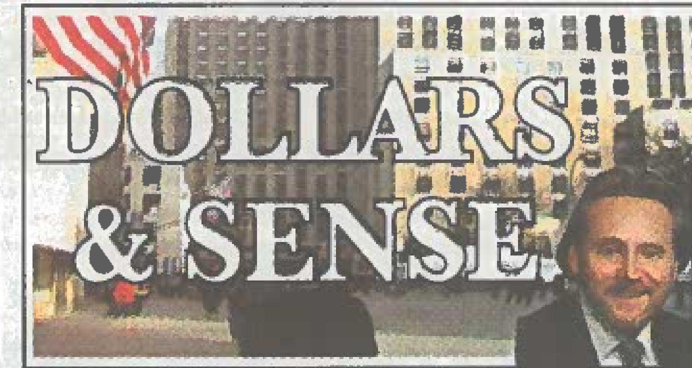
Are sale prices and value correlated?



with Bob Knakal

Q. In columns you have written previously you have indicated that the volume of sales is likely to increase very significantly in 2012. Do you believe value will rise in 2012 also?

A. Your question is a very interesting one. The answer revolves around what your definition of "value" is. That definition can be what properties sell for in arm's length transactions in the open market or could be what their value is when taking normal market conditions into account. Let's consider volume first.

It is clear that the volume of sales will pick up significantly as we move further into the new year. In 2011, the first half of the year performed very well, leaving everyone, at the end of the second quarter, believing that we were on track for a sustainable and uninterrupted recovery.

The dollar volume of sales hit a peak of over $8.5 billion in the second quarter of 2011 and then dropped to $7.4 billion in the third quarter. Volume dropped further to $6.3 billion in the fourth quarter.

In terms of the number of properties sold, the peak was achieved in the third quarter of 2011 with 599. In 4Q11, the number sold dropped slightly to 572.

We expect the dollar volume of sales and the number of properties sold in 1Q12 to be slightly above or below 4Q11 totals. If we extrapolate these results and annualize the data, 2012 would produce lower numbers than 2011 did.

However, we believe that both the dollar volume of sales and the number of properties sold will grow sharply as we move into the year given current market conditions.

> *"This low cost financing dynamic is exerting tremendous downward pressure on cap rates, thus increasing the prices properties are selling for."*

Supply has been the main determinant of sale volume in the market and supply has been very low of late. We do, however, have an externality which will tangibly alter this condition.

The external pressure of an anticipated large increase in the federal capital gains tax rate will force additional supply into the market as sellers who are contemplating a sale within the next few years will opt to sell now to take advantage of this year's rate as opposed to waiting and perhaps paying a much higher rate.

Certainly, the increase in the rate will rival the anticipated appreciation rate over the next year or two.

To the extent supply increases, we expect sales volume to rise accordingly as any new supply should be absorbed quite easily by the market as extraordinary demand exists from a diverse set of drivers in the marketplace today.

With regard to value, I think it is important at this point to differentiate between value of property and the price at which buildings will be trading. Many don't necessarily agree that the two go hand-in-hand today.

We presently have a scenario under which the extremely low supply of available properties, coupled with the massive amount of capital that is seeking to acquire real estate is creating a situation in which upward pressure is being exerted on property value.

This is, in and of itself, not enough of a reason to create a disconnect between sale price and value. A key ingredient to the mix above is the extraordinary low interest rate environment that we are operating in.

Years ago, investors were locking in 5.5 percent fixed-rate mortgages believe that rates could not get any lower. Then rates dropped below 5 percent and then into the low to mid- 4 percent range. Today, many banks are announcing five year fixed-rate loans at 3.5 percent or less. If a borrower is willing to float, rates are in the 2s.

We have seen the market a 6 percent cap just a few months ago. Today, these same assets are trading a cap rates below 5 percent.

We also have several multifamily properties in Manhattan on which cap rates will get well below 4 percent. The story is the same across all of the city's submarkets and across all asset classes and product types.

Traditional economic theory suggests that low interest rates, over extended periods of time, create asset bubbles. Today's circumstances eerily force us to think about that. In a high school debating class, a very compelling argument could be made that asset bubbles are being created in the commercial real estate market now based on our extraordinarily low interest rates.

However, the counterpoint to this could be that low rates will be with us for so long that the negative impact of low rates will not manifest itself in additional distress.

Without a doubt, rates will rise. When and to what extent are the only questions.

While it is difficult to say that money is "easy" today and regardless of your perspective on when rates will rise and how much they will increase, today's market conditions make us mindful of one of commercial real estate's time-tested axioms:

Typically, in times when money is easy, and rates are low, the benefits inure to sellers. Consequently, we see many sellers taking advantage of these conditions today.