larger companies that temporarily evacuated—especially those in the crucial energy sector—have returned. Government relief agencies, contractors doing cleanup work and various advocacy groups have set up shop. Also, some tightening in the market has occurred because some damaged offices have not reopened, while others were converted to condos and hotel rooms before the storm. Despite the steady demand for office space, and with the occupancy rate much better than it was at the beginning of 2005, some landlords are worried that tenants may later scale back if insurance rates for storm damage continue to rise.

Industrial and retail prospects

The New Orleans industrial market seems to be on track for a decent year. This property segment is viewed as having the best value relative to price and as having a potential return that exceeds its relative risk. Industrial warehouse was rated second-highest with respect to investment conditions and second-highest for increase in value prospects, just behind the apartment sector.

Industrial research and development's (R&D's) investment conditions were below that of industrial warehouse, but the sector is still expected to see a 1.6 percent increase in value and a 3.8 percent increase in effective rent.

According to an article in *The Times-Picayune*, there were 30.7 million square feet of retail space in the metro area pre-Hurricane Katrina, and 21.7 million square feet of retail space post-Hurricane Katrina. Despite the decline in supply, retail sales in suburban areas have soared. Additional big-box space is projected, with as much as 3 million square feet of new retail space planned for the suburbs of Covington, Mandeville and Slidell.

Survey respondents viewed retail as the most overpriced of all the property sectors. Despite this, risk was still viewed as equal to return for the property type. Investment conditions for the different retail subsectors ranged from 4.6 to 5.2 on a scale of 1 to 10, with 1 being poor and 10 being excellent. Value is expected to decline for the regional retail mall and retail power center subsectors. Retail neighborhood and community centers are expected to go in the other direction and see a 4 percent increase in value. All retail subsectors are expected to see increases in effective rent over the next year.

Hotels and apartments

The apartment sector earned the highest investment conditions rating among all commercial real estate sectors (7.2 on a scale of 1 to 10, with 10 being the highest) in the RERC special investment survey for the New Orleans market. The apartment sector is also viewed as offering the best return on risk.

Demand for the property type is up mostly because a large

portion of New Orleans' residential real estate was damaged by the hurricane. Unable to return to their former homes, some residents have opted to rent. The increased demand has caused a dramatic increase in rents; RERC expects to see a positive 8.5 percent effective rent change over the next year.

Hotels are still on the recovery path after Hurricane Katrina, but there is a very positive outlook. The sector is perceived to have returns greater than the degree of risk and to be priced at a level equal to the sector's value. The property type also received a good investment conditions rating and is expected to see increases in value and effective rent.

Despite the positive outlook, room rates have yet to reach pre-Hurricane Katrina levels. According to *Times-Picayune* real estate writer Greg Thomas, in May 2005 (prior to Katrina), the average room rate in New Orleans was \$146 a night. By April 2006, the average room rate was between \$110 and \$115 a night.

Supply also is still not at pre-Hurricane Katrina levels. In August 2005 there were 36,000 hotel rooms in the metro area, but a month later the number of rooms open for business was 1,260. By mid-2006, however, there were nearly 28,000 rooms available at corporate flags and historic boutique hotels in New Orleans. In addition, the Fairmont and the Ritz Carlton are scheduled to reopen in December 2006, and Strategic Hotels & Resorts announced a new downtown revitalization project with a renovated New Orleans Hyatt, National Jazz Center and urban park opening in fall 2007.

More traction for smaller deals

Given the geographic dynamics of this market and the nature of what this region has gone through over the past year, there were relatively few "typical" property sales in New Orleans post-Hurricane Katrina. And according to raw transaction research collected by the Louisiana Area Commercial Database (LACDB) and analyzed by RERC in the *RERC/CCIM Investment Trends Quarterly*, the majority of deals in this market were less than \$2 million. There were only a handful of deals between \$2 million and \$5 million, and even fewer above the \$5 million threshold.

That is not to say it was a quiet investment period for this market, as the LACDB reported a total of 195 transactions totaling \$96 million during the last 12 months.

After Hurricane Katrina, many businesses snapped up office space in New Orleans or Baton Rouge—or both. In addition, many developers and investors knew there would be plenty of demand for places to live, and began investing in the multifamily sector. In addition, some New Orleans office buildings (mostly class-C space) have been turned into condominiums to deal with the shortage of available housing.

Baton Rouge is the city that many of those working to redevelop New Orleans have called home while rebuilding projects are under way, and in fact 41 percent of the transactions reported by the LACDB occurred in Baton Rouge during the last year. Continue to look to this area as a very desirable area to conduct transactions—that is, if you can find a willing owner who is selling at a good price.

As shown in Figure 7, in general, the unit sale price for properties in Louisiana was lower than in the South region and in the nation. It is interesting to note that prices for Louisiana office, industrial and retail properties are from 24 percent to 29 percent lower than prices in the South region overall, although

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Louisiana apartment prices are 16 percent higher than those for the overall region. That is an extremely strong pricing message when you consider condo conversions in the non-Louisiana South region areas.

Further, Louisiana property sector prices are from 7 percent to 38 percent lower than their respective national counterparts. We would expect to see a pricing difference like this, given that the nature and dynamics of the Louisiana market are different than other parts of the nation. While apartments are holding their own against the South region and the nation, the biggest difference rests in the retail category—but this gap is expected to start to disappear.

Investor courage required

In order for the displaced residents of New Orleans to return to the area, much investment in the housing sector needs to occur. This makes multifamily investment in New Orleans a window of opportunity for investors.

However, lingering concerns over the availability of property insurance are depressing prices in some areas of the region. Even so, 100 percent of those respondents surveyed indicated that insurance will be available, but at a cost. Given the demand factors, this increased cost will be passed on to consumers—there simply is not a choice.

With that said, investors should not look to pick up cheap assets at a discount. Vacancy rates on all types of properties in the area are dropping sharply, making it a more promising place for investment as the space market gains traction.

There is a strong probability that the gap between the spread of prices for Louisiana assets versus prices on a national level will narrow. High construction costs and improving supply/demand factors are working to juice prices in this region and to provide

attractive long-term returns.

For an area battered by storms, there seems to be strong optimism on the pricing side of commercial real estate. Local market participants already have realized that pricing is strong and getting stronger; however, outsiders swooping in for cheap deals are just now finding out about this market reality.

RERC sees the New Orleans and Louisiana investment market continuing to improve from an attractiveness standpoint, with more debt and equity money betting on the future and moving into the region. The hurricanes clearly took a devastating toll on the area, but as you walk the streets and listen to the people, there is a firm commitment to make this region even better than it once was, a sense of pride in what they are planning to do and the conviction that they will be successful in their efforts. This commitment resonates from people who have lived their entire life in the area to the students who now populate the universities.

Under each brick, there is hope and the commitment to pursue the real estate opportunities that are only beginning to be properly understood. It will take courage, patience and conviction to embrace and develop this vision—but if the tasks were simple, there would be less opportunity to pursue and the potential for higher returns would not exist. **MB**

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Figure 7 Transaction Comparisons

Louisiana (July 1, 2005–June 30, 2006)					
	Office	Industrial	Retail	Apartment	Total
Number of Transactions	91	49	27	27	195
Volume (\$ millions)	\$48	\$21	\$12	\$16	\$96
Unit Price					
Average	\$91	\$38	\$93	\$65,087	---
Median	\$78	\$27	\$70	\$42,667	---
South Region (July 1, 2005–June 30, 2006)					
Number of Transactions	554	330	339	515	1,811
Volume (\$ millions)	\$9,556	\$1,963	\$3,738	\$11,000	\$28,788
Unit Price					
Average	\$137	\$56	\$158	\$91,687	---
Median	\$120	\$49	\$132	\$72,289	---
National (July 1, 2005–June 30, 2006)					
Number of Transactions	1,931	1,298	1,114	1,612	6,202
Volume (\$ millions)	\$60,974	\$11,334	\$17,627	\$35,898	\$138,019
Unit Price					
Average	\$179	\$72	\$194	\$110,619	---
Median	\$155	\$61	\$157	\$85,651	---

NOTE: Unit prices based on data derived from samples of commercial transactions on local, regional and national levels.

SOURCES: RERC AND THE LOUISIANA AREA COMMERCIAL DATABASE, AS PUBLISHED IN THE *RERC/CCIM INVESTMENT TRENDS QUARTERLY*