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Back to the Boom

Like the Greenspan-era housing bubble of 2005, today's low interest rate environment is creating a new bubble in the commercial property market.

The New York City investment sales market over the past three or four weeks has been happily reminiscent of the market in 2007. This, folks, is the best market we have seen in five years.

Cap rates are compressing sharply, values are up, bidding wars at or above the asking price are commonplace as buyers are climbing all over each other to purchase the relatively few properties that are available for sale.

I'm bringing these dynamics to your attention today because I think building owners are seeing a wonderful moment in time for potential sellers to take advantage of these market dynamics. This may come across as one of the most self-serving correspondences I've ever sent, but if you follow the points below I think you may agree with my conclusions.

Presently in the investment sales market there is a very sharp supply-demand imbalance, with demand greatly exceeding supply. On the supply side, there are relatively few

properties on the market for sale, as many potential sellers have indicated that they are not interested in letting go because of a lack of alternative investments into which to deploy the proceeds from the sale. Meanwhile, we haven't seen as many sellers as we anticipated to take advantage of this year's capital gains tax rates, which are likely to increase next year.



**Robert
Knakal**

Interestingly, the mergers and acquisitions business for companies has been extraordinarily active, as company sellers appear to be more aware of this potential tax increase and are taking advantage of this year's rate more aggressively than participants in the real estate market.

Along with this low supply of properties for sale, demand drivers appear to be at an all-time high. The institutional capital that inflated the asset bubble in the 2005-2007 period had been on the sidelines for a couple of years but has now reemerged, in some cases stronger than before, and is actively com-

peting with the high-net-worth individuals and established New York families that have been extremely active since the downturn.

These investors are being joined by foreign investors that are coming to the market in numbers unseen in the 28 years that I have been brokering properties in the city. We expect direct investment from foreign investors to approximately double the long-term trend line and, including indirect foreign investment (mostly in the form of equity financing), foreign capital should account for more than 40 percent of the total investment sales activity this year.

Imbalance is exerting tremendous upward pressure on values as we have seen cap rate compression of nearly 100 basis points just within the past few months. Many of the properties that we have on the market now are achieving pricing well in excess of what we anticipated and, in many cases, investment properties are being sold at or above their asking prices.

Much of the activity has been caused by the extraordinarily (and artificially) low interest rate environment that exists today. About three months ago we saw sever-

al banks begin to offer five-year fixed-rate loans at approximately 3.5 percent. I was informed by a client this week that they just received a fixed-rate loan below 3 percent. These rates are exerting pressure on property values.

Comparisons to 2007 are plentiful in that the cap rates being paid for properties today are approximately where they were then and, in some cases, lower than 2007 levels. The bargain today, so far, has been slightly better, however. In 2007, investors were purchasing at an average cap rate of 4 to 5 percent (in Manhattan) but borrowing at approximately 6 percent; therefore, negative leverage was significant. Today, cap rates are once again averaging around 4 to 5 percent, but borrowers are still getting positive leverage. This positive leverage may be short-lived as cap rates continue to compress. This is clearly having a tangible impact on the market.

Low interest rates, in the broader economy, are having the effect of numbing the short-term pain of the monstrous debt that the country has and is, simultaneously, masking the long-term burden of

constant, massive, budget deficits. For the real estate industry, it is creating a dynamic in which property values are being correlated with these low rates and leading some buyers, we believe, into a position of paying more for properties than they probably should.

History has shown evidence that low interest rates always inure to the benefit of sellers, not buyers. Additionally, low interest rates over a long period of time, history has also shown us, create asset bubbles. Just as the extended period of time when interest rates were low during the Greenspan chairmanship of the Fed led to the housing bubble in 2005-2007, we believe a strong case could be made that the low interest rate environment of today is creating the same type of asset bubble in the commercial property market.

To the extent this comes to pass, it's a case for focusing acquisitions on value-added plays. I would encourage a strategy of selling assets with stable cash flows.

Rknakal@masseyknakal.com
Robert Knakal is the chairman and founding partner of Massey Knakal Realty Services.