Flurry of Activity Forecasted Across New York

December turns out to be a banner month for investment sales, just as 2012 is turning into top-notch year for acquisitions

Robert Knakal

Currently, things couldn't be much better in the New York City investment sales marketplace. The pace of activity is hectic, as buyers and particularly sellers rush frantically to get transactions closed by the year's end.

This action leaves no doubt that the fourth quarter of 2012, and notably December, will produce a tremendous flurry of activity that will bring quarterly metrics (number of buildings sold and dollar volume of sales) to levels that will rival those last seen in 2007 (in January, we predicted that the fourth quarter of 2012 would have 1,000 properties sold citywide and more than $10 billion of sales, and it appears we will be close to both of these marks).

There are several reasons for this great activity: low interest rates, excessive demand and, most importantly, increased supply brought on by the threat of increases in capital gains taxes. So the biggest questions on the minds of sales brokers are, will this activity continue, and what will 2013 bring?

It is my opinion, unfortunately, that the number of properties sold in 2013 will be 20 to 30 percent below the number that we will see in 2012. The reasons for this are based on historical empirical evidence and the fact that a very tangible externality (tax policy) has greatly impacted seller behavior this year.

The looming threat of increased capital gains taxes has influenced behavior in several sectors of the economy very significantly. We have seen hundreds of companies issue dividends ahead of schedule so that investors can take advantage of this year's low capital gains rates. Many of these businesses have even borrowed money in order to be able to pay the dividends early. After advocating for higher tax rates and for the higher-bracket taxpayers to pay an even greater "fair share," the chairman of Cisco proceeded to borrow $3 billion so his company could pay accelerated dividends to shareholders, including himself, to the tune of about $14 million.

We have even seen one company accelerate its fourth quarter 2012 dividend, as well as its next eight quarterly dividends that were to be paid in 2013 and 2014. Those dividends are all being paid prior to the end of this year. This behavior clearly illustrates that tax policy, and tax rates, do indeed significantly impact the behavior of market participants, notwithstanding what some billionaire in Omaha says.

This looming threat of capital gains tax increases has also impacted our commercial real estate sales market very tangibly. It has created a rise in the supply of available properties, as sellers want to take advantage of this year's lower rates. This additional supply of product has been quickly absorbed by the excessive demand in the city's building sales market. We anticipate that this year's turnover rate in Manhattan will be around 3.5 percent or higher.

This activity will push the turnover rate of properties in New York to near-record levels. Using the Manhattan submarket as an example, there are approximately 27,600 buildings south of 96th Street, and going back to 1984, the average turnover of this stock is about 2.6 percent, or 719 buildings per year (see the chart). Interpreted another way, this 2.6 percent historical average means that, on average, when an investor purchases a property in Manhattan, it is held for 40 years before being sold. Yes, 40 years!

Going back to 1984, turnover of sales has exceeded 3 percent on only five occasions, each one a cyclical peak in the market. We did, however, have an unusual circumstance in 1986, when turnover exceeded 3 percent (at 3.4 percent); it then exceeded 3 percent (3.5 percent) again in 1988. We believe this was caused by the significant change in tax laws that occurred in 1986, which impacted seller behavior and effectively "stole" activity that normally would have occurred in 1987. Without this externality, we would have had a steady increase climbing up to a peak in 1988.

The same impact on market participant behavior has recently been observed when other externalities have been introduced. When the cash-for-clunkers program went into effect, auto sales spiked, only to evaporate after the program ended. Similarly, the first-time home-buyer tax credit produced a healthy increase in home sales, only to see sales wane after the program ended. Both auto sales and home sales have regained momentum, but these externalities accelerated activity that would have occurred in subsequent periods. The same thing has occurred in our commercial real estate sales market. So the question becomes, will this time around be like the 1986-1988 period or will 2013 stand alone as a year in which volume peaked, followed by three or four years of declines? Regardless of which of the two scenarios plays out, it would be unprecedented for turnover to exceed 3 percent again next year, leading therefore to the opinion that the number of buildings sold is likely to be down 20 to 30 percent. We always look for a reversion to the long-term trend, which allows us to predict the general direction of this metric. (It should also be noted that the dollar volume of sales could, in fact, grow next year, even with the number of buildings sold slipping, if the office building sector can gain some momentum).

If the number of properties sold does slide by 20 to 30 percent next year, we will have the same large pool of buyers competing over a smaller supply of available properties, thus exerting tremendous upward pressure on values. This is particularly true if interest rates stay low throughout 2013, which is fully expected. While we do not believe the Fed will be able to hold rates down in perpetuity, we do think that it is likely rates will stay low throughout 2013.

This means that 2013 will not be as good as 2012 for sales brokers and other intermediaries who depend on transaction volume for there livelihood. It will, however, be a good year for property owners, who will see the value of their assets rise. These conditions of low supply and rising values will also benefit sellers, as they should be able to take advantage of these conditions to obtain record pricing for those assets they chose to sell.

Beyond 2013, market conditions will mainly be dependent upon the interest rate environment and the city's real estate tax policy. Fed chairman Bernanke claims he will keep rates low through 2015, but many economists doubt whether the Fed will actually be able to control rates much longer. Rates have been low for a long time, and history has taught us that low rates for long periods of time ultimately create asset bubbles (see the housing market of 2004 through 2007). Certainly, rates will rise at some point, and when they do, it will likely be faster and to a greater extent than folks realize.

The city's real estate tax policy will also have a profound impact on the future market. For several years now, the city has been using income-producing properties as ATM machines to help plug holes in municipal budgets. The slush fund that Mayor Bloomberg tucked away also helped, but that fund has now evaporated. To the extent that the city needs to find ways to bridge future deficits, rest assured that commercial income-producing properties will be the source of much of that funding.

Clearly, there are many factors that will impact the sales market moving beyond 2013, but the two mentioned above will be key. Let's hope the city's economic growth and development is enough to lessen the impact of these factors. That would be in all of our interests. Meanwhile, enjoy what is likely to be a wild ride between now and the end of the year.

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